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Partners cannot be employees, although many will try

TAXING MATTERS
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Can a partner also be an employee?

This question is extremely important for partnerships, including LLCs, that grant equity interests to key employees, as it determines how payroll is handled and eligibility for certain benefit plans.

Unfortunately, the IRS takes the view that a partner cannot be an employee for tax purposes. Recent guidance invites comments from the public as to whether the rule should be retained while shutting down a practice that some taxpayers had used to avoid the rule.

For tax purposes, being an employee is simple. Your income is withheld from your paycheck every month. Your employer pays half of your employment taxes and deducts the other half from your check. At the end of the year you get a simple form W-2, enter it into TurboTax and, if all goes well, receive your refund.

In contrast, partners are responsible for their own income tax compliance. No tax is withheld and (in an active business) the partner is required to pay self-employment tax on all of his or her earnings. Not only is the reporting and compliance more difficult, but the partner is required to pay 100 percent of the self-employment tax.

Wage withholding and self-employment taxes are not the only reason why being an employee is better than being a partner. For health, welfare and fringe benefit purposes, partners are required to include the value of certain benefits in income that employees can exclude. The benefits are treated as guaranteed payments from the partnership.

In addition, partners are prohibited from participating in so-called cafeteria plans, such as flexible spending accounts.

These rules are notable because they generally do not apply to stockholders in corporations. Stockholders can be treated as employees of entities that they own. Accordingly, prior to the advent of the LLC, most small business owners were treated as employees. However, now that LLCs treated as partnerships for tax purposes have become extremely common, their owners must be treated as partners.

One area where this problem frequently arises is when certain key employees of an LLC are given small partnership interests as owners. Usually, it is not anyone's intention to change their status for payroll purposes. However, this is a result of the current law.

Taxpayers have come up with a variety of strategies to avoid this problem. One approach was to simply place a disregarded LLC under the partnership and have that entity serve as the employer.

There was a technical argument that this worked because the individuals were not in form employed by the partnership that they owned. In my view, this was very aggressive as LLCs are, in general, ignored for tax purposes.

In the guidance released earlier this month the Service shut down this theory, holding that partners in a partnership that own a disregarded entity cannot be employees for tax purposes regardless of who employs them.

In doing so, the IRS opened the door to modifying the general rule. In the preamble to the new regulations the IRS noted that taxpayers have requested that the IRS modify its rules to allow partnerships to treat partners as employees in certain circumstances. The Service drew specific attention to partners who obtain a small ownership interest in the partnership as an employee compensatory award or incentive.

The IRS invited comments from the public as to how the employee benefits and employee tax rules would apply in such situations, including comments on circumstances in which it may be appropriate to permit partners to also be employees of the partnership.

This official request for comments is a confirmation that the IRS is thinking hard about these rules.

Until a law change, creative taxpayers will continue to utilize various approaches to structure around the rule that partners cannot be employees. There are a number of structures in common use in the marketplace, including tiered partnership structures and structures utilizing C and S corporations.

The IRS noted that commentators had requested guidance on tiered partnerships and invited taxpayer comments but did not address the other workarounds. While these workarounds are clever, taxpayers need to be cognizant of the risks both on the employment/withholding front and with respect to health and welfare plans and fringe benefits.

In addition, where profits interests (the partnership equivalent of stock options) are granted, companies need to consider whether treating the recipient as a partner presents the risk of causing the receipt of the profits interest to be taxable.

The rule that all partners cannot be employees has, as in my view at least, long outlived its usefulness. The IRS is right to be considering alternatives.

The "loophole" shut down by the recent guidance was always too good to be true. Businesses that wished to obtain employee treatment for their partners under current law will need to evaluate the risks and potential benefits of some of the more elaborate workarounds.

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