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Client Alert Commentary

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Partnerships: IRS Extends Prohibition on Treating Partners as Employees

Employees of partnerships, LLCs or their disregarded entity subsidiaries who receive equity in such entities may be treated as "self-employed" for tax purposes.

On May 3, 2016, the US Treasury Department (Treasury) issued new temporary and proposed regulations[1] (the Regulations) addressing the self-employment tax treatment of an individual that is both: (i) an employee of an entity that is disregarded for federal income tax purposes (such as a single-member limited liability company (LLC)), commonly referred to as a "DRE"; and (ii) a partner or member in a parent partnership or LLC that owns the DRE employer.[2] The Regulations provide that, for self-employment tax purposes, the DRE is disregarded and the individual is subject to the same self-employment tax rules as a partner in a partnership that does not own the DRE.

Characterizing employees as self-employed has potentially significant implications, in that self-employed individuals:

- Are subject to K-1 reporting rather than W-2 reporting, which means, among other things, that the "employer" company will not withhold taxes and the individual must instead pay estimated taxes
- Generally must pay self-employment taxes (SECA) on their compensation rather than ordinary employment taxes (FICA), thus requiring the individual to pay the equivalent of both the employer and employee portions of these taxes (roughly doubling the employment tax burden on the individual, though the employer component may be partially offset by an income tax deduction)
- Are ineligible to participate in "cafeteria" or Section 125 flexible spending and dependent care programs
- Have the full cost of employer-provided health insurance and life insurance included in income, although the cost of the health insurance is deductible
- May be unable to defer certain compensation for tax purposes under "nonqualified deferred compensation" programs

While the preamble to the Regulations indicates support for the holding of Rev. Rul. 69-184, which provides that a partner in a partnership cannot be an employee of the same partnership, Treasury and the Internal Revenue Service expressly requested public comment in connection with the Regulations regarding instances where permitting "employees" who are partners or members to be characterized as employees of the relevant partnership or LLC may be appropriate (such as when an individual holds a small ownership interest through a co-invest or an incentive award). This request for comment suggests

that the application of both historic guidance and the new Regulations to scenarios in which partnerships and LLCs sell or award equity directly to their employees remains unresolved.

LLCs and partnerships that have existing "employees" who, under the Regulations, may be recharacterized as "self-employed" individuals, should assess the potential impact of this characterization on both historic and prospective tax withholding, tax reporting and benefit plan participation practices. Accordingly, such entities should monitor these developments closely and consider participation in the comment process as an opportunity to propose useful and appropriate exceptions to the general prohibition against treating partners/members as employees.

Entities the Regulations may affect include, for example:

- Private equity firms that use an LLC holding company structure and award equity in the upper tiered LLCs to employees of a DRE operating company subsidiary
- Operating partnerships in an UPREIT structure that issue equity directly to their employees (or to employees of a DRE subsidiary)
- Other partnerships and LLCs, including certain start-ups, that issue equity directly to their employees (or to employees of a DRE subsidiary)

The Regulations do not apply until the later of August 1, 2016, or the first day of the latest starting plan year for an affected plan (*i.e.*, a health or retirement plan that is unavailable to self-employed individuals) of a DRE following May 4, 2016. However, for organizations that do not maintain benefit plans at a DRE entity (including partnerships and LLCs that employ equity holders directly), these Regulations will take effect on August 1, 2016.

Steps to Take Now

- Review the extent to which any partnership or LLC, or any DRE subsidiary of a partnership or LLC, employs holders of partnership or LLC equity and, if so, whether the entities have treated these individuals as employees with respect to compensation and benefit plan participation.
- If such entities (or subsidiary DREs) have treated partnership/LLC equity holders as employees, confer with tax and legal advisers as to whether/when remedial action may be warranted with respect to tax withholding/reporting and benefit plan participation, or whether these arrangements should be restructured.
- Consider supporting industry or trade group comments proposing relief from the partner-employee characterization prohibitions, including in the context of small minority interests and incentive equity awards.

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Endnotes

[1] Temp. Treas. Reg. § 301.7701-2T.

[2] These Regulations supplement and clarify existing regulations that already provide that a DRE "employee" who owns the employer/DRE in the capacity of a sole proprietor is "self-employed" (and not an employee). *See* Treas. Reg. § 301.7701-2(c)(2)(iv)(C)(2).