



## Immediate Changes May Be Required for Partnerships that Employ Partners through a Disregarded Entity

On May 3, 2016, the IRS and Treasury issued proposed and temporary regulations under section 301.7701-2 relating to the employment tax treatment of employees of a disregarded entity that is wholly owned by a partnership (the “Regulations”). If the employees of the disregarded entity are also partners in the partnership that owns it, the Regulations may require immediate changes to the withholding and benefits treatment of those individuals. This article discusses the Regulations and their potential impact on partnerships that may have taken a position contrary to the Regulations for earlier tax periods (including tax periods in 2016 prior to the effective date of the Regulations).

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### Background

To understand what is at stake with regard to the changes made by the Regulations, some background regarding the differences in the employment tax and benefit treatment of employees and partners taxes may be useful. Subtitle C imposes Federal Insurance Contribution Act (“FICA”) taxes,<sup>1</sup> Railroad Retirement Tax Act (“RRTA”) taxes, Federal Unemployment Tax Act (“FUTA”), and federal income tax withholding taxes. These taxes are referred to together in this article as the “Employment Taxes.” Subtitle C imposes employment tax requirements on both employees and employers but is not applicable to individuals who are “self-employed.”

### Employer Rules

Section 3121(d)(2) generally defines an “employee” as “any individual who under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.” Under the usual

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<sup>1</sup> In this article, “FICA” includes Medicare and the Additional Medicare unless separately discussed.

common law rules, a person is an employee (and not an independent contractor, for example) if the employer has the right to direct and control the individual with respect to both “the result to be accomplished by the work” and “the details and means by which that result is accomplished” and the “employer” is the person who exercises that control over the work and the payment of wages.<sup>2</sup> Section 3121(a) defines “wages” as all remuneration for employment.<sup>3</sup> An officer of a corporation is a “per se” employee of the corporation, even if only the board of directors has direction and control over the officer’s actions.

An employer is required to withhold federal and state income tax and FICA/Medicare from an employee’s income (as well as paying any employer’s share of FICA/Medicare and FUTA). Under section 3403, if an employer fails to properly withhold on an employee’s federal income, the IRS has a statutory right to collect the missing withholding from the employer. Further, the employer may be subject to penalties for failing to withhold and deposit timely. These rules are referred to in this article as the “Employer Rules.”

### *Employee Benefit Exemptions*

Congress has provided a significant number of exemptions from both federal income tax and from FICA/Medicare for various employee benefits. These include:

- Employer-provided health care costs
- Pre-tax employee-paid health care (e.g., cafeteria plans, flexible savings accounts (“FSAs”))
- Employer matching contributions and other employer contributions to qualified retirement plans
- Certain education benefits

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

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<sup>2</sup> See also the factors listed in Revenue Ruling 87-19, 1987-1 C.B. 296.

<sup>3</sup> The employer and employee each pay half of the applicable FICA/Medicare, other than the Additional Medicare on wages above \$200,000, which is withheld by the employer but not matched by the employer. An employee making \$500,000 pays 7.65 percent in FICA/Medicare on amounts up to \$118,500, pays 1.45 percent on amounts between \$118,500 and \$200,000, and likely pays 2.35 percent on wages above \$200,000.

- Section 105 disability premiums
- Incentive stock options

The following example illustrates the application of these rules to someone that is both a shareholder in a corporation and an employee of that corporation.

### *Example 1*

A, an individual, owns 15 percent of the outstanding stock of X, an entity classified as a corporation for federal tax purposes. No S election is in effect with respect to X.

A performs services for X, and receives a salary of \$400,000, which is commensurate with the value of A's services. Both X and A are subject to the Employer Rules with respect to A's services. Thus, for example, X must withhold employment taxes with respect to A's salary and deposit them with the IRS. A pays FICA/Medicare totalling \$14,947 (\$9,065.25 of the first \$118,500 of income, \$1,181.75 on income between \$118,500 and \$200,000, and \$4700 on income in excess of \$200,000). X pays \$13,147 (\$9,065.25 on income up to \$118,500 and \$4,081.75 on the remainder). Thus, the total FICA/Medicare tax paid with respect to A's \$400,000 is \$28,094. Note, however, that X is entitled to a deduction against its income for its share of the FICA/Medicare tax.

A participates in X's section 401(k) plan and makes an \$18,000 elective deferral of income (which is nevertheless subject to FICA). X also receives a 100 percent matching contribution capped at 6 percent of its contribution; this matching contribution is not subject to FICA. A and A's family are covered under X's health care coverage plan. Premiums under the plan are paid 70 percent by employer contributions and 30 percent by A's employee pre-tax contributions to the X Cafeteria Plan. A also contributes \$2,500 to the plan's FSA to use in paying for co-pays and deductibles. X's total health benefits that are not subject to income tax or FICA are approximately \$22,500.

The qualified retirement plan contributions are exempted from income as contributed (but will eventually be taxable ordinary income on distribution). However, like the health benefits, the employer contributions to the qualified retirement plan will never be subject to FICA/Medicare. The same would be true for most other tax-free employee fringe benefits.

### *Partner Rules*

In contrast to the above, the IRS does not treat a partner that performs services for his or her partnership as an employee for the purposes described above. Specifically, in Revenue Ruling 69-184,<sup>4</sup> the IRS concluded that the 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 (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954). Instead, a partner who devotes 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 a self-employed individual rather than an employee.

Under the IRS's view, if a partner in a partnership is treated as a self-employed individual, the partner generally is subject to self-employment tax with respect to his or her distributive share of the partnership's income. Specifically, section 1402(a) provides in relevant part that an individual's "net earnings from self-employment generally includes his distributive share (whether or not distributed) of income or loss described in § 702(a)(8) from any trade or business carried on by a partnership of which he is a member."<sup>5</sup> Section 702(a)(8) requires a partner to include all taxable income or loss of the partnership in the partner's distributive share, except for other items of income requiring separate computations, such as capital gains, charitable contributions, and dividends. Under this general rule, all of an individual partner's share of income or loss described in section 702(a)(8) is subject to self-employment tax unless a particular exclusion applies. Section 1402(a)(13) (the "Limited Partner Exclusion")

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<sup>4</sup> 1969-1 C.B. 256.

<sup>5</sup> As clarified by Revenue Ruling 69-184, 1969-1 C.B. 256, "[b]ona fide members of a partnership are not employees of the partnership...." Instead, a partner who provides services to the partnership is treated as a self-employed individual.

excludes from net earnings from self-employment the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent those payments are established to be in the nature of remuneration for those services.<sup>6</sup>

A partnership is not required (and indeed is not permitted) to withhold federal income tax from a partner. Thus, each partner in a partnership must make estimated tax payments each quarter. Also, a partner is required to report taxes in each state in which the partnership has business, and a partner is often subject to “phantom income,” which is income the partner does not actually receive but must nevertheless be allocated to the partner who then pays income tax on that income. Under these rules, a partner subject to SECA pays 15.3 percent on the first \$118,500 of SECA income, 2.9 percent on SECA income between \$118,500 and \$200,000, and 3.8 percent on SECA income above \$200,000. A partner generally may deduct an amount equal to half of the total SECA paid.<sup>7</sup> The rules described in this section are referred to in this article as the “Partner Rules.”

### *Partner Benefit Exemptions*

Most of the benefits that are tax and FICA-free for employees are available to partners but not on quite the same terms—(1) some benefits are provided identically to both partners and employees; (2) some benefits are treated as taxable income to the partner, are subject to SECA, and then may be deductible on the individual partner’s tax return; and (3) a few are simply not available to partners at all. For example:

- Health benefits—A partner is not permitted to make pre-tax premium payments or pre-tax FSA contributions under a section 125 cafeteria plan. A partnership may pay health care insurance premiums for a partner, but such benefits are treated as guaranteed payments and are

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<sup>6</sup> Whether a member of an entity classified as a partnership for federal tax purposes is a limited partner for purposes of the Limited Partner Exclusion has been the subject of much debate. For simplicity we assume solely for purposes of this article that any partner described will does not qualify for the Limited Partner Exclusion.

<sup>7</sup> Note, however, that 0.9 percent of the SECA tax paid on income above \$200,000 (individual filing separately) and above 250,000 (filing jointly) is not deductible by the partner. See section 164(f)(1).

subject to SECA. However, the partner can generally take an offsetting 100 percent federal tax deduction under section 162(l) on the partner's Form 1040 equal to the health insurance premiums (or premium equivalents in a self-funded plan). The practical effect of these rules is that a partner cannot use the \$2,500 FSA exclusion and must pay SECA on health care insurance premiums.

- Employer contributions to a qualified retirement plan—A partner is allowed to participate in a qualified retirement plan of the partnership and allowed to receive “employer” contributions. With regard to defined contribution plans and most defined benefit plans, any benefits or accruals on the partner's behalf are treated as taxable guaranteed payment income subject to SECA. The partner may generally take a tax deduction for these contributions to the retirement plan on the partner's Form 1040.
- Working condition fringe benefits are excluded for both partners and employees.
- Certain other benefits, such as section 127 educational benefits, are not available but the partner may be able to take a tax deduction for the cost of education that is work related.

To illustrate the application of these rules, consider the following example.

### *Example 2*

B, an individual, owns a 5 percent interest in the profits and losses of PRS an entity classified as a partnership for federal tax purposes. PRS operates a law practice with respect to which B, a licensed attorney, devotes his time and energy. In exchange for his services, B is paid a “salary” of \$400,000.

The “salary” paid to B likely should be characterized as a guaranteed payment under section 707(c). As such, that payment should be subject to self-employment tax under section 1402.

B participates in the partnership's health plan and section 401(k) plan. The \$20,000 health premium paid by the partnership for the partner is guaranteed payment income subject to SECA. Further, B contributes \$18,000 as an elective contribution to the

section 401(k) plan and receives a 100 percent match (capped at 6 percent of section 401(a)(17) considered compensation of \$265,000, or \$15,900). The \$15,900 matching contribution is treated as guaranteed payment income, subject to SECA and then generally 100 percent deductible.

Thus, B, as a partner, is subject to SECA on its \$400,000 "salary" plus the \$35,900 in payments that are made by the partnership for B's benefits, but are not excludable from SECA for total income subject to SECA of \$435,900. Thus, B will pay \$29,424 in total SECA tax (\$18,130.50 on SECA up to \$118,500, \$2,363.50 on amounts between \$118,500 and \$200,000, and \$8,930 on amounts in excess of \$200,000). B can then deduct approximately \$13,668.

Recall that, as an employee with the same salary in Example 1, A and its employer together paid \$28,094 in FICA/Medicare tax. Thus, the difference between SECA and FICA at the \$400,000 salary level is approximately \$1,330. B also loses the right to have \$2,500 of pre-tax FSA contributions, which has some value. Note, however, that the hardship of any additional SECA tax paid will be offset by B's deduction of a portion of the SECA tax paid in calculating B's federal income tax liability. Given that B is in a high federal tax bracket, the benefit of that deduction may be significant.<sup>8</sup>

## The Section 7701 Regulations

The entity classification regulations under section 7701 (commonly referred to as the "check the box" regulations) generally provide that a business entity that is not classified as a *per se* corporation under section 301.7701-2(b) (an "eligible entity") generally may choose its classification for federal tax purposes. Specifically, an eligible entity with two or more members may elect to be classified as either an association taxable as a corporation or as a partnership. An entity with just one owner

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<sup>8</sup> For simplicity, we have assumed that B as a partner in a partnership will be paid the same amount as A as an employee. Note, however, that if A was an employee of the partnership and then became a partner therein, A might wish to negotiate an increase in income to compensate the partner for the payment of what is effectively the employer's share of FICA.

may elect to be classified as an association taxable as a corporation or as an entity disregarded as separate from its owner (a “disregarded entity”). Under these rules, an entity formed in the United States as a limited liability company or any form of partnership (i.e., a limited partnership, a limited liability partnership, or a general partnership) generally will be classified for federal tax purposes as a partnership or a disregarded entity in the absence of an election otherwise.

If an entity is disregarded as an entity separate from its owner, the activities of the disregarded entity generally are treated in the same manner as a sole proprietorship, branch, or division of the owner. Thus, all the assets, liabilities, and items of income, deduction, and credit of the disregarded entity generally are treated as assets, liabilities, and such items (as the case may be) of the entity’s owner. However, section 301.7701-2(c)(2)(iv) provides a special rule relating to the employment tax obligations of disregarded entities. Under that special rule, a disregarded entity is treated as a corporation with respect to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Code) (the “Employment Tax Exception”).

Notwithstanding the above, the regulations in effect prior to promulgation of the Regulations applied for certain purposes the general rule that a disregarded entity is disregarded as an entity separate from its owner (the “General Rule”). Specifically, as in effect prior to promulgation of the Regulations, section 301.7701-2(c)(2)(iv)(C)(2) stated that the General Rule applies (and thus the Employment Tax Exception treating a disregarded entity as a corporation for employment tax purposes does *not* apply) “to taxes imposed under Subtitle A, including Chapter 2 – Tax on Self-Employment Income. Thus, the owner of an entity that is treated in the same manner as a sole proprietorship under [section 301.7701-2(a)] is subject to tax on self-employment income.” The former regulations contain one example illustrating the stated rule. In the example, a sole proprietorship owns a disregarded entity with employees including the sole proprietor. The example concludes that the sole proprietor is subject to self-employment tax.



## Pre-Regulations Treatment of Employees of a Disregarded Entity Owned by a Partnership

The language of former section 301.7701-2(c)(2)(iv)(C)(2) did not specifically indicate whether it was intended to apply only to a disregarded entity that would be characterized as a sole proprietorship (i.e., a disregarded entity owned for federal tax purposes by an individual). That, along with a question as to whether the employment tax provisions should “trump” the self-employment provisions unless otherwise specified, led some tax practitioners to conclude there was uncertainty with regard to the application of the rules to a particular situation. Specifically, some practitioners concluded that, if a partnership owned all the equity interests in a disregarded entity and the partners in the partnership were compensated by that disregarded entity for their services, then the compensation received by the partners would be subject to the Employer Rules, rather than to the Partner Rules, and the employer might be liable for failure to properly withhold federal income tax and FICA/Medicare tax on the amounts earned for services to the disregarded entity. Consider the following example.

### *Example 3*

C, an individual, owns a 5 percent interest in the profits and losses of PRS an entity classified as a partnership for federal tax purposes. The remaining interest in the profits and losses of LLC is owned by X, a corporation. PRS’s only asset is all the outstanding equity interest in LLC, an entity disregarded as an entity separate from PRS for federal tax purposes. LLC operates a management company that employs several individuals, including C. In exchange for their services, C and the other employees are paid a salary directly by LLC.

The General Rule provides that LLC generally should be treated as a corporation for purposes of the employment tax rules of subtitle C of the Code. If LLC was actually a corporation for federal tax purposes, as a person providing services for LLC in the operation of its trade or business, C would be treated as an employee of LLC and subject to the Employer Rules described above and would be treated as an employee with regard to benefits properly provided by the LLC.

In contrast, if LLC is not classified as a corporation for federal tax purposes, then LLC would be treated as a division or branch of PRS. If so, any payments made to C in exchange for services would be payments made to a partner, rather than an employee. Thus, those payments would be subject to the Partner Rules.

After consideration, some tax practitioners concluded that an entity in the fact pattern described in the example above, could be required to treat C as an employee of LLC, an entity treated as a corporation for employment tax purposes. Thus, C would be subject to the Employer Rules with regards to payments made by LLC to C in exchange for services. We refer to this position in this article as the "Employee Position." Thus, some entities remained concerned that the IRS could require withholding and FICA/Medicare payment with regard to amounts earned by C, as these services were provided to an LLC treated as a separate corporation for employment tax purposes.

Under section 414(b) and (c), many of the non-cash benefits provided by related employers are treated as provided by a "single employer" (all the related companies are treated as a single company for purposes of testing to see whether the benefits are provided in a nondiscriminatory manner. Thus, a tiered group of entities (parent owns 80 percent or more of subsidiaries) generally has one benefit plan for the employees of all the related entities. This is not required, but if the different related entities have different plans, the company must carefully test to make sure enough nonhighly compensated employees in each of the entities are entitled to benefits that meet the nondiscrimination tests.

In the example above, C can contribute elective contributions and receive a matching contribution to the section 401(k) plan in much the same manner as a partner providing services only to the partnership, but as an employee, C can exclude (from both income and FICA) the retirement plan contributions, rather than treating the same contributions as guaranteed payment income from the partnership and then taking a tax deduction on Form 1040.

With regard to health benefits, if C is required to be treated as an employee, C can contribute and pay for part of the self-funded health benefit tax-free. If C is treated as a partner, C has guaranteed payment income on the benefits and can then take a 100 percent tax deduction for the same benefit on the Form 1040). However, C, as an employee, is allowed to participate in the FSA plan (capped at \$2,500) and would not be able to do so as a partner. C may also participate in a few other, smaller tax-free fringe benefits that are not available to a partner.

C also benefits because LLC, as employer, does income tax withholding and thus C does not have to routinely handle estimated taxes each quarter. Because C is already a partner in an upper tier partnership, C will have to file just as many state tax returns, but C's compensation from LLC is dealt with in just one jurisdiction rather than being spread across several state tax filings.

### The Regulations and Their Implications

The Regulations eliminate the possibility that a partner in a partnership should be subject to the Employee Rules (as opposed to the Self-Employment Rules) with respect to payments made by a disregarded entity owned by the partnership. Specifically, the Regulations clarify that the rule that a disregarded entity is treated as a corporation for employment tax purposes does not apply to the self-employment tax treatment of any individuals who are partners in a partnership that owns a disregarded entity. Thus, partners in a partnership that owns a disregarded entity that employs the partners are subject to the Self-Employment Rules in the same manner as partners in a partnership that does not own a disregarded entity.

Based on the preamble to the Regulations, it seems the IRS's primary motivation for issuing the Regulations did not relate to differences between the amount or manner of employment taxes paid under the Employer Rules as opposed to the Partner Rules. Instead, the IRS and Treasury were concerned that the Employee Position "permitted partners to participate in certain tax-favored employee benefit plans." However, because the major benefits are, in fact, available to both employees and partners, and are generally tax deductible on the partner Form 1040, the difference between treatment as a partner and treatment as an employee

can be fairly small, and may amount to only the \$2,500 FSA benefit for co-pays and certain health costs as well as the value of a few more minor benefits (such as the qualified transportation benefit) that are not available to partners.

From our experience, the drivers of having employment in addition to partnership status is to permit income tax withholding for the majority of the service income, and to reduce the confusion and impact of putting all compensation on scattered state Forms K-1 rather than reporting the compensation in the work location. There may be also be a difference in the SECA cost, but because of the deductions for the major benefits and the SECA deductions, these differences are seldom significant.

### Effective Date of Regulations

Because the IRS and Treasury issued the Regulations in both proposed and temporary form, there is no period during which the regulations will simply be proposed pending comments from the public. Instead, as temporary regulations, the Regulations may take effect immediately. The Regulations provide a delayed effective date for certain partnerships. Specifically, the Regulations provides that, to allow adequate time for partnerships to make necessary payroll and benefit plan adjustments, the Regulations will apply 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” (based on the plans adopted before, and the plan years in effect as of, May 4, 2016) sponsored by an entity that is a disregarded entity.

For this purpose, 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 these regulations. Although this delayed effective date is welcome, it may not provide the time needed to change the reporting protocol through third-party service providers. More importantly, to the extent payments currently characterized as compensation must be reported as guaranteed payments in the future, compensation arrangements may need to be renegotiated and documented to provide a “gross-up” to the service provider for his or her increased tax burden.

For partnerships that do not have affected plans, the entity should stop federal (and probably state) income tax withholding and FICA/Medicare withholding in August 2016 and warn partners to send in estimated taxes for the rest of the year. Because the second calendar quarter for withholding starts on July 1, 2016, partnerships might consider halting the federal income tax withholding and FICA/Medicare withholding as of the end of the second quarter, rather than have withholding and deposits for part of a quarter. In these situations, the need for negotiations and documentation mentioned above are even more urgent.

For a partnership that has a qualified retirement plan, the qualified retirement plan is likely unaffected by the rules (though it is a good idea to determine whether the plan—(1) provides language permitting self-employed individuals into the plan; and (2) has a definition of compensation that includes “net income from self employment” (most plans do). For partners who have been treated as eligible for an FSA or cafeteria plan, the Regulations are effective with regard to these individuals as of January 1, 2017 (for a calendar tax-year partnership). Thus, starting in 2017 these individuals will not be permitted to make FSA or other cafeteria plan contributions. It is not clear whether the FSA grace period (after the end of the calendar year) would apply to the partners; it may be better to consider using all FSA contributions before the Regulations are effective.

It is also not completely clear whether a limited liability company that has contracted with a professional employer organization (a “PEO”) with regard to individuals who have been treated as employees of the limited liability company but who are partners in an upper-tier entity is likely to be treated as having an “affected plan.” We would argue that such a limited liability company should be treated as having an affected plan, even if it is maintained by the PEO co-employer. If the former employees are in a PEO and are in a cafeteria plan or a PEO-qualified retirement plan, then those individuals certainly are affected by the Regulations. Thus, participation in the PEO plans likely must terminate by the end of the period.

We hope there will be additional guidance on the issue, but for now it appears that after the Regulations are final the partnership may need to establish its own qualified retirement plan to cover individuals who are service providers but who will not be in the PEO-qualified retirement plan.

Section 3511(f) generally excludes partners from being treated as co-employees of a PEO. A partnership can certainly also establish its own health plan. However, the partnership must be careful if the partnership will have its own plan for partners that is different from the PEO plan that covers individuals who are still employees; nondiscrimination rules likely will apply in such a case.

## Conclusion

For those partnerships that applied the Employee Rule to partners employed by a disregarded entity owned by the partnership, changes will be necessary. Either the entity needs to begin treating these individuals only as partners (with the timing of necessary changes depending on whether the partners are covered under an affected plan), or the entity needs to consider other structures to reach essentially the same result that is now prohibited by the Regulations. Please contact the authors to discuss: [Deanna Walton Harris](#) at (202) 533-4156; [Paul Kugler](#) at (202) 533-6420, or [Karen Field](#) at (202) 533-4234.



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