

TAX / CORPORATE

ALERT

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IRS SHUTS DOWN WORK AROUND FOR TREATING A PARTNER AS AN EMPLOYEE

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The IRS has long taken the position that a partner cannot also be an employee of the partnership. The prohibition also applies to persons that hold equity in a limited liability company (“LLC”) that is taxed as a partnership – an LLC member cannot also be an LLC employee.

Not permitting dual partner or member/employee status in today’s business environment can be problematic. The use of LLCs has grown exponentially and so has the use of equity incentive compensation for the millennial generation and start-ups. Issuing incentive equity to an employee turns him or her into a partner for tax purposes. This often results in unwanted consequences for the former employee, such as not having income taxes withheld on compensation, being required to pay self-employment taxes and to file quarterly estimates on self-employment income, and perhaps no longer being eligible for certain employee benefits.

A Work Around

One fairly common work around on the prohibition on dual partner/employee status has been for the LLC or partnership to form a wholly-owned LLC subsidiary (“LLC Sub”). LLC Sub would then employ the workers, but incentive equity would be issued by the upper level LLC or partnership (“LLC Parent”). The goal was to achieve a dual status for these persons – on one hand, an employee with W-2 income and employee benefits of LLC Sub,

and on the other hand, a partner or equity participant of LLC Parent.

The LLC Sub is a disregarded entity for income tax purposes, but it is treated as a separate corporation for certain employment tax purposes. Some tax planners have taken the position that this separate corporate treatment justified dual tax treatment: a member of LLC Parent could be a partner of, and receive a Schedule K-1 from, LLC Parent. At the same time, that person could also be an employee of, and receive a W-2 from, LLC Sub and enjoy certain employee benefits.

The IRS’s Response

The IRS shut down this approach with regulations issued on May 3, 2016. (T.D. 9766.) In the preamble to the regulations, the IRS states that tax planners had misinterpreted the rules by treating LLC Sub as a separate entity in the situation described above. The regulations specifically target the use of a disregarded entity (such as a single member LLC) owned by a partnership or limited liability company to act as the employer.

The regulations provide that treating a disregarded entity as a separate entity for employment tax purposes does not apply to the self-employment tax treatment of individuals who are partners in a partnership (or members in an LLC) that owns a disregarded entity. According to the IRS, these regulations merely “clarify” the existing rules,

which the IRS interpret as not permitting this dual tax position. As a result of the regulations, it is clearly no longer permissible to rely on a structure in which a wholly-owned limited liability company treated as a disregarded entity is used to employ partners or members of its owner. These folks are self-employed!

In an effort to provide partnerships with time to make payroll and benefit plan adjustments to accommodate this interpretation, the regulations are effective the later of (i) August 1, 2016 or (ii) the first day of the latest-starting plan year following May 4, 2016 of an affected plan sponsored by a disregarded entity.

Observations

According to the regulation's preamble, the IRS said it issued the regulations because the disregarded entity structure enabled some partners to participate in "tax-favored employee benefits plans." In fact, a more common use of the structure is to enable employers to continue to treat managers or high level employees as "employees" after they receive incentive equity in an LLC or a partnership. By converting these employees to partners for tax purposes, the receipt of equity may have a significant negative impact by making the employee a partner subject to self-employment taxes, quarterly estimated returns, etc.

To that end, the IRS in the preamble to the May 3, 2016 regulations has requested comments on in what circumstances it may be appropriate to permit partners also to be employees of the partnership for incentive compensation purposes. So there may be some relief for the dual status prohibition in the long term for incentive awards, but for now using a disregarded entity as the employer is no longer a viable option. For now, caution should also be used in granting incentive compensation in the form of equity in a partnership or limited liability company as well. ♦

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