Dual Status: Treating Partners as Employees

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This Practice Note provides an overview of the current law related to treating individuals as both partners and employees of the same entity. It describes the types of equity compensation granted by partnerships and the appealing tax characteristics of the profits interest, the different tax and benefits rules that apply to employees versus partners and the consequences of treating a partner as an employee. This Practice Note also analyzes various approaches to handling the dual status issue.

Many businesses are conducted through:

- Limited liability companies (LLCs).
- Limited liability partnerships (LLPs).
- Other entities treated as partnerships for federal income tax purposes.

For ease of reference, except where otherwise indicated, all entities taxed as partnerships are referred to in this Note as partnerships and both partners and members of LLCs who provide services to the applicable entity are referred to as partners.

To retain talent and incentivize performance, partnerships, like their corporate counterparts, often want to grant equity compensation to their service providers. But granting an equity interest to an employee in a partnership has significant tax consequences because, regardless of the employer's intent, the employee generally becomes a partner in the partnership immediately on grant. This Note addresses:

- The types of equity compensation granted by partnerships.
- The tax and benefits rules that apply to employees versus partners.
- Whether an individual can have dual status, that is, be both a partner and employee of the same entity.
- How partner compensation should be treated for self-employment tax purposes.
- The consequences of treating a service provider as both a partner and an employee.
- Alternative approaches to handling the dual status issue.

TYPES OF EQUITY COMPENSATION GRANTED BY PARTNERSHIPS

Partnerships grant the following types of equity compensation:

- **Capital interests.** This is the right to share in the capital of the partnership at the time of grant, so that the grantee would receive a share of the proceeds if the partnership's assets were sold at fair market value and proceeds distributed in a complete liquidation.
- **Profits interests.** This is the right to participate in the appreciation in value of the partnership above a certain threshold, but not in existing capital or accumulated profits. This means that on a liquidation of the partnership immediately after grant, the recipient would not participate in liquidating distributions.
- **Options on partnership interests.** This is the right to participate in income and/or the appreciation in the value of the assets of the partnership realized after the time of grant.

Because of their flexibility and attractive tax characteristics, profits interests have become the most popular form of equity compensation for partnerships. Under current law, profits interests can be structured so that the recipient of the profits interest is not subject to tax at the time of grant or vesting. The recipient is also generally entitled to long-term capital gain treatment on the later sale of the interest in the partnership if certain requirements are met. For more information on the tax treatment of profits interests and other forms of equity compensation for partnerships, see *Practice Notes, Profits Interests (http://us.practicallaw.com/3-422-4189)* and *Partnership Equity Compensation (http://us.practicallaw.com/1-525-2704).*

An employee who receives a capital interest or a profits interest immediately becomes a partner in the partnership. An employee who receives an option on a partnership interest becomes a partner when he exercises the option.

A partnership may also grant a phantom equity interest, which is the right to receive a cash payment equal to the value of a partnership interest when a specified payment event occurs. An employee who receives a phantom equity interest does not become a partner in connection with the grant. However, phantom equity:

- Does not offer the holder preferential tax treatment. Rather, phantom equity is taxed as ordinary compensation income when the compensation is paid or constructively received.
- Is subject to the restrictive rules of Section 409A. For more information on Section 409A, see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview (http://us.practicallaw.com/6-501-2009).*

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THE SAFE HARBOR FOR PROFITS INTERESTS AND THE SIGNIFICANCE OF BEING TREATED AS A PARTNER

Profits interests have become popular because of their attractive tax characteristics. Revenue Procedure 93-27 creates a safe harbor under which the receipt of a profits interest is not a taxable event at the time of grant or vesting. Rather, the holder of the interest generally receives favorable tax treatment when he subsequently sells the interest. Revenue Procedure 2001-43 clarifies that failing to treat the recipient of a profits interest as a partner from the grant date may cause the grant of an unvested profits interest to fail to qualify for this safe harbor, which could potentially result in an unvested profits interest being taxed on its fair market value on the vesting date.

REVENUE PROCEDURE 93-27

Revenue Procedure 93-27 creates a tax incentive for structuring incentive compensation in the form of a profits interest by providing a safe harbor for the grant of certain profits interests. Under the revenue procedure, if structured appropriately, the receipt of a profits interest is not taxable to the holder at the time of grant or vesting, but instead the holder receives capital gain treatment on the sale of the interest. If not structured properly, a profits interest could be taxable on grant.

The revenue procedure defines a capital interest as an interest that gives the holder a share of the proceeds if the partnership's assets are sold at fair market value and the proceeds are distributed in a complete liquidation of the partnership. A profits interest is then defined as a "partnership interest other than a capital interest."

A key question, therefore, in determining whether a partnership interest is a profits interest is whether its liquidation value is $0. If so, the grant of the partnership interest is not subject to tax. However, the safe harbor does not apply if either:

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets.
- Within two years of receipt, the partner disposes of the profits interest.
- The profits interest is a limited partnership interest in a publicly traded partnership.

If an interest intended to be a profits interest does not fall within the safe harbor of Revenue Procedure 93-27, it is not necessarily taxable. Instead, interests outside the parameters of the revenue procedure must be tested under relevant case law to determine whether the receipt of the interest would result in immediate tax consequences. The two foundational cases that examine the proper tax consequences of the receipt of a profits interest are *Diamond v. Commissioner* and *Campbell v. Commissioner* (*492 F.2d 286 (7th Cir. 1974)* and *943 F.2d 815 (8th Cir. 1991)*). For more information on these cases, see *Practice Note, Partnership Equity Compensation: Grant of a Profits Interest: Case Law (http://us.practicallaw.com/1-525-2704#a638114).*

Revenue Procedure 93-27 was later clarified by Revenue Procedure 2001-43, which highlights potential adverse tax consequences for partnerships that fail to treat holders of profits interests as partners.

REVENUE PROCEDURE 2001-43

Revenue Procedure 2001-43 provides guidance on the treatment of the grant of a substantially nonvested profits interest for the provision of services to or for the benefit of the partnership. Before Revenue Procedure 2001-43 was issued, it was unclear whether the holder of an unvested profits interest could make an IRC Section 83(b) election to accelerate the timing of taxation of the interest to the grant date (when the profits interest has no value) rather than the vesting date (when presumably the value of the interest would be greater). In general, the revenue procedure provides that in the case of a profits interest that meet the requirements of Revenue Procedure 93-27's safe harbor, no election is required to treat the interest as vested on the grant date **so long as the recipient is treated as a partner for tax purposes** and begins to receive allocations on a fully vested basis immediately on grant.

This clarification is significant because it means that if a service provider is granted a profits interest but the partnership does not treat the recipient of the interest as a partner from the grant date, then the benefit of the Revenue Procedure 93-27 safe harbor is lost.

DIFFERENT TAX AND BENEFITS RULES APPLICABLE TO EMPLOYEES VERSUS PARTNERS

It is important for partnerships granting equity interests to their employees, and employees receiving these interests, to understand the tax and benefits implications of the grant. Under current law, an employee who receives even a small partnership interest immediately becomes a partner in the partnership and is subject to more complex tax rules than the rules that apply to employees. Additionally, the individual can no longer participate in certain tax-advantaged benefit plans. Failing to treat recipients of partnership interests as partners can have significant adverse implications (see *Consequences of Treating a Partner as an Employee*). This section summarizes certain general tax and benefits rules as they apply to:

- Employees (see *Tax and Benefits Rules Applicable to Employees*).
- Partners (see *Tax and Benefits Rules Applicable to Partners*).

TAX AND BENEFITS RULES APPLICABLE TO EMPLOYEES

The tax and benefits rules that apply to employees are generally more familiar to service providers and less challenging than the rules that apply to partners.

Wage Withholding and Payroll Taxes - Employees

Two main differences in the tax treatment of employees and partners are:

- How employees and partners pay income taxes on amounts received from the partnership for services rendered.
- How employees and partners pay their Social Security and Medicare taxes (generally referred to as payroll or employment taxes).

A partnership withholds income tax on its employees' wages and reports their income on a Form W-2. In contrast, a partnership does not withhold income taxes on payments to partners for services rendered to the partnership (see *Wage Withholding and Payroll Taxes*).

The Federal Insurance Contributions Act (FICA) imposes payroll taxes on employers and employees to finance social security and certain Medicare benefits. Payroll taxes consist of a:

- 12.4% social security tax, up to a wage base limit.
- 2.9% Medicare tax, with no wage base limit.
- 0.9% additional Medicare tax for certain high earners.

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Employees pay 50% of the social security and Medicare taxes, which their employer is generally responsible for withholding from their paychecks and remitting to the Internal Revenue Service (IRS). The employer pays the remaining 50% of these taxes. The additional Medicare tax applies only to employees. Special rules apply to withholding and payment of the additional Medicare tax. For more information on payroll taxes, see *Practice Note, Payroll (FICA) Taxes (http://us.practicallaw.com/1-512-7630).*

In contrast, partners are responsible for paying 100% of the self-employment tax (see *Wage Withholding and Payroll Taxes*).

Benefit Plan Participation - Employees

Employers frequently offer their employees the ability to participate in tax-advantaged benefit plans. For example, many employers offer certain benefit coverage through cafeteria plans, which allow employees to pay for their benefits on a pre-tax basis through a salary reduction agreement. Pre-tax benefits available under a cafeteria plan often include:

- Group health insurance coverage.
- Group term life insurance (limited to $50,000).
- Short- and long-term disability coverage.
- Flexible spending arrangements (also known as flexible spending accounts or FSAs).

As long as the plan satisfies certain non-discrimination requirements under IRC Section 125, amounts used to pay for these benefits are generally not included in an employee's taxable income and are not subject to FICA taxes.

For more information on cafeteria plans, see *Practice Note, Cafeteria Plans (http://us.practicallaw.com/1-507-0676).*

Unemployment Insurance - Employees

In addition to FICA taxes, employers are responsible for paying taxes under the Federal Unemployment Tax Act (FUTA). This tax provides funds to pay unemployment compensation to employees who lose their jobs through no fault of their own. Only employers pay FUTA tax, and they cannot deduct FUTA tax from employees' wages.

Employees who qualify for unemployment benefits are entitled to temporary benefit payments designed to partially replace their wages while they look for another job. The benefit amount is determined by each state under a formula tied to the individual's prior earnings. A common formula is 50% of what the individual earned before termination up to a maximum amount based on the state's average earnings.

Unreimbursed Expenses - Employees

While a partner can deduct unreimbursed, ordinary and necessary business expenses on his tax return and generally reduce his earned income for self-employment purposes (see *Tax and Benefits Rules Applicable to Partners: Unreimbursed Expenses*), an employee can deduct (as miscellaneous itemized deductions) unreimbursed, ordinary and necessary business expenses only to the extent that their aggregate annual amount exceeds 2% of his adjusted gross income. Deductible expenses could include, among other things:

- Dues to professional societies.
- Business liability premiums.
- Home office expenses.
- Licenses and regulatory fees.
- Malpractice insurance premiums.
- Union dues and expenses.
- Work-related education expenses.

TAX AND BENEFITS RULES APPLICABLE TO PARTNERS

The tax law generally considers the business conducted by a partnership to be conducted directly by each of its owners. Partnerships are considered pass-through entities, which means that all of the profits and losses of the partnership pass through the partnership to its individual partners. A partnership does not:

- Pay federal or state income tax.
- Withhold income or payroll taxes from the compensation paid to its US partners.

Partners are therefore subject to different tax and benefits rules that can be confusing to those encountering them for the first time.

Wage Withholding and Payroll Taxes - Partners

Under the IRS' view, an individual cannot be both a partner and an employee for purposes of wage withholding, payroll taxes or FUTA (*Revenue Ruling 69-184*). The fixed, periodic compensation of a partner (often referred to as guaranteed payments or the partner's draw) is therefore self-employment income rather than employee wages. A partner's salary is reported to the partner on a Schedule K-1 as a guaranteed payment rather than on a Form W-2. The partnership itself files an informational return (Form 1065) with the IRS, which the IRS uses to ensure that each partner is reporting his income correctly. Because there is no employer withholding, partners must pay estimated taxes quarterly, including both income tax and a 15.3% self-employment tax, which consists of:

- A 12.4% social security tax on net earnings from self-employment, up to a cap.
- A 2.9% Medicare tax on net earnings from self-employment, not subject to a cap.

Taxpayers with self-employment income above certain thresholds must also pay an additional 0.9% Medicare tax.

Unlike FICA taxes which are the shared responsibilty of the employer and the employee, the partner is responsible for paying the full amount of self-employment tax. However, a partner can deduct half of his self-employment tax contribution (other than the 0.9 additional Medicare tax) from his taxable income (*IRC § 164(f)*).

A partner's distributive share of partnership income and losses may or may not be self-employment income depending on whether the partner qualifies as a "limited partner" (see *Applicability of Self-employment Tax to "Limited Partners"*).

Individual partners are also required to file state tax returns in all states where the partnership does business.

Benefit Plan Participation - Partners

Partners are subject to many limitations on their ability to participate in tax-advantaged benefit plans. For example, a partner may not participate in a cafeteria plan sponsored by the partnership and, while a partner may participate in a partnership-sponsored health

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or dental plan, the cost of coverage is generally fully taxable to the partner. However, a partner generally can reduce adjusted gross income by the cost of the health and dental insurance coverage.

Unemployment Insurance - Partners

Partnerships may be required to pay FUTA taxes to fund unemployment benefits for their employees. However, partners are not eligible for unemployment benefits if their service is terminated by the partnership.

Unreimbursed Expenses - Partners

A partner can deduct unreimbursed ordinary and necessary business expenses on his tax return, which generally reduces the partner's earned income for self-employment purposes.

APPLICABILITY OF SELF-EMPLOYMENT TAX TO "LIMITED PARTNERS"

The self-employment tax applies to net earnings from self-employment, which is the sum of an individual's:

- Gross income from any trade or business carried on by the individual, less deductions attributable to the income.
- Distributive share of partnership taxable income or loss from a trade or business carried on by the partnership.

(*IRC § 1402(a)*.)

However, if the partner is a limited partner, self-employment income does not include the limited partner's share of income or loss from a partnership, other than guaranteed payments for services rendered to the partnership (*IRC § 1402(a)(13)*). IRC Section 1402 does not define "limited partner" and was enacted before the creation of LLCs and LLPs. This lack of guidance has created uncertainty over how the exclusion for a limited partner's distributive share applies to LLC members and partners in an LLP.

Because of this lack of guidance, some LLC members and partners of LLPs have taken the position that their distributive shares of income from an LLC or LLP that is in the business of performing services are not subject to the self-employment tax. The Tax Court in *Renkemeyer, Campblee & Weaver, LLP v. Commissioner* addressed whether three attorney partners' distributive shares of an LLP's business income were subject to self-employment tax (*136 T.C. 137 (2011)*). The court held that a partner must generally include his distributive share of partnership income (which includes fees for providing services) in calculating his net earnings from self-employment, unless an exclusion applies. While the petitioners argued that their interest in the law firm should qualify for the exclusion under IRC Section 1402(a)(13) for the distributive share of income of a limited partner in a limited partnership, the court, looking at the legislative history of IRC Section 1402(a), found that this exclusion is designed to exclude earnings of an investment nature made by limited partners who are passive investors and not fees received by limited partners for performing services for the partnership.

In a second case involving the self-employment tax obligations of members of a pass-through entity (in this case an LLC) in the business of providing services, the District Court of New Mexico held that members of the LLC must pay self-employment taxes on their share of LLC income (*Riether v. United States, 919 F. Supp. 2d 1140 (D.N.M. 2012)*). This case involved a tax refund action initiated by two individuals who were the sole members of an LLC. The individuals challenged the government's determination that they failed to report $10,878 in self-employment taxes. In the year at issue, the LLC treated the individuals as employees for some of the LLC's earnings by paying them wages and reporting them on Form W-2s and as partners for the remainder of the LLC's earnings by issuing them Schedule K-1s. The individuals argued that because their employer issued them Form W-2s, they were not self-employed. Unpersuaded, the court held that **all** of the LLC's income should have been treated as self-employment income, as the individuals were members of the partnership and therefore not employees for purposes of the self-employment tax.

These two cases indicate that, at least in the case of service partnerships, the IRS will likely successfully challenge attempts by partners to bifurcate "wage" income from partnership distributive shares for self-employment tax purposes.

In September 2014, the IRS released Chief Counsel Advice 201436049 (the CCA), which involved an investment manager LLC that earned management fees from various hedge funds for its investment advisory services. The investment manager took the position that its members were limited partners and therefore exempt from self-employment tax on their distributive share of management fee income. Extending *Renkemeyer* and *Riether* to the hedge fund business, the CCA concluded that the distributive share of partnership income allocated to members of the investment manager who were providing services to the investment manager was not income of an investment nature that Congress sought to exclude from self-employment tax when it enacted IRC Section 1402(a)(13). Therefore, the members were not limited partners within the meaning of IRC Section 1402(a)(13) and were subject to self-employment tax on their distributive share of management fee income. While the CCA is not binding on taxpayers and may not be cited as precedent, it provides an indication of the views of the IRS and how they are likely to address this issue going forward.

CONSEQUENCES OF TREATING A PARTNER AS AN EMPLOYEE

Whether intentionally or unintentionally, partnerships often fail to treat former employees who hold partnership interests as partners for employment tax purposes, which can have significant consequences, including:

- It can result in the underpayment or overpayment of payroll or employment taxes.
- If the partner impermissibly participates in what is intended to be a tax-advantaged cafeteria plan, the partner may owe unanticipated taxes on the benefits received and the cafeteria plan can be disqualified.
- The partner cannot take advantage of the Revenue Procedure 93-27 safe harbor with respect to the tax treatment of any unvested profits interests, which could potentially result in the profits interest being taxed on its fair market value on the vesting date, rather than the grant date.
- It can become an issue on audit for both the partnership and the partner.

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APPROACHES TO HANDLE DUAL STATUS ISSUE

Because of the real and perceived disadvantages and challenges associated with status as a partner rather than an employee (see *Different Tax and Benefits Rules Applicable To Employees Versus Partners*), various structures have been developed to allow the holder of an equity award to enjoy the benefits of equity ownership while continuing to be treated as an employee for certain compensation and benefits purposes.

TIERED PARTNERSHIPS

Under this approach, the operating partnership grants an equity interest to another partnership (often called the management investment entity), causing the other partnership to become a partial owner. Employees then receive equity interests in the management investment entity (rather than the operating partnership), which correspond to the equity interest granted by the operating partnership to the management investment entity. This is done so that the employees are not direct owners of the operating partnership. The operating partnership therefore continues to treat these service providers as employees.

Some practitioners argue that in this scenario the management investment entity should not be respected as a separate partnership because there is no business purpose behind the management investment entity. Rather, the equity interests held by employees in the management investment entity should be treated as direct interests in the operating partnership. However, there are several non-tax reasons to structure the partnerships in this manner, including:

- The operating partnership is better able to preserve the confidentiality of its books and records (because the employees are not security holders in the operating partnership and therefore do not have the same rights to access this information).
- Because the employees are not signatories to, and therefore would not be provided a copy of, the operating partnership agreement, the operating partnership is also better able to preserve the confidentiality of the economic deal among the partners and investors in the operating partnership.
- Using a separate management investment entity ensures that the entire equity pool is granted up-front and will therefore be entirely available for, and allocated to, employees.
- In the initial process involving the sale or other transaction involving the operating partnership, utilizing a separate management investment entity facilitates the ability of the operating partnership to negotiate a transaction without notifying employees.
- The separate management entity structure alleviates the difficulties associated with having multiple security holders of the operating partnership, especially in the context of closing a sale of the partnership or other transaction given the difficulty of obtaining votes and signatures from multiple owners, and avoids having to plan around a situation in which each management equity holder potentially has a veto right.

ESTABLISHING A SEPARATE ENTITY TO HOLD THE PROFITS INTERESTS

Under this scenario, the service provider maintains employee status because a separate entity, such as an LLC owned by the employee and another person, such as the employee's spouse, holds the profits or capital interest granted to him. Practitioners generally do not recommend this approach because there does not appear to be a business purpose to this structure, making it less likely that the separate entity would be respected as a separate partnership for tax purposes.

If the entity is wholly owned by the employee, it will in any event be disregarded as separate from the employee for tax purposes, thereby defeating the purpose of using the entity in the first place.

The employee may be able to achieve the desired result by having a corporate entity (such as an S corporation) hold the equity interest, but doing so would require the employee to comply with administratively burdensome corporate formalities. An S-corporation also would not by itself avoid a potential challenge that it lacks a valid business purpose other than securing federal tax advantages.

The efficacy of these structures depends on the factual context in which the particular structure is used. Recognizing the issues, and perhaps unfairness, with equity holders being regarded as partners in all cases, the IRS has announced that it is considering whether in at least certain circumstances dual status as a partner and an employee should be permitted. In the meantime, it is important to:

- Understand the implications of granting equity interests to partnership employees.
- Immediately treat those who are granted equity interests as partners.

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