THE TAX ADVISER

Partners as Employees? Properly Reporting Partner Compensation

PARTNERS & PARTNERSHIPS

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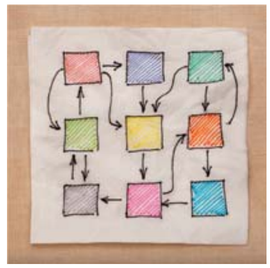
EXECUTIVE SUMMARY



- As partnerships increasingly offer equity interests to retain valued employees, these employees may be unaware of the employment tax consequences of receiving a partnership interest.
- Many partnerships continue to treat those former employees who hold partnership interests as employees for employment tax purposes, even though the IRS clearly believes these employee/partners cannot be employees.
- If the IRS discovers this treatment, the possible consequences go far beyond employment tax liability. For example, it might cause a grant of an unvested partnership interest to fail to qualify for the safe harbor in Rev. Proc. 2001-43.
- One solution to the tax filing complexity that employees face when they become partners would be for Congress to enact legislation allowing partnerships to file composite partnership U.S. federal income tax returns.

Evolution in pay practices over the past two decades has piqued interest in a common question arising in the partnership area: How do partnerships treat (former) employees once they receive an equity interest in a partnership? May a partner in a partnership also be an employee of the partnership in which the partner holds the partnership interest? (That is, may a partner in a partnership also be an employee of the same partnership for purposes of the Federal Insurance Contributions Act (FICA) and the collection of tax at source on wages.[1])

This renewed interest is driven by compensation practices that have shifted dramatically over the past two decades. Even with two economic downturns driving down profits and drying up job prospects, employers often found (and continue to find) it difficult to retain key talent without offering them some kind of equity interest. In the case of a partnership, providing an equity interest can have significant consequences. For example, whereas employees can exclude from income certain employer-paid benefits, partners may not exclude those benefits when paid by the partnership. Moreover, partners are strictly prohibited from participating in some employee benefit plans.

Often, the partnership interests granted to employees are very small. Because many employees who receive these small interests do not understand or want to comply with the more complex tax rules associated with being a partner in a partnership (including a more complicated individual income tax return), partnerships often want to continue to treat the partner/former employee as an employee for purposes of withholding and remitting FICA taxes. Other times, through oversight, a partnership simply fails to change the employee's treatment in its accounting system. For these and other reasons, tax advisers often are asked whether it is possible to treat a partner/former employee as an employee for purposes of withholding and remitting FICA taxes.

This article examines the general test for employee status and some of the ways federal tax law treats employees differently from partners and the consequences and risks of treating a partner as an employee. Next, the article looks at common planning techniques to avoid the IRS's prohibition[2] on a partner also being an employee of the partnership in which the partner holds a partnership interest for employment tax purposes. Finally, the article recommends action Congress could take to solve this problem.

Employee vs. Partner Status

Test for Determining Employee Status

The Code does not define the term "employee,"[3] but current Treasury regulations provide useful guidance regarding when an individual is an employee for federal tax purposes. Generally, an employer-employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services both with respect to (1) the result but also as to the details and (2) the means by which the result is accomplished.[4] Moreover, people who follow an independent trade, business, or profession in which they offer services to the public are generally not employees.[5] Importantly, whether an employer-employee relationship exists will be determined based on all the facts and circumstances,[6] and any designation placed on the relationship by the parties "is immaterial" to the determination.[7]

The IRS has set forth 20 factors it uses to determine whether an employer-employee relationship exists.[8] The importance of each factor varies based on the particular circumstances of each case. Moreover, no one factor is deemed controlling.

Differences in the Tax Treatment of Employee vs. Partner

U.S. federal tax laws make numerous distinctions between a partner and an employee.

FICA and wage withholding vs. self-employment taxes: One area of distinction is how partners and employees pay their Social Security (old-age, survivors, disability insurance)[9] and Medicare (hospital insurance) taxes, which are commonly referred to as employment taxes.[10] Employees, through FICA, pay only half of the employment taxes on their wages and make that payment via withholdings from their payroll checks, which their employers then remit to the U.S. government.[11] Individual partners, however, through the Self-Employment Contributions Act (SECA), pay the full amount of their employment taxes and pay the taxes via quarterly estimates.[12]

Importantly, because an individual partner owes the entire amount of his or her employment taxes on the partner's self-employment earnings, if a partnership pays part of the partner's tax, then the partnership should report the amount paid on the partner's behalf as a guaranteed payment to the partner[13] (i.e., any time a partnership pays a liability of a partner, the payment should be treated as a distribution to the partner followed by the partner's payment of the partner's employment tax liability[14]). Additional employment taxes will be due on those guaranteed payments. Moreover, any amount of employment tax not paid by the partnership on the individual partner's behalf must be paid directly by the partner.

Finally, if the partnership pays part of an individual partner's employment taxes, but the partner is involved in other self-employment activities (other partnerships or sole proprietorships) and those other activities lose money, then the partnership may overpay the partner's employment tax liability. (The Code imposes employment taxes on the "net earnings from self-employment" of individual partners,[15] which includes income or loss from every partnership in which the individual partner holds an interest and net income from any other trade or business activity carried on by the taxpayer.[16])

Certain benefit plan participation: Another area of distinction between a partner and an employee relates to the right to participate in certain benefit plans.

Health, welfare, and fringe benefit plans: The income tax rules for health, welfare, and fringe benefit plans prohibit partners from excluding the value of benefits from income in the same way that employees can.[17] Health, welfare, and fringe benefits paid on behalf of a partner are generally not excluded from the partner's income[18] and are treated as guaranteed payments because they are made without regard to the partnership's income. The value of those benefits is therefore included in the partner's gross income.[19] The partner may be entitled to a deduction on his or her individual return to the extent provided in Sec. 162(l).

Cafeteria plans: The rules related to cafeteria plans are even more onerous than the ones for other employee benefits. Partners are strictly prohibited from participating in cafeteria plans.[20] Thus, including partners in cafeteria plans may disqualify the plan entirely and result in a loss of the tax benefits sought when adopting the plan.

Tax-Free Receipt of Unvested Profits Interests

Before 2001, taxpayers and their advisers were unsure whether the recipient service provider of an unvested profits interest in a partnership could make an election under Sec. 83(b) to accelerate the timing of the taxable event to the time of grant (when the fair market value (FMV) of the interest was $0 under existing IRS guidance) versus the later time of vesting (when FMV may be significant).[21] Some questioned whether Sec. 83 applied solely to corporations and not to partnerships. Most advisers believed, however, that Sec. 83 also applied to a transfer of partnership interests for services. Thus, a Sec. 83(b) election could be made upon receipt of an unvested profits interest, and taxpayers were advised to make a Sec. 83(b) election upon receiving the interest.

In 2001, the IRS issued Rev. Proc. 2001-43[22] providing that, so long as certain conditions are satisfied, the IRS will not tax the receipt of an unvested profits interest by a service provider (i.e., the interest will be treated as being received as of the date of grant when the value is $0—not at the future vesting date when the value may be significant). Assuming the recipient service provider complies with the revenue procedure, he or she does not even have to make a Sec. 83 (b) election (i.e., Rev. Proc. 2001-43 applies without any action on the part of either the partnership or the partner so long as its requirements are satisfied).

In addition to complying with all the rules of Rev. Proc. 93-27,[23] Rev. Proc. 2001-43 adds, among others, the following requirement:

> The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest.[24]

Continuing to treat a partner who has received an unvested profits interest as an employee for purposes of withholding and remitting employment taxes, issuing the partner a Form W-2, *Wage and Tax Statement*, etc., likely runs afoul of the additional requirement set forth above. Thus, any partner who is treated as an employee at any time after receipt of an unvested profits interest likely cannot satisfy Rev. Proc. 2001-43, and, thus, the IRS will likely argue that the issuance of the profits interest ought to be fully taxable upon vesting at the then FMV.

It is important to note, though, that Rev. Proc. 2001-43 is a safe harbor; taxpayers may always argue for a given result even if they do not satisfy the safe-harbor requirements. Thus, if a partnership continues to treat a partner as an employee after the partner receives an unvested partnership profits interest in exchange for services, the partnership and the employee may argue that existing case law supports their position that the tax implications of the receipt of the unvested profits interest in exchange for services should be determined upon grant (i.e., should not be a taxable event).

It seems a huge risk to take, however, when it would be so easy to adjust the books and records to treat the partner/former employee as a partner for purposes of paying the partner's employment taxes. At a minimum, partnerships and employees deciding to take positions outside of Rev. Proc. 2001-43 would have to pay advisers to research the law, draft opinions, etc., to ensure that receipt of the unvested profits interest in exchange for services is tax free.

The IRS has also issued proposed regulations and an accompanying proposed revenue procedure dealing with the grant of compensatory partnership interests.[25] While neither has been finalized (and, thus, they do not have to be followed), both require, as a condition to having the incidence of taxation at the grant date (versus the later vesting date), the recipient of an unvested profits interest to make an election under Sec. 83(b) to be treated as a partner at the date of grant.

Current State of the Law

As stated above, the IRS takes the position that a partner in a partnership may not also be treated as an employee of the same partnership in which the partner holds an interest, for employment tax withholding and remittance purposes.[26] Case law interpreting the 1939 Code held a partner could not be an employee of his partnership under any circumstances, adopting the aggregate theory of partnership taxation.[27]

In 1954, however, Congress changed its view of partnership tax—a partner may be an aggregate of its members or a separate entity. Some provisions of the 1954 Code adopted the aggregate view of partnership taxation while others adopted the entity view of partnership taxation. Moreover, Congress directed that, if a given provision did not provide either way, the view that is "more in keeping with the provision" should prevail.

Included among the "entity" Code provisions was Sec. 707(a), which provides that a partner may have dealings with a partnership in which the partner holds an interest in other than a partner capacity. Sec. 707(a) introduced the possibility that, given the right circumstances, a partner may also be an employee of a partnership in which the partner holds an interest.

The first court to address whether a partner may occupy the dual status was the Court of Claims in 1967.[28] The issue was whether a managing partner could exclude from income under Sec. 119 meals and lodging the partnership provided. In concluding that a partner could not hold the dual status of employee and partner for purposes of Sec. 119, the court held that "[a] partnership is not a legal entity separate and apart from the partners, and, accordingly, a partnership cannot be regarded as the employer of a partner for the purposes of Section 119 of the 1954 Code."29 Apparently, the Claims Court did not view the changes to the Code enacted in 1954 treating the partnership as an entity separate from its partners in certain instances to have altered this conclusion.

The next court to address the issue of whether a partner could be an employee of the partnership in which the partner holds an interest was the Fifth Circuit, in *Armstrong v. Phinney*.30 In *Armstrong*, as in *Wilson*, the Fifth Circuit considered whether a partner could exclude from income under Sec. 119 meals and lodging the partnership provided. The Fifth Circuit held that, in the context of Sec. 119, a partner could also be an employee of the partnership in which the partner held its partner interest. The court found that the enactment of Sec. 707(a) had altered the law so that a partner could be both a partner and an employee of the same partnership and stated broadly that:

> [I]t is now possible for a partner to stand in any one of a number of relationships with his partnership, including those of creditor-debtor, vendor-vendee, *and* employee-employer.31

Importantly, however, the *Armstrong* case did not deal with a payment to a partner for services or FICA withholding. Instead, it dealt solely with whether a partner could also be treated as an employee of the same partnership for purposes of Sec. 119. Thus, any part of the *Armstrong* decision that expresses the court's opinion on matters outside of the Sec. 119 issue is dicta, which may have persuasive but not precedential value.32

Soon after the *Armstrong* decision, the IRS issued two general counsel memoranda studying the issue of whether a partner could occupy the dual status of partner and employee in the same partnership.33 Both of the memoranda criticized the *Armstrong* decision and disagreed strongly with the *Armstrong* court's holding that a partner may also be an employee of the same partnership in which the partner holds an interest.

In General Counsel Memorandum 34001, the IRS noted that *Armstrong* did not involve FICA withholding and that it found "no warrant for the dictum of the Armstrong case for employment tax purposes." It discussed in detail why the IRS believed that a partner could not be an employee for employment tax purposes. Soon after issuing the two general counsel memoranda, the IRS issued Rev. Rul. 69-184, ruling that:

> Bona fide 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). Such a partner who devotes his 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, in either event, a self-employed individual rather than an individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. Sections 1402(a) and 3121(d)(2) of the Code.34

Thus, according to the IRS, a person can be a partner in a partnership or an employee of a partnership, but may not be both a partner and an employee of the same partnership.

Finally, in 1977, the Fifth Circuit (the same court that decided the earlier *Armstrong* case) considered whether management fees paid to partners were payments under Sec. 707(a).35 Thus, unlike the earlier *Armstrong* case (dealing with Sec. 119), the *Pratt* case was directly on point involving payments to partners for services.36 The partners received a 5% management fee payable from gross partnership revenue in exchange for the partners' managing the shopping centers the partnership owned.

In concluding that the management fees were not Sec. 707(a) payments, the court held that "in order for the partnership to deal with one of its partners as an 'outsider' the transaction dealt with must be something outside the scope of the partnership."37 Thus, the same court that rendered the *Armstrong* decision reached a different conclusion when confronted with an actual payment to a partner for services and held that the only time Sec. 707(a) could apply is when the transaction between the partner and the partnership is something "outside the scope of the partnership."

Shortly after the *Pratt* decision, the IRS issued Rev. Rul. 81-30038 with facts nearly identical to those in *Pratt* and agreed with *Pratt's* holding. In the same *Internal Revenue Bulletin*, the IRS issued Rev. Rul. 81-30139 with facts distinguishable from those in *Pratt* (the partner provided services substantially the same as the services it rendered as an independent contractor or agent to persons other than its partnership) and ruled that the payments were Sec. 707(a) payments.[40]

Thus, while the enactment of Sec. 707(a) raised the possibility that a partner may also be an employee of the same partnership in which the partner holds an interest, the IRS has repeatedly opposed treating partners as employees of partnerships in which the partners held an interest.[41] Moreover, the primary support for the proposition that a partner may also be an employee of the partnership in which the partner holds an interest comes from dicta in court cases. After initially stating in dicta that a partner may be an employee of the partnership in which the partner holds an interest, the Fifth Circuit has more directly addressed the issue in *Pratt*. The facts of the *Pratt* case were directly on point (payments to a partner for services), and the decision greatly limited those circumstances in which a partner may be an employee of the partnership in which the partner holds an interest.

Given the holding in *Pratt*, it would be difficult for taxpayers in the Fifth Circuit to treat a partner as an employee of the same partnership in which the partner holds an interest unless the services performed by the partner are outside the scope of the partnership's activities. Also, it is questionable whether the *Armstrong* case can be cited as persuasive authority outside the Fifth Circuit given the more recent decision of the Fifth Circuit in *Pratt*. At a minimum, taxpayers outside the Fifth Circuit wishing to rely on the dicta of the Fifth Circuit in the *Armstrong* case must also deal with the more recent direct holding of the Fifth Circuit in the *Pratt* case.

Consequences of Granting an Employee an Interest in a Partnership

Tax law recognizes two kinds of interests in a partnership: (1) a capital interest and (2) a profits interest. A partnership capital interest is an interest in a partnership that would provide the partner some amount of money if, immediately after receipt of the interest, the partnership were to sell all of its assets for FMV and liquidate.[42] A partnership profits interest is a partnership interest other than a capital interest.[43] A profits interest represents solely an interest in any future profits.

Stated differently, if a partnership were to liquidate immediately after issuing a profits interest, the profits interest recipient would, by definition, receive nothing. If a purported interest holder will receive something upon liquidation of a partnership immediately after the profits interest is granted, then the interest is, by definition, not a profits interest.

Employee Receives a Capital Interest

When an employee is granted a capital interest in a partnership, the employee becomes a partner in the partnership immediately for U.S. tax purposes, but only if the interest is of a sufficient size. Court cases and administrative guidance are inconsistent regarding what size interest can constitute a member interest.[44] Many practitioners require that the interest be at least a 1% interest to be respected.[45]

Treasury regulations provide that an eligible entity with at least two members can elect to be classified as, or may default into, a partnership.[46] The Code also defines a "partner" as a "member of a partnership."[47] The word "member" is not defined in the Code or Treasury regulations. It is clear, however, that U.S. federal tax law—not state law—determines whether a person is a member (partner).[48]

Assuming the interest is sufficiently large to constitute a partnership interest, the recipient (former) employee should be treated as a partner regardless of whether the employee pays anything for the interest or receives the interest as compensation for past, present, or future services.[49]

Employee Receives a Profits Interest

Similar to the receipt of a capital interest in a partnership, an employee also generally becomes a partner in a partnership upon receipt of a profits interest in the partnership. The IRS has recognized that a pure profits interest partner is a partner for U.S. federal tax purposes.[50] So, even where an employee is granted solely a share of future profits, if any, and has no immediate right to any amount if the partnership were to liquidate, the employee receiving the interest becomes a partner upon receipt of the profits interest.[51]

A more complete discussion of when one becomes a partner or whether a partnership exists for U.S. federal tax purposes is beyond the scope of this article.[52]

Risks of Treating a Partner as an Employee for FICA Purposes

Once an employee is granted an interest in a partnership, as discussed above, the employee becomes a partner and ceases to be an employee, except for specific provisions of tax law that treat certain partners as employees for very limited purposes. The question can be asked why taxpayers should care whether a partnership continues to treat a partner as an employee of the partnership in which the partner holds an interest. If the partnership decides to continue to treat the partner as an employee for employment tax withholding and remittance purposes, then the partnership assumes a large amount of risk related to a number of vital tax law issues. Many of these risks involve the key differences between an employee and a partner discussed above.

Rev. Proc. 2001-43 likely does not apply to a partner treated as an employee: As discussed above, for years taxpayers and practitioners wondered whether the recipient of an unvested partnership profits interest could make a Sec. 83(b) election (i.e., whether the receipt of an unvested partnership profit interest was subject to Sec. 83(b)). In 2001, the IRS issued Rev. Proc. 2001-43, providing that, so long as certain detailed requirements are satisfied, the recipient of an unvested partnership profits interest can be properly treated as a partner from the date the unvested profits interest is granted. (Treating a partner as the owner from the grant date is the same result obtained if the recipient of the unvested profits interest had made a Sec. 83(b) election and, thus, suggests that Sec. 83 can apply to unvested partnership interests.[53]) Being treated as a partner for U.S. federal tax purposes as of the grant date is a condition precedent to achieving favorable capital gain treatment of carried interests granted by private-equity funds—carried interests are a kind of profits interest.

One requirement listed in Rev. Proc. 2001-43 is that the recipient of the unvested profits interest be treated "as the owner of the partnership interest from the date of its grant." Because the IRS, in Rev. Rul. 69-184, takes the position that a partner cannot also be an employee of the partner's partnership for employment tax withholding and remitting purposes, treating the recipient service provider as an employee for purposes of withholding and remitting employment taxes likely violates the requirement in Rev. Proc. 2001-43 that the recipient service provider be treated "as the owner of the partnership interest from the date of its grant."

Stated differently, the IRS takes the position that a service provider must be treated as the owner of the partnership interest from the date of grant to qualify under Rev. Proc. 2001-43. The IRS also takes the position that a partner in a partnership may not also be an employee of the same partnership. As a result, any recipient of an unvested profits interest who continues to be treated as an employee for employment tax purposes likely violates Rev. Proc. 2001-43 and, thus, must rely on law outside of Rev. Proc. 2001-43 to be treated as a partner for purposes of the taxation of carried interests.[54]

Risk of violating cafeteria plan rules: Including a partner in a cafeteria plan will cause the plan to violate rules governing the formation and operation of cafeteria plans.[55] Thus, if a partnership continues to treat partners as employees for purposes of employment tax withholding and remittance, then care must be taken to not include the partner being treated as an employee in the partnership's cafeteria plan.

Risk of not paying all employment taxes due: If 100% of a partner's share of self-employment income (whether guaranteed payment or share of partnership profits) is reported to the partner on Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, as is required, there is little risk that the partner will fail to report his or her entire share of partnership income and pay all employment taxes due on the income. The income subject to self-employment tax reported on Schedule K-1 flows to Form 1040, Schedule SE, *Self-Employment Tax*, rather seamlessly. However, if a partnership decides to treat certain partners as employees for payroll tax purposes, then there is a risk that not all of the partner's allocable share of partnership income will be reported on Form W-2 because the partnership tax return will not be completed until months after the Form W-2 must be filed with the IRS and the partnership will not have final numbers to use in preparing Form W-2.

If not all of the partner's FICA earnings are reported on Form W-2, then the partner may not pay all employment taxes due on the partner's proportionate share of partnership earnings, unless the remainder is later reported on Schedule K-1. If a partnership continues to treat partners as employees for purposes of employment withholding and remittance, then care must be taken to report all of the partner's earnings either on Form W-2 or Schedule K-1. This would include, for example, reporting as a guaranteed payment any employment tax paid by the partnership on behalf of the partner being treated as an employee for employment tax withholding and remittance purposes. That guaranteed payment would also, in turn, be subject to self-employment tax.

It should be noted that the goal of avoiding a complicated individual income tax return by not having to deal with the complexities of partnership taxation cannot be achieved under current law. Any employment taxes the partnership paid under FICA and reported on Form W-2 must be reported as a guaranteed payment to the partner on the partner's Schedule K-1, which will necessitate reporting the amount on Schedule E, *Supplemental Income and Loss*; Schedule SE; and possibly other places on the U.S. federal individual income tax return.

Risk of overpaying employment taxes: Under SECA, employment taxes are imposed on "net earnings from self-employment." Sec. 1402 defines net earnings from self-employment to include earnings from each partnership in which the partner holds an interest plus earnings from a variety of other sources (including sole proprietorships). If a partner is treated as an employee of a partnership and employment taxes are paid under FICA on the partner's behalf based solely on the earnings of that partnership, then the partner may overpay employment taxes if the partner's other self-employment activities have an overall net loss.

Query: Is the partnership, or the partnership's tax matters partner, liable for any overpayment of self-employment tax paid by a partner being treated as an employee of the partnership if the employee's other self-employment activities result in a net loss?

Risk to the qualified production activities calculation (Sec. 199): Sec. 199 allows a deduction equal to a specified percentage of a taxpayer's "qualified production activities income" or, if less, a taxpayer's taxable income for the year,[56] except that the deduction may not exceed 50% of the taxpayer's W-2 wages for the tax year that the taxpayer pays its workforce.[57] For purposes of Sec. 199, W-2 wages means, for any tax year of that taxpayer, the sum of the amounts in Secs. 6051(a)(3) and (8) (wages for income tax withholding and deferred compensation amounts) the taxpayer paid to employees employed by that taxpayer during the calendar year that ends during that taxpayer's tax year.[58] Also, for purposes of Sec. 199, "employee" has the definition set forth in Sec. 3121(d)(1) and Sec. 3121(d)(2). Importantly, neither self-employment income nor guaranteed payments to partners are required to be reported under Sec. 6051 and, thus, are not W-2 wages for purposes of Sec. 199.

This gives partnerships qualifying for Sec. 199 benefits an incentive to treat partners as employees because treating the partner as an employee for purposes of FICA tax withholding and remittance purposes might increase the Sec. 199 deduction. Those partnerships should take care to exclude those amounts reported to partners on Form W-2 from the calculation under Sec. 199(b)(1).

Uniform capitalization calculation (Sec. 263A): Sec. 263A requires taxpayers to capitalize all direct costs and an allocable share of indirect costs to the cost of inventory and property the taxpayer produced.[59] While it is clear that employee wages are subject to the Sec. 263A capitalization rules, the IRS regulations are generally silent on their application to partnerships. Thus, it is not clear that guaranteed payments for services are subject to the Sec. 263A capitalization rules. (However, a guaranteed payment for the use of capital is generally treated the same as interest for purposes of Sec. 263A.[60]) For those taxpayers subject to Sec. 263A, treating a partner as an employee for purposes of FICA withholding might also have ramifications under the Sec. 263A capitalization rules.

Compliance with requirement for substantial authority: Sec. 6664 prohibits taxpayers from taking positions on tax returns unless there is substantial authority for the tax treatment of an item[61] or a reasonable basis for the tax treatment of an item and the taxpayer discloses the tax treatment on Form 8275, *Disclosure Statement*.[62] The substantial-authority standard is an objective standard;[63] it is satisfied if the weight of the authorities supporting the position is substantial in relation to the weight of authorities supporting a contrary position.[64]

In practice, the substantial-authority standard is generally interpreted as requiring approximately a 40% likelihood that the tax return position will be upheld on its merits if it is challenged.[65] The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial-authority standard is satisfied.[66]

Because substantial authority is an objective standard, the taxpayer's or the tax return preparer's belief that substantial authority exists does not matter. Substantial authority either does or does not exist for each position taken on a return, and the IRS, during an audit, will make its own determination. If the IRS determines that substantial authority did not exist at the time the taxpayer took the position, then the IRS will assess penalties unless the taxpayer meets the lower standard of having a reasonable basis for the position and disclosed the position on Form 8275 when the tax return was filed.

Because the primary support for treating partners as employees of the partnership in which the partner holds an interest is dicta in cases, taxpayers should carefully consider what level of support exists for treating a partner as an employee for employment tax withholding and remittance purposes. If they determine that substantial authority does not exist, but there is a reasonable basis, then they should adequately disclose the position on Form 8275 to avoid any penalties.

Similar rules exist for tax return preparers, subjecting them to penalties if they sign a return in which there is not (1) substantial authority for each tax position taken in the return or (2) a reasonable basis for each tax position taken in the return and appropriate disclosure on Form 8275 is made for every position taken based on the lower standard of reasonable basis.[67]

Compliance with AICPA Statements on Standards for Tax Services: The AICPA Statement on Standards for Tax Services (SSTS) No. 1, *Tax Return Positions* (AICPA, *Professional Standards*, Vol. 2), provides that a member should not recommend a tax return position or take a position on a tax return that the member prepares unless that position satisfies applicable reporting and disclosure standards. Recent revisions to Interpretation No. 1-1[68] of SSTS No. 1 make clear that an AICPA member should not take a position on a tax return that the member prepares unless that position satisfies applicable reporting and disclosure standards imposed by the governing tax authorities, including the U.S. federal tax authorities (Congress and the IRS). Thus, any member of the AICPA must adhere to the rules summarized in the previous section to avoid violating the AICPA Standards.

Planning Techniques to Treat Partners as Employees for Withholding Tax Purposes

Taxpayers frequently work around the prohibition on a partner being an employee of the partnership in which the partner holds an interest. Below are a few of the more common techniques in use today.

Tiered Partnerships

Taxpayers often use a tiered partnership structure to avoid the prohibition on a partner's being an employee of his own partnership. For example, a partner in an upper-tier partnership may properly be treated as an employee of a lower-tier partnership so long as the partner of the upper-tier partnership does not hold a partnership interest in the lower-tier partnership (or vice versa). Under this arrangement, the employee of a lower-tier partnership is granted an interest in an upper-tier partnership in which the employee does not hold a partnership interest. Thereafter, the employee continues to be treated as an employee of the partnership in which the partner was employed before being granted an interest in the upper-tier partnership.

Disregarded Entity Beneath a Partnership

A few years ago, the IRS modified the check-the-box regulations to provide that an otherwise single-member disregarded entity will be treated as an entity separate from its owner for purposes of employment taxes and collection of income (withholding).[69] However, if the owner of the disregarded entity is an individual, the individual owner will generally be subject to self-employment tax—not wage withholding.[70] In this example from the regulations, an individual owns 100% of an entity that is disregarded from its owner for U.S. federal tax purposes. However, the disregarded entity is treated as in existence for purposes of subtitle C of the Code (employment taxes and collection of income) for nonowner employees. The example goes on to make clear, however, that for the individual owner, the disregarded entity continues to be disregarded, and the individual must pay his or her own self-employment tax.

Some taxpayers take the position that if a partnership is the sole owner of a disregarded entity (i.e., a partnership is interposed between the disregarded entity and the individual in the regulation example), then employees of the disregarded entity can also be issued partnership interests in the upper-tier partnership, while continuing to be treated as employees of the lower-tier disregarded entity that is wholly owned by the upper-tier partnership in which the partner holds an interest. Presumably, the position is based on the fact that a partnership—not an individual—owns all the interests in the disregarded entity and, thus, the example from the regulations does not apply.

Such a reading of the regulation is likely a stretch. Simply interposing a partnership (the existence of a partnership) should not change the tax answer obtained if the partnership were not in existence. Yet the existence of a partnership is the only meaningful difference between the regulation example and the position taken by some taxpayers. Thus, the partnership's ownership of the disregarded entity should not operate to avoid the IRS prohibition on partners' being treated as employees.

Even if such a structure does work to avoid the prohibition on a partner's being an employee of the partnership in which the partner holds an interest, the taxpayer should have a nontax business purpose for the existence of the partnership.71 Avoiding the IRS's prohibition on treating a partner as an employee of the partnership in which the partner holds an interest should not be a satisfactory nontax business purpose.

S Corporation Holding an Interest in a Partnership

Sometimes, a partner will choose to have an S corporation hold the partner's interest in a partnership as a means to reduce overall self-employment taxes. Despite the similarities in the tax treatment of S corporations and partnerships, under current law, the self-employment tax regimes differ significantly for shareholders of S corporations and partners in partnerships. Generally, as long as an S corporation pays its shareholders reasonable compensation, any S corporation earnings flowing to the shareholders above and beyond that reasonable compensation is not subject to self-employment tax. Conversely, general partners in a partnership generally pay self-employment tax on 100% of their earnings flowing from the partnership.

Moreover, although still somewhat unresolved, limited partners who are actively engaged in the activities of the partnership may not be able to avoid paying self-employment tax on 100% of their nonguaranteed payment earnings flowing from the partnership. Currently, the Code indicates that limited partners are subject to self-employment tax only on any guaranteed payment paid to the limited partner by the partnership.72 In *Renkemeyer*,73 the Tax Court recently held that members of a limited liability partnership are not treated as "limited partners" for purposes of avoiding self-employment tax under Sec. 1402(a)(13) on their respective shares of the partnerships' income. Following the Tax Court's reasoning, a court that addresses the issue may treat a limited partner who is actively engaged in the partnership's activity as subject to self-employment tax on 100% of the limited partner's distributive share of the partnership's earnings.74

Some taxpayers have been successful in convincing courts that they do not have to pay self-employment tax on 100% of the earnings flowing from a partnership where the partnership interest is held by an S corporation and where the taxpayer convinces the court that the S corporation has paid the taxpayer reasonable compensation.75 This structure likely works only where there is a strong nontax business purpose to hold the partnership interest inside the S corporation and the S corporation employs others who contribute to the S corporation's profits. Absent strong nontax business purposes for forming the S corporation, a court will likely consider the S corporation a sham whose existence should not be recognized, which would leave the individual shareholder in the S corporation as a direct partner in the partnership.76 Without other S corporation employees contributing to the S corporation's profits, a court would likely find that 100% of the S corporation's earnings are attributable to the S corporation shareholder's services and, thus, 100% of the S corporation's earnings must be paid to the S corporation shareholder as reasonable compensation.

Recommendation

Despite the risks, many taxpayers—at their own peril—continue to treat partners as employees for FICA tax withholding and remittance purposes. As long as the IRS's stated litigation position is that a partner may not also be an employee of the partnership in which the partner holds a partnership interest, anyone choosing to treat a partner as an employee should understand that the IRS may challenge the treatment.

One might ask, however, "What is the risk?" If all the employment taxes have been paid, then why should a taxpayer care whether the IRS challenges the treatment? As discussed above, a number of risks for the partnership and those partners being treated as employees arise from continuing to treat those partners as employees.

One way for Congress to resolve the quandary faced by employees who receive minor interests in a partnership and who do not want to deal with the complexity of partnership tax reporting and compliance would be to allow partnerships to file a composite U.S. federal partnership income tax return and allow partners to opt in or opt out of the composite return. Under such a regime, the partnership would pay each partner's share of any tax due based on the partner's share of total partnership taxable income for those partners who do not opt out of the composite return. Those partners who opt out of the composite return would receive a Schedule K-1 and report their share of the partnership income on their individual returns exactly as they do under the current system.

Many states already allow partnerships to file a composite partnership income tax return and allow partners the right to opt out of the unified return. For those states that do allow a composite return, the partnership pays the tax on the partner's behalf and the partner has no other filing requirement in that state. If a composite federal return were allowed, then partners receiving small partnership interests (whether profits or capital interests) could participate in the composite federal partnership income tax return and allow the partnership to pay any tax owed on the partner's share of partnership profits.

If Congress were to allow a composite U.S. federal partnership income tax return, it would have to consider how to address separately stated items and certain individual return limitations. One source of guidance might be how the various states that allow a composite partnership income tax return address these issues. (Importantly, most states adopt the federal tax regime, including all limitations. Thus, if states have adopted a composite partnership income tax return model, then there must be a method to deal with separately stated items and individual return limitations.)

Another issue Congress must address if it decides to allow a composite partnership income tax return is whether and to what extent each partner will be subject to self-employment tax. Currently, the partnership determines whether a partner's distributive share of partnership income is subject to self-employment tax and reports self-employment income on each partner's Schedule K-1.

Consistent with the Tax Court's reasoning in *Renkemeyer*, Congress should amend Sec. 1402 (a)(13), and related provisions, to provide that whether a partner is subject to self-employment tax depends on whether the partner participates in the partnership's activities. Importantly, however, Congress should not determine whether a partner is subject to self-employment tax based on whether the partner has "rights to manage" (the test currently proposed under Sec. 469) because doing so could lead to inequitable employment tax treatment of partners (owners of entities) and employees who do not own an interest in the entity they work for but who perform the same functions as partners with rights to manage the partnership.

Whether a composite U.S. federal partnership income tax return regime is enacted or not, Congress should not enact a law allowing partners to be treated as employees for U.S. federal tax purposes unless and until laws are changed to eliminate the risks and issues outlined above, including the risk of disqualifying certain employee benefit plans or prohibiting a service provider partner treated as an employee for employment tax withholding and remittance purposes from complying with Rev. Proc. 2001-43.

Moreover, even if the decision is made to allow partners to be treated as employees for employment tax withholding and remittance purposes, reporting requirements should be enacted to ensure that 100% of the partner's self-employment income is reported each year, and the rules must address situations in which the partner is involved in multiple self-employment activities, some of which have losses that could result in overpaying FICA taxes.

Conclusion

While treating a partner as an employee for employment tax withholding and remittance purposes may not seem that risky, there are real risks to that position. This article has identified some, and there are no doubt others. Until the tax laws are changed to eliminate those risks, partnerships should give careful consideration before deciding to treat any of their partners as employees. Recognizing the increased tax compliance burden placed on employees who receive small interests in a partnership, though, Congress should enact legislation allowing a partnership to file a composite partnership tax return for its partners, with the option for partners to opt out and file their own returns.

Footnotes

[1] Chapters 21 and 24, respectively, subtitle C, Internal Revenue Code of 1986, as amended.

[2] Rev. Rul. 69-184, 1969-1 C.B. 256.

[3] Sec. 7701(a)(20) indicates that the term "employee" includes certain full-time insurance salesmen, but it does not otherwise define the term.

[4] Regs. Sec. 31.3401(c)-1(b).

[5] Regs. Sec. 31.3401(c)-1(c).

[6] Regs. Sec. 31.3401(c)-1(d).

[7] Regs. Sec. 31.3401(c)-1(e).

[8] Rev. Rul. 87-41, 1987-1 C.B. 296. Most of these factors are derived from court cases on the employee/independent contractor issue.

[9] Sec. 3101(a).

[10] Sec. 3101(b).

[11] Secs. 3101, 3102, 3121, 3401, and 3402.

[12] Secs. 1401 to 1403 and 6654.

[13] Sec. 707(c).

[14] See, e.g., Sec. 707(c) and Rev. Rul. 91-26, 1991-1 C.B. 184.

[15] Sec. 1401.

[16] Sec. 1402.

[17] See, e.g., Notice 2005-8, 2005-4 I.R.B. 368.

[18] See, e.g., Sec. 106.

[19] Sec. 707(c) and Rev. Rul. 91-26, 1991-1 C.B. 184.

[20] Prop. Regs. Sec. 1.125-1(g)(2).

[21] Rev. Proc. 93-27, 1993-2 C.B. 343.

[22] Rev. Proc. 2001-43, 2001-2 C.B. 191.

[23] Rev. Proc. 93-27, 1993-2 C.B. 343.

[24] Rev. Proc. 2001-43, 2001-2 C.B. 191, §4.01.

[25] REG-105346-03; Notice 2005-43, 2005-1 C.B. 1221 (containing the proposed revenue procedure requiring the Sec. 83(b) election be made as a condition to having the incidents of taxation determined at the grant date (versus the later vesting date)).

[26] Rev. Rul. 69-184, 1969-1 C.B. 256.

[27] See, e.g., *Robinson*, 273 F.2d 503 (3d Cir. 1959); *Briggs*, 238 F.2d 53 (10th Cir. 1956); and *Doak*, 234 F.2d 704 (4th Cir. 1956).

[28] *Wilson*, 376 F.2d 280 (Ct. Cl. 1967).

[29] Id.

[30] *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968).

[31] Id. at 664.

[32] At least two other cases have held, also in dicta, that Sec. 707(a) makes it possible for a partner to be an employee in limited contexts. See Sowell, "Partners as Employees: A Proposal for Analyzing Partner Compensation," 90 *Tax Notes* 375, n. 51 (Jan. 15, 2001) (Sowell).

[33] General Counsel Memorandum 34001 (12/23/68) and General Counsel Memorandum 34173 (7/25/69).

[34] Rev. Rul. 69-184, 1969-1 C.B. 256.

[35] *Pratt*, 550 F.2d 1023 (5th Cir. 1977).

[36] Id.

[37] Id.

[38] Rev. Rul. 81-300, 1981-2 C.B. 143.

[39] Rev. Rul. 81-301, 1981-2 C.B. 144.

[40] For a more detailed discussion of Sec. 707(a) and the history of the partner/employee issue, see Sowell, *supra* note 32 at pp. 375–91.

[41] General Counsel Memorandum 34001 (12/23/68); General Counsel Memorandum 34173 (7/25/69); Rev. Rul. 69-184, 1969-1 C.B. 256; and Rev. Rul. 81-300, 1981-2 C.B. 143.

[42] Rev. Proc. 93-27, 1993-2 C.B. 343, §2.01.

[43] Id., §2.02.

[44] See, e.g., Rev. Proc. 89-12, 1989-1 C.B. 798 (prior to the check-the-box regulations, the IRS required a general partner to have at least a 1% interest in all items of partnership profits and

losses as a prerequisite to obtaining a favorable IRS letter ruling); IRS Letter Ruling 8338069 (general partner had a 0.1% interest); IRS Letter Ruling 8436030 (general partner had a 0.01% interest); IRS Letter Ruling 8422104 (general partner had a 0.01% interest); IRS Letter Ruling 200411041 (general partner had a 0.01% interest); IRS Letter Ruling 201220012 (general partner had a 0.01% interest); IRS Letter Ruling 8113037 (0.001% interest is not enough to qualify as a partner); and *Historic Boardwalk Hall, LLC*, 136 T.C. 1 (2011) (a general partner interest of 0.1% may be recognized for U.S. federal tax purposes). See also "How Small Can a Partner's Interest Be: Is 0.1% (or 0.01%) the 'New' 1%?" 114-3 *J. Tax'n* 186 (March 2011) (Shop Talk column).

[45] See Rev. Proc. 89-12, 1989-1 C.B. 798 (requiring a general partner interest to be at least 1% to be respected for IRS letter ruling purposes).

[46] Regs. Sec. 301.7701-3(a).

[47] Secs. 761(b) and 7701(a)(2).

[48] Regs. Secs. 301.7701-1(a)(1) and (3).

[49] Also assuming the interest is either (1) vested upon receipt or (2) the employee satisfies the requirements of Rev. Proc. 2001-43.

[50] See, e.g., Rev. Proc. 2001-43, 2001-2 C.B. 191 (recognizing an unvested profits interest holder as a partner) and Rev. Rul. 81-300 (no mention of any partner making a capital contribution before implicitly concluding a partnership exists by holding certain payments to be guaranteed payments under Sec. 707(c)).

[51] Id.

[52] For a more complete discussion of these issues, see, e.g., Sloan, "Opening Pandora's Box: Who Is (or Should Be) a Partner?"; Lipton, "When Is a Partner Not a Partner?"; and Carman, "The Uncertain Certainty of Being a Partner: Classification as a Partner for Tax Purposes," in *The Partnership Tax Practice Series: Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*, Practising Law Institute, Vol. 2, pp. 455, 547, and 595 (2009).

[53] Rev. Proc. 2001-43, 2001-2 C.B. 191.

[54] Similarly, proposed regulations and an accompanying proposed revenue procedure also require, as a condition to having the incidence of taxation at the grant date of an unvested profits interest, that the recipient make an election under Sec. 83(b) to treat the recipient as a partner at the date of grant. See *supra* note 25 and surrounding text.

[55] Prop. Regs. Sec. 1.125-1(g)(2). See *supra* note 20 and surrounding text.

[56] Sec. 199(a).

[57] Sec. 199(b)(1).

[58] Sec. 199(b)(2).

[59] Secs. 263A(a)(2) and 263A(b).

[60] Regs. Sec. 1.263A-9(c)(2)(iii).

[61] Sec. 6664(d)(3); Sec. 6662(d)(2)(B)(i); and Regs. Sec. 1.6662-4(d).

[62] Sec. 6662(d)(2)(B)(ii).

[63] Regs. Sec. 1.6662-4(d)(2).

[64] Regs. Sec. 1.6662-4(d)(3)(i).

[65] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), 1:160 (7/22/99).

[66] Regs. Sec. 1.6662-4(d)(2).

[67] See generally Sec. 6694 and the Treasury regulations promulgated there-under.

[68] Interpretation No. 1-1, "Reporting and Disclosure Standards," of AICPA Statement on Standards for Tax Services No. 1, *Tax Return Positions*.

[69] Regs. Sec. 301.7701-2(c)(2)(iv).

[70] Regs. Sec. 301.7701-2(c)(2)(iv)(D), Example.

[71] For a discussion of other planning techniques to avoid the prohibition on a partner being an employee of the partnership in which the partner holds an interest, including employee leasing, see Sowell, *supra* note 32.

[72] Sec. 1402(a)(13).

[73] *Renkemeyer*, *Campbell & Weaver, LLP*, 136 T.C. 137 (2011).

[74] See also Prop. Regs. Sec. 1.1402(a)-2(h) (proposing to subject a limited partner that actively participates in the partnership to self-employment tax). After the proposed rules were issued in 1997, Congress promptly imposed a one-year moratorium on this issue, which prevented the IRS from finalizing Prop. Regs. Sec. 1.1402(a)-2(h) (see Section 935 (moratorium on some regulations) of the Taxpayer Relief Act of 1997, P.L. 105-34). By deciding the issue in *Renkemeyer*, the Tax Court served notice that it is willing to wade into the issue today despite the 1997 congressional moratorium, given that Congress has failed to act. Other courts will likely follow the *Renkemeyer* court's reasoning as soon as the issue surfaces on audit and is litigated.

[75] See, e.g., *Grigoraci*, T.C. Memo. 2002-202.

[76] In *Grigoraci*, for example, a strong business purpose existed because the partnership the taxpayer entered was a general partnership under state law that did not offer any liability protection to its partners. Thus, the taxpayer had to form a corporation to hold its partnership interest as a liability shield from obligations of the general partnership (id.).

EditorNotes

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