Passthrough Partner

Partners and W-2 Employee Status

By J. Leigh Griffith

The limited liability company taxable as a partnership (LLC) is now the most common form of private business entity in the United States. Private businesses must compete in order to attract and retain key managers and critical employees and often must use equity in lieu of high salaries. It is now common for the LLC to provide equity in the LLC to attract, retain and motivate such personnel. In closely held, smaller operating LLCs, it is increasingly common for long-time employees of a non-executive level to receive small equity interests as a reward for long and loyal service. LLC equity can be provided in the form of options, capital interests or profits interests. The tax effect on the LLC and the key managers or historic employees is significantly different depending on the form of such equity. With respect to compensatory partnership options, the holder is not considered a tax partner and there are no allocations of profits or losses to the recipient while the recipient holds the option prior to exercise. Taxable compensation income will be generated to the recipient upon exercise equal to the difference between the exercise price and the fair market value of the equity received. The recipient may be required to provide the LLC cash to pay the exercise price and fund the withholding tax and the employee’s share of FICA and FUTA. The award of a capital interest involves immediate taxation to the employee upon grant (if not subject to a substantial risk of forfeiture) or upon vesting (if subject to a substantial risk of forfeiture). At such time, the recipient may be required to provide the LLC cash to fund the withholding tax and for the employee’s share of FICA and FUTA. If the capital interest is subject to vesting, the unvested member does not receive an allocable share of profits and losses until vesting. In the case of either the exercise of the option or the vesting of the capital interest, the then-current members of the LLC receive a corresponding deduction for the value of the capital interest. In contrast, if a profits interest is granted, the member is treated as a “partner” immediately and receives his or her allocable share of profits from day one, even if the profits interest is unvested. The proper implementation of a grant of a profits interest will neither trigger taxable income to the employee upon grant or vesting nor a deduction to the then-existing members. Under the IRS’s current position, an employee who is not already a member becomes a self-employed member for employment tax, benefits and other taxes upon the grant of a profits interest, upon the vesting of a capital interest.
interest or upon the exercise of an option regardless of the size of the interest.

As the profits interest advantages of “no cash required” and “no income tax on receipt or vesting” has become better known, more and more LLCs are awarding profits interests not only to executive-level employees but very small interests to long-term nonexecutive employees. It is not uncommon to see small interests awarded to long-term mid-level employees or even administrative staff as a motivational tool. Sometimes the profits interests do not participate in current operating profits, but are interests that will monetize for the recipient only upon a sale of the business and/or perhaps on the retirement of the individual. Generally, the service recipient continues to receive the same compensation as that prior to the award of the profits interest and is not asked to share in the entrepreneurial risk.

Often grants of profits interest are made (1) by LLCs that do not understand the tax ramifications of such grants, and (2) to people that are ill prepared for the complexities of self-employment and who have no desire to be self-employed. If the recipient receives a K-1, the recipient is often surprised. This is especially true when the profits interest is unvested and/or not participating in the current profits and operating distributions of the LLC but is only a participation in the future growth in the value of the LLC. The loss of employee status can be a major issue for executives and, in the author’s experience, a major issue for almost all of the mid-level employees, administrative staff or others who have always been employees throughout their working careers. These people do not wish to be treated as self-employed with the different tax rules, quarterly payment requirements and the more complex personal income tax returns. In addition, from the LLC’s standpoint, the grossing up of income to cover the otherwise “employer’s share” of FICA, FUTA, the taxes that will be imposed on the person for group term life insurance, transportation fringes, qualified moving expense reimbursements and other benefits that are non-taxable to the employee but taxable to the self-employed is an administrative burden and expense.

Many accountants, even many CPAs that advise closely held businesses and their executives, do not appear to understand the IRS’s position that the receipt of a profits interest for services rendered to or for the benefit of the LLC in furtherance of the LLC’s business makes a person self-employed and no longer eligible to be treated as a W-2 employee with respect to such LLC. Frequently, tax returns are prepared reflecting the member with a profits interest as a W-2 employee—sometimes with a K-1 reflecting a small share of the businesses’ profits or losses above the W-2 compensation. As discussed below, this treatment is inconsistent with the IRS’s view of the law and has little support in the case law.

**Purpose of This Column**

Before exploring the current state of the law and the IRS’s position, the author wishes to make it perfectly clear that this column is not advocating audit activity. The purpose of this column is to raise practitioner awareness of the issues and to encourage the Treasury and the IRS to consider taking steps that would permit the treatment of small interest individuals performing traditional employee services to be able to properly be classified as employees with respect to fixed payments. In the author’s experience, the private operating business LLCs generally do not treat new members as employees to “game” the system. Rather, the treatment occurs because (1) the LLC does not understand there is a problem in so doing, (2) the administrative burdens on both the LLC and the individual are considered impractical, and/or (3) as a matter of business necessity, as the member who is acting as a traditional employee desires to be treated as an employee with respect to the wage-like payments (often guaranteed payments under Code Sec. 707(c)) and will be most upset being treated as self-employed. The purpose is to attract, hold and incentivize the individual, not to irritate the individual. Expensive and sophisticated accounting gross-up calculations and records is a heavy burden to many of the smaller private LLCs. From the government’s perspective, there is a significant benefit to the Treasury and the IRS to have withholding and FICA and FUTA taxes remitted by the LLC as the payments are made to the holder of a small interest. In the absence of an LLC-level liquidity event, generally such payments are by far the lion’s share of the “income” of the recipient from the LLC. A broad and systemic disregard of the federal tax law by taxpayers and tax preparers is a very serious tax policy philosophical concern. This is a particularly vexing problem with respect to small interest members not assuming entrepreneurial risk and serving the LLC in capacities similar to that of employees or officers of a corporation. As discussed later in this column, the District Court’s observations in Riether and its citation of Rev. Rul. 69-184 combined with the growing use of small profits or other LLC interests for individuals providing officers and employees types of services with respect to fixed and perhaps bonus compensation make this an important matter to be quickly resolved in a practical manner. Now that the issue is before the IRS and Treasury leadership, the “broken window” theory may force a reaction, which will hopefully be to address
the problem in a practical, yet principled, manner permitting such small interest holders to be treated as employees with respect to their fixed compensation as opposed to a massive audit response.

Present State of Technical Tax Law

There are perhaps six stages of the development of the tax law concerning services by a partner to a partnership in which the partner is a member and (1) the classification the relationship between the partner and the partnership either as in a capacity of a partner or other than a partner, and (2) if “other than a partner,” as an independent contractor or as an employee. Each stage is characterized by a change of law, administrative position of the IRS, or judicial decision. These are (1) the pre-1954 Code stage, (2) the period of 1954–1968/69 (period marked by no guidance), (3) the period of 1969–1977 (period split between the IRS and courts), (4) the period of 1977–1984 (Pratt and Rev. Rul. 1981-300 and Rev. Rul. 1981-301), (5) the period of 1984–2013 (impact of Code Sec. 707(a)(1)(B)), and (6) the of period 2013–present (IRS attention since Riether). From a relevancy standpoint as to the magnitude of the issue, the major turning point for this issue was the adoption of LLC statues in all 50 states to the magnitude of the issue, the major turning point for this issue was the adoption of LLC statues in all 50 states. A partner could be in a capacity other than that of a partner or employee. Each stage is characterized by a change of law, administrative position of the IRS, or judicial decision. These are (1) the pre-1954 Code stage, (2) the period of 1954–1968/69 (period marked by no guidance), (3) the period of 1969–1977 (period split between the IRS and courts), (4) the period of 1977–1984 (Pratt and Rev. Rul. 1981-300 and Rev. Rul. 1981-301), (5) the period of 1984–2013 (impact of Code Sec. 707(a)(1)(B)), and (6) the of period 2013–present (IRS attention since Riether). From a relevancy standpoint as to the magnitude of the issue, the major turning point for this issue was the adoption of LLC statues in all 50 states.

Pre-1954 Code

Before the 1954 Internal Revenue Code, a tax partnership was treated as an aggregate of its partners. A partner could not be an employee of his partnership. For example, the Fourth Circuit Court of Appeals in Doak stated:

... Unincorporated businesses, unlike corporations, incur no income tax. The tax accrues against the partners or co-owners on their distributive shares of the profits. ... This fundamental principle is easily overlooked because for purposes of accounting convenience partnership records reflect the income and expenses of the venture as a separate and independent business unit. But the income is taxable to the partners in their individual capacities, and each is entitled to his proportionate share of the expenses.

For tax purposes, a partnership has no legal existence independent from the individual partners. The partnership and the partners are one and the same legal entity ... In the eyes of the taxing statute, therefore, a partner cannot be an employee of the partnership ...

Indeed, the concept that a partner could not be an employee of a partnership in which the person was a partner pre-dates the 1939 Code. In 1927, in the case of S.U. Tilton Est., the Board of Tax Appeals stated:

A partner devoting his time and energies to the business of the firm is in fact working for himself and cannot be considered as an employee of the firm in the sense that he is in the service of another ... In effect any allowances drawn by a partner from partnership assets are payments which he makes to himself and no man can be his own employer or employee.

The Period 1954–1968/69

The 1954 Code, however, changed the “impossibility” paradigm. Under the 1954 Code forward, a partnership is treated as an entity for some purposes and remains an aggregate for other purposes. Generally, the entity paradigm was adopted by the 1954 Code for transactions between a partner and the partnership. Code Sec. 707(a) was added to the Code and provided that a partner rendering services to the partnership other than in his capacity as a member of the partnership shall be considered as occurring between the partnership and one who is not a partner. This introduced the possibility that there may be circumstances in which the provision of services to a partnership by a partner could be in a capacity other than that of a partner and hence an employee or an independent contractor.

The first case after the enactment of the 1954 Code that explored the possibility that a partner could also be an employee was Wilson. The issue involved Code Sec. 119 and the exclusion of certain lodging and meals from the income of a partner/employee. In that case, the Court of Claims did not discuss Code Sec. 707(a), but stated “[t]he trouble is, however, that the “convenience of the employer” rule that is embodied in Section 119 of the 1954 Code does not have any application to the facts of this case. ... 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 purpose of Section 119 of the Code.” The Court of Claims cited pre-1954 Code cases and did not discuss Code Sec. 707(a). Whether the Court was aware of Code Sec. 707(a) is unknown. In a later analysis of the Chief
With respect to the period 1968/69 to 1975, in the 1968 case of *Armstrong v. Phinney* involving Code Sec. 119, the Fifth Circuit Court of Appeals found the enactment of Code Sec. 707(a) changed the landscape and stated: “... it is now possible for a partner to stand in any one of a number of relationships with his partnership, including ... employee-employer.” With respect to payments to a partner for services or FICA withholding, the IRS’s position is the comments are merely dicta, as the case did not involve employment taxes, nor was there a determination that the individual was an employee.

Following *Armstrong*, the IRS studied the situation resulting in two General Counsel Memorandums in the course of the analysis and ultimately Rev. Rul. 69-184. In GCM 34173 (the “GCM”), the General Counsel’s analysis found that as early as 1940 in *H.H. Wegener* the IRS recognized and advocated a recognition of the distinction between a partner acting in the capacity as a partner and a partner acting in the capacity other than as a partner dealing with the partnership. In that case, the taxpayer was engaged in the business of drilling oil wells and was also a member of a partnership owning oil leases under development which required the drilling and exploitation in order to keep the oil lease. The taxpayer argued that one-third of the profit received from the drilling was not income to him but a distribution of a part of his capital investment. While finding the argument “ingenious,” the court rejected the argument and concluded:

... the development and operation of the property was carried on by the joint venture and that petitioner, as an individual, drilled the oil wells for Gant, Garvin & Wegener, and not for himself as to his interest, and for Grant and Garvin as to their interest. We do not think that the joint venture was paying petitioner a profit for drilling wells on his own property.

In this GCM, the Chief Counsel’s Office interpreted *H.H. Wegener* as standing for the proposition that a person may perform services for his partnership in a capacity other than that of a partner. However, the Chief Counsel’s office stated “... he has never been considered a partnership employee when he does so. Instead, in such a situation, he has been regarded as an independent contractor acting individually for his own account.” The GCM correctly notes that Code Sec. 707(a) does not characterize the partner as an employee, but simply recognizes that there are situations in which a partner is engaging in a transaction in a capacity other than as a partner.

The GCM shifts its analysis from Code Sec. 707(a) to 707(c), which deals with guaranteed payments to partners for services or capital in their capacity as partners and examines the legislative history of Code Sec. 707(c) to support its conclusion that a partner cannot be an employee of his or her partnership. The House viewed the partner receiving such payments “like any other employee who is not a partner.” The “employee” characterization, however, was dropped in the Senate Report where guaranteed payments were to be treated, not as amounts paid to a partner acting as an employee of the firm, but as amounts paid to a partner acting “as one who is not a partner.” In the GCM’s view, Code Sec. 707(a) is merely a codification of the existing principle that a partner dealing with his partnership in that context is an outsider with the following cite: “Cf. Harvey M. Toy B.T.A. Memo. Dec. Dkt. Nos. 106024, 106025 (1942) (taxpayer member of a partnership engaged in the real estate brokerage business who purchased several properties through the firm for his individual account, was properly taxable on his distributive share of the partnership’s commissions from these transactions); S. Rept. 1622, supra, 380.”

The GCM goes on to quote from a leading partnership tax treatise at the time, Willis, *Handbook on Partnership Taxation* discussing Code Sec. 707(c) and guaranteed payments stating:

When it is all sifted down, the net effect of considering guaranteed compensation paid to a partner ‘as made to one who is not a partner’ is quite innocuous and marks little change from prior law. The Senate Committee on Finance suggests that one significant effect is to clarify the tax status of the situation where the guaranteed compensation paid to a partner exceeds partnership net income, computed before deducting compensation to the partners.

The GCM points out Code Sec. 707(c) provides that guaranteed payments are considered as made to one who is not a member of the partnership only for purposes of Code Sec. 61(a) (relating to gross income) and, subject to Code Sec. 263, for purposes of Code Sec. 162(a) (relating to trade or business expenses). The Regs. emphasize that “[f]or the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner’s distributive share of ordinary income.” The GCM focuses on collateral consequences of various Code sections that would be impacted by treating...
payments for services in a capacity other than that as a partner as wages. Two related concerns represent potential double income taxation to the recipient. The first involves a partner including his or her distributive share of partnership gross income in his or her individual tax return. Gross income is not reduced by guaranteed payments. Therefore, if a guaranteed payment were simply a Code Sec. 61(a) “compensation for services” the recipient’s gross income would include the amount of the guaranteed payment plus the distributive share of the partnership’s gross income. The GCM concludes the discussion of this issue as “[s]tated another way, if a guaranteed payment were true compensation for services, section 702(c) would, in effect, require inclusion of the amount of such payment in the recipient’s gross income twice, once as a portion of his distributive share of the partnership gross income and once directly as guaranteed payments.”34 The second concern centers on Code Sec. 61(a) which requires inclusion of compensation (Code Sec. 61(a)(1)) and inclusion of a partner’s distributive share of partnership gross income (Code Sec. 61(a)(13)). Again the GCM postulates a double inclusion of income to recipient.

As an extension of the above concerns, the GCM also postulates double inclusions in the administration of the employment taxes provided in Subtitle C and the self-employment tax provided in Subtitle A.

If Code Sec. 707(c) payments were treated as true compensation, the payment would be taxed in the tax year received by the partner and not the tax year in which the partnership’s year ends. Guaranteed payments are, by statute, reported by the recipient as distributive share income for the recipient’s year-end or with the partnership’s year-end.35

In conclusion, in the GCM and in the subsequent Rev. Rul. 69-184, the IRS rejected Armstrong, and continued to hold that a partner cannot be an employee of the partnership.36 In the IRS’s view, wages of an employee under Code Sec. 3121(a) and self-employment income of a partner under Code Sec. 1401 are mutually exclusive. In Rev. Rul. 69-184, the IRS summed up its position as simply: “[p]artnership remuneration is not ‘wages’ subject to FICA, FUTA, and income tax withholding.”37

1977–1984

The period 1977–1984 is marked by the judicial and administrative concept that an individual providing services to a partnership in which the individual was a partner could be in a capacity as self-employed if the services were outside the scope of the partnership. In 1977, in Pratt,38 the Fifth Circuit (the Circuit that decided Armstrong) specifically addressed Code Sec. 707(a) and concluded 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.”38 In this case, Fifth Circuit considered whether a five-percent gross revenue management fee paid by a partnership to a partner to manage the partnership’s shopping centers were payments under Code Sec. 707(a). The Court’s conclusion in this case specifically recognized that in absence of the services of the partners, the partnership would pay a third party similar amounts but determined such duties were the duties to be performed were activities for which the partnership was created in the first place, i.e., the management of the shopping centers. The Court quoted a portion of the Tax Court’s reasoning in finding the payments were not expenses:

Here, the record indicates that in managing the partnership petitioners were acting in their capacity as partners. They were performing basic duties of the partnership or business pursuant to the partnership agreement. ... There is no indication that any one of the petitioners was engaged in a transaction with the partnership other than in his capacity as a partner. We therefore hold that the management fees were not deductible business expenses of the partnership under section 707(a).39

A few years later, the IRS issued Rev. Rul. 81-300, which paralleled the holding of Pratt. The IRS also issued Rev. Rul. 81-301, which held that under specific circumstances described therein, an “advisor general partner” who could be removed by the board on 60 days’ notice; who could resign on 60 days’ notice; who provided similar investment advisory services to others as an independent contractor; and who received compensation from the partnership of a percentage of daily gross income received Code Sec. 707(a) payments (in a capacity other than as a partner). While such income allocation was not a distributive share of income under Code Sec. 702(a) nor a guaranteed payment under Code Sec. 707(c), the IRS determined such payments...
were to an independent contractor and not an employee.\textsuperscript{40}

If the \textit{Pratt} rationale, Rev. Rul. 300 and Rev. Rul. 301 are followed, the services provided by a partner must be outside the scope of the partnership to be rendered in a capacity other than that of a partner or must be of a nature that the partner is otherwise clearly acting as other than in the capacity of a partner with conditions that are inconsistent with those of a partner. Assuming those circumstances exist and the partner is acting other than in the capacity as a partner, the question then arises: in what capacity is the person providing such services—an employee or an independent contractor? The Code defines “partner” as a “member” of a partnership.\textsuperscript{41} Neither the Code nor the regulations define “member.” While the Code does not define “employee,” the regulations provide guidance to determine when a person is an employee for federal tax purposes. An employer-employee relationship generally exists when the person for whom services are performed has the right to control and direct the individual performing the services both with respect to (1) the result and the details, and (2) the means by which the result is accomplished.\textsuperscript{42} Generally, those following an independent trade, business or profession offering services to the public are not employees.\textsuperscript{43} The determination is based on facts and circumstances, and Rev. Rul. 87-41 provides 20 unweighted factors for analysis. Logically, in most situations, the service provider recipient of a partnership interest (capital or profits) is likely to be providing services within the scope of the partnership, or the partnership would not make the grant. However, can Rev. Rul. 81-301’s logic be used to argue that the provision of administrative services by a small interest member where the LLC has both the right to control and direct the member as to both the results to be achieved as well as the means by which the results are achieved is not that of a partner but one of an employee?\textsuperscript{44} In addition, it is at least arguable that administrative services such as those provided by assistants and office staff are outside the scope of the partnership even though they are facilitating the business. Many believe the interest owned by a partner must be more than \textit{de minimis}, but there is no identified authority or common understanding as to what interest, if any, is so small it can be ignored for purposes of determining whether someone is a partner. In most situations where the substantial service provider is not providing services within the scope of the partnership or in the capacity of a partner (as indicated in Rev. Rul. 81-301), the provider likely will be an independent contractor.

1984–2013

The period 1984–2013 is marked by the addition of Code Sec. 707(a)(2)(A) contained in the Deficit Reduction Act of 1984 (the “1984 Act”). This section provides that if a person provides services to a partnership and there is a related direct or indirect allocation and distribution to such partner, if the performance of such services and allocation when viewed together are properly characterized as a transaction occurring between the partnership and a partner acting as other than a partner, the transaction shall be treated as between one who is not a partner and the partnership.

Code Sec. 707(a)(2)(A) at a minimum expands the scope of Code Sec. 707(a)(1) and appears to make it more feasible for a partner to provide services to a partnership of which he or she is a member as clearly services that are within the scope of the partnership’s business are encompassed by Code Sec. 707(a)(2)(A). However, Code Sec. 707(c) dealing with guaranteed payments also contemplates payments to partners by a partnership for services within the scope of a partnership’s business and retains the character of the partner as a partner for most purposes of the Code. This sets up the question of how to resolve the tension between these two sections in the context of a service partner as a partner/employee or independent contractor vs. simply a partner receiving a guaranteed payment.

The legislative history of Code Sec. 707(a)(2)(A) indicates its purpose was to prevent aggressive taxpayers from avoiding the capitalization rules by using distributions and allocations rather than guaranteed payments.\textsuperscript{45} The Staff of the Joint Committee on Taxation’s general explanation in connection with the 1984 Act (the “1984 Blue Book”)\textsuperscript{46} provides five factors the staff considered to be relevant in determining whether services are rendered in a capacity other than that as a partner. These are:

1. risk as to the fact and amount of the payments;
2. transitory status of the partner;
3. proximity in time of the provision of the services to the distribution and allocation;
4. significance of the tax benefits to the recipient partner or the partnership in the decision of the recipient partner to become a partner; and
5. size of the partner’s continuing interest in relation to the payment for services.

The Blue Book indicates that the first factor is the most important. That factor, however, overlaps with the pre-existing guaranteed payment provision of Code Sec. 707(c), which provides:

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for purposes of section 61(a) (relating to gross
income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

The Regs. under Code Sec. 707(c) treat such payments as a part of the partner’s distributive share of income subject to self-employment tax, and not as wages of an employee of the partnership subject to withholding.\(^{47}\) Since Code Sec. 707(a)(2)(A) simply characterizes the allocation and distribution as subject to Code Sec. 707(a)(1), it does not address the character of the transaction. Code Sec. 707(a)(2)(A) uses the terms “transfers of property and allocation” and Code Sec. 707(c) uses the term “payment.” Is that a controlling distinction or difference? Does the wording associated with the agreement under which a partner provides services the controlling factor between a “guaranteed payment” in which the member retains the status of a partner with a limited carve out of related tax effects and a Code Sec. 707(a)(2)(A) transaction for service in which a partner is performing services within the scope of a partnership’s business in a capacity other than that as a partner?

The significance of Code Sec. 707(a)(2)(A) to the partner/employee analysis is unclear, but it may open the door for an IRS administrative action to permit the holders of a small membership interest who are providing ministerial or officer functions and generally receiving most of their annual economics from the LLC in the form of fixed payments to be treated as employees.

### 2013–Present

The new element is the visibility and pressure created by action of the District Court judge in Riether,\(^{48}\) citing Rev. Rul. 69-184 and expressly holding that a partner cannot be an employee. One of the many issues in that case was whether the taxpayers were liable for unpaid self-employment taxes on their distributive share of an LLC’s earnings in which they were the sole members and for which they provided services and received a W-2. The taxpayers’ argument was they each received a W-2 from their LLC employer, and thus, they were not self-employed. Each received a W-2 and a K-1. The Court stated:

In fact, Plaintiffs should have treated all of the LLC’s income as self-employment income, rather than characterize some of it as wages. Rev. Rul. 69-184 says ‘members of a partnership are not employees of the partnership’ for purposes of self-employment taxes’. ... Instead, a partner who participates in the partnership business is ‘a self-employed individual’. Because Plaintiffs did not elect the benefits of corporate-style taxation under Treasury Regulation §301.7701-3(a), they should not have treated themselves as employees in distributing the remaining $51,500 of the LLC’s income. The IRS made no bones about this, however, presumably because Plaintiffs had paid self-employment tax on that income through withholding.\(^{49}\)

The citation of Rev. Rul. 69-184 and the judge’s comments may have embarrassed the IRS. At a minimum, the Court’s position has raised the visibility of the issue to the National Office of the IRS and may pressure the IRS and the Treasury to review and perhaps enforce or modify its position. In the interim, it is possible that revenue agents will become sensitive to the employee/partner issue.\(^{50}\)

The increased visibility of the issue following Riether caused the New York City Bar Association Committee on Taxation of Business Entities\(^{51}\) and the accounting firm of McGladrey\(^{52}\) to each submit comments suggesting a change in the IRS position concerning dual status partners (i.e., both an employee and a partner). The ABA Section of Taxation’s Partnership Committee’s LLC and LLP Subcommittee, in conjunction with other committees of the ABA Section of Taxation, are presently preparing an issue and recommendation paper. Articles are beginning to appear in various tax and accounting publications.\(^{53}\)

### Potential Tax Ramifications of Treating a Partner as an Employee Under the Current IRS View of the Law

At the current time, there only appears to be one case—Armstrong—supporting (in dicta) that a partner can be an employee of his or her partnership. It is possible that the analysis of the IRS in Rev. Rul. 81-301 could be argued to be supportive of such analysis for administrative and other small interest personnel. As discussed above, the Circuit Court that rendered that decision appears to have backtracked in Pratt, which is generally interpreted as basically overturning Armstrong’s dicta. There is dicta in Riether clearly expressing the view that a partner cannot be an employee and citing Rev. Rul. 69-189, which, as discussed above, specifically provides that a partner cannot be an employee of his or her partnership. With the degree of relevance, if any, unknown, regulations under the Affordable Care Act provide that a partner is not an employee for purposes of the mandatory rules.\(^{54}\) This background makes it difficult to see “substantial authority” for the proposition that a partner of a partnership is an employee of such partnership except perhaps in most unusual circumstances, if then.
If a tax advisor or preparer decides to rely upon Armstrong or believes that Code Sec. 707(a)(1) and (a)(2)(A) provides support for the treatment of a partner in a specific situation as an employee subject to W-2 reporting, the tax advisor and/or tax return preparer must determine (1) if the service provider is a partner, (2) if so, whether the services are the services in the capacity of a partner, (3) if not, are the services those of an employee or an independent contractor. The Code provides a less than useful definition of “partner”—a “member of a partnership”—with neither the Code nor the Regs. defining “member.” While the Code does not define “employee,” the Regs. do provide guidance to assist in determining when an individual is an employee. An employer-employee relationship generally exists when the person for whom services are performed has the right to control and direct the individual performing the services both with respect to (1) the result and the details, and (2) the means by which the result is accomplished. Generally, those following an independent trade, business or profession offering services to the public are not employees. The determination is based on facts and circumstances, and Rev. Rul. 87-41 provides 20 unweighted factors for analysis.

As previously discussed, LLCs now commonly grant a “profits interest” to an individual for services. In order to qualify as a profits interest, the recipient must provide services to or for the benefit of the LLC. There is no requirement that such services must be within the scope of the partnership’s business. However, there is a requirement that the recipient of the profits interest must be treated as a partner for federal income tax purposes from the date of grant forward and take into account his or her distributive share for the entire period during which the service provider has the interest. The safe-harbor assures the recipient will have the benefit of no income on both the receipt and vesting of such interest and later will ordinarily recognize largely capital gains on disposition. Taking the position that such a recipient was not a partner with respect to the compensation paid for the services for which the profits interest is associated may well place the situation outside the safe-harbor. Unless the IRS or the courts decide that the specific interest is a profits interest even though it is outside the safe-harbor, this interest would presumably be evaluated in the same manner as a “capital interest.” There would be taxable compensation to the recipient upon the later of the grant or vesting, a deduction to the then-existing partners at such date, and no allocation of profits to the service provider prior to such date.

In addition to the potential loss of “profits interest” status as a result of the failure to treat the service provider as a partner from the date of grant of an interest otherwise qualifying as a profits interest, there are other potential tax ramifications to the LLC, the service member recipient and the employees of the LLC other than the service member recipient. These include the following:

- For the non-partner employees, if the LLC has a cafeteria plan, the participation of a partner can disqualify the cafeteria plan for all employees.
- While it is unclear if guaranteed payments to partners for services must be capitalized under Code Sec. 263A, it is clear that W-2 wages must be capitalized. This may increase the partnership’s current year income creating a level of phantom income for all the partners.
- The qualified production activities deduction of Code Sec. 199 is limited to 50 percent of the W-2 wages paid. Under the applicable definitions, neither self-employment income nor guaranteed payments to partners are W-2 wages. In situations where the production deduction activities produce results that equal or exceed the limitation, the characterization of a partner as having a dual status with W-2 compensation may increase the Code Sec. 199 benefit, but a reclassification by the IRS would reduce this benefit and create a deficiency.
- With respect to LLCs engaged in multi-state commerce and subject to tax in many states, if there is a difference in one or more states’ sourcing rules or payroll factor computations between W-2 and guaranteed payments, the treatment of compensation paid to partner/employees as W-2 expense may move more taxable income to some states and less to others than if the distributive share was reported as a guaranteed payment to a partner. It is possible, if the compensation is sufficiently significant, one or more states may challenge the employee classification and W-2 to change the apportionment.

Some potential tax ramifications for the partner/employee include the following:

- As discussed above, the risk that the treatment as a W-2 employee jeopardizes the receipt of an otherwise profits interest could be very material for the partner. If the service provider is not a tax partner because the interest is not a profits interest and is not vested, all distributions, if any, received presumably will be subject to employment tax and be ordinary income. During this period any capital gains the LLC generates will be irrelevant to such member, as he or she does not receive any tax benefit. The service provider’s otherwise share of depreciation and other non-cash deductions and credits will not flow to the service provider until and as interests vest. However, the same is true if any otherwise share of LLC income that is not
represented by cash distributions, as that income will flow to the other partners. At the time of vesting, the fair market value of such vested interest will represent compensation on which the individual is to pay tax even though the individual did not receive cash. In addition, if vesting occurs at the time of a liquidity event, all income will be compensation subject to ordinary income tax rates and employment taxes as opposed to most constituting capital gains.

- The treatment of the service provider as an employee can have negative tax consequences to such service provider. Since employment taxes are imposed on the individual’s net self-employment income, it is quite possible a nonrefundable overpayment of employment taxes attributable to such person will occur if the individual has self-employment losses from other activities. Those losses will not reduce the employment taxes associated with W-2 income as all W-2 income is subject to employment taxes.

- If the partner/employee has unreimbursed business expenses will the partner/employee be subject to the Code Sec. 67(a) two-percent adjusted gross income “haircut” for such expenses. For the self-employed, assuming the partnership agreement provides for expenses that partners are expected to bear, unreimbursed business expenses are deductible business expenses (reducing self-employment income on which social security taxes are computed as well as taxable income without the two-percent haircut). There is no known authority as to how to approach the two-percent adjusted gross income “haircut” in the context of a dual status partner/employee with respect to expenses associated with the individual’s activities for the partnership. Presumably, some sort of tracing might be required associating the expenses with the employee or partner activity. This will be an administrative burden to both the taxpayer and the IRS.

- The final income of the LLC is unlikely to be known when the W-2s are issued so the W-2 partner is likely to have a plus or minus adjustment with respect to his distributive share if he or she is to receive the appropriate amount at some time. Other flow-through items are likely to be included in the K-1 and will need to be reported by the W-2 partner. The partner/employee will still be subject to the complexities of the self-employed tax regime even if the fixed payments (and perhaps bonuses) are treated as employee compensation.

- If the LLC has a fiscal year other than the calendar year, there will be a difference in the timing of income. The partner/employee will be subject to tax on the income reported in a given calendar year on his or her W-2. A member will be tax on his or her distributive share not when the partner receives the cash, but in the tax year in which or with which the LLC’s tax year ends.

- If a member has been treated as an employee, withholdings have occurred, reducing the fixed dollars of compensation actually received by the member. If such withholdings are not remitted to the IRS, however, the member has potential tax exposure. If it is determined that the partner was not an employee with respect to the payments on which the LLC withheld, the member will be subject to income tax on the actual amounts received, and the individual will not receive credit for the amounts withheld. A small business LLC that issues equity to attract and/or retain key personnel is often a risky enterprise, and many of those go out of business. Often, payroll taxes have not been timely remitted as the entity was struggling to stay alive. A true employee, however, would receive credit for such amounts even if the IRS did not receive the funds. A self-employed partner would have received the full guaranteed payment or would be aware that he or she is not being paid or fully paid.

There may be potential ramifications to the tax return preparer as well. Under Code Sec. 6694, if a tax return preparer takes a position for which there is or was no substantial authority, and the position is not disclosed as provided in Code Sec. 6662(d)(2)(B)(ii)(I)—i.e., on Form 8275—the preparer may be subject to penalty. The penalty is the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return. The author understands the Office of Professional Responsibility is monitoring such penalties and may seek to take action on recurrent practitioners or firms. In addition, the AICPA Statement on Standards for Tax Services No. 1, Tax Return Positions provides that a CPA should not recommend a tax return position or take a position on a tax return that the member prepares unless the position complies with the applicable reporting and disclosure standards imposed by the relevant governing tax authorities. If there is not substantial authority for the W-2 treatment, is the CPA violating this standard?

With respect to the attempt to grant a nonvested profits interest to a service provider but to classify such provider as a W-2 employee, if the profits interest is disqualified as a profits interest, in the years in which vesting occurs, there may be a substantial understatement of tax. If an unsophisticated service provider receiving a W-2 after receiving a profits interest later has an IRS adjustment asserting a large liability (for example in the year of a liquidity event for which the individual claimed long-term capital gain)
with interest and perhaps penalty, the service provider is likely to be very unhappy and may seek a “contribution” from the tax advisor and/or preparer as well.

Present Strategies for Creating W-2/Partners

For those LLCs affirmatively willing to deal with the potential problem and with tax advisors aware of the potential problem, there are a number of strategies that can be employed with varying degrees of likelihood of success if challenged on the technical merits.

The first is to simply say that the services are provided in exchange for a distribution and allocation, and the partner providing such services is subject to the direction and control of the partnership and as such, is in the capacity of a common law employee and with respect to the compensation that is not dependent on the LLC’s profits, is a W-2 employee. This appears to be a common approach (either by default or conscious decision) but is clearly contrary to the IRS’s present position. As a technical matter, the tax return preparer should determine (1) whether the member is providing services in a capacity other than that as a partner, and, if so, (2) whether the appropriate characterization of that capacity is that of an independent contractor or an employee. If the preparer determines that under the factors of Rev. Rul. 87-41 the member would be serving in a capacity as an employee but for the fact the member is a partner, the preparer should determine if there is substantial authority for the concept of a partner providing services as an employee. If not, the preparer should consider disclosing the position on Form 8275, which would protect the preparer from preparer penalties in the event of an audit and a reclassification.

This disclosure, however, may be unpopular with clients.

Other methods require the establishment of another entity to either hold the membership interests of the LLC for which the individual member is an employee or to employ the member to provide services to the LLC. Each of these other structures can be awkward and impose a cost of creation and maintenance. Each of the other methods recognize that the ownership of the individual receiving the compensation must be such the individual is either (1) not a member of the LLC receiving the services, or (2) employed by and receiving compensation from another entity which in turn is providing services to the LLC.

One method involving the establishment of a new entity requires the creation of a single-member LLC wholly owned by the LLC in which the member holds an interest. As a wholly owned LLC, the LLC is disregarded for income tax purposes. However, for employment tax purposes, the single-member LLC is treated as a corporation with respect to federal employment taxes, including federal income tax withholding, FICA and FUTA. Therefore, this structure would appear to permit the treatment of a partner providing services to the single-member LLC to be treated as an employee of the single-member LLC as opposed to the operating LLC and will be subject to the employment taxes at the single-member LLC level. Unfortunately, this structure has the technical problem that under temporary Regs., the single-member LLC is disregarded for federal income tax purposes, including the self-employment tax. Therefore, under these final and temporary Regs., it appears the employee-partner may be subject to self-employment tax on the same compensation because, for income tax and self-employment tax purposes, such payment is treated as a guaranteed payment from the operating LLC. Code Sec. 1402(b) provides partial relief by permitting a reduction of self-employment net income subject to the Old Age, Survivors and Disability Insurance portion of the self-employment tax by the amount of the individual’s wages but that does not solve the entire problem. The element of double counting is clearly wrong since it was never intended that an individual could be subject to both the employment taxes and the self-employment tax on the same compensation. However, the IRS has expressed negativity toward the use of the single-member LLC in such circumstances. A technical argument as to why it is appropriate by a taxpayer could lead to a technical argument by the IRS for the element of double taxation.

A second method involves the creation of a holding partnership or S corporation, which in turn holds the interest in the operating partnership. This structure is often found where management has an aggregate fixed or formula percentage ownership of the operating LLC and investors the remainder. The use of a holding partnership permits individual managers to come and go using changing allocations, the freezing of an individual manager’s interest on departure, or the redemption of the individual manager upon leaving) without the necessity of transfer of interests at the operating LLC level nor involving the investors in decision as to who receives what interest. Often this partnership is a manager-managed LLC in which the primary individual(s) are the managers and key associates of the primary individuals are the other members. If there are bona fide business reasons for the creation of the holding partnership, the risk of the any successful assertion that the partnership should be disregarded under the anti-abuse rules or a successful challenge that the partnership should be considered an aggregate of its members is minimized. The use of an S corporation can achieve similar results,
but the one class of stock rule limits flexibility. Since a shareholder of an S corporation can be an employee of the S corporation, however, the use of an S corporation as the holding company does not have the same tax issues as a partnership and if the S corporation owns the membership interest no challenge to the W-2 status of the service provider is foreseen.

A third option is the creation of an entity to provide services to the LLC and the service providers are employees of such entity while members of the LLC. The partnership variation has similar potential issues as partnership holding company. In addition, using a separate service providing entity could shift the cost of various employee benefits from the operating LLC to the service entity, which would be an independent contractor of the operating LLC. The gross-up and related administrative issues that the operating LLC desires to avoid will be faced if the individual service provider’s compensation is going to equate to being an employee of the operating LLC.

**Conclusion**

At this time it is clear that the present position of the IRS is that an individual cannot be an employee of the partnership in which he or she is a partner. In circumstances in which an individual partner is providing services outside the scope of the partnership’s business or in other unusual circumstances where such partner is not providing services as a partner, the IRS believes that the partner is an independent contractor and not an employee. The Code statutorily recognizes that a partner can enter into transactions with his or her partnership in a capacity other than that as a partner. Code Sec. 707(a)(1)’s provisions as modified by Code Sec. 707(a)(2)(A) recognize a partner can provide services to a partnership in a capacity other than as partner. Code Sec. 707(a) does not characterize that relationship either as an independent contractor or as an employee. Code Sec. 707(c) specifically authorizes “guaranteed payments” not dependent on the profits of the partnership to compensate a partner for providing services to the partnership in the capacity of a partner. Code Sec. 707(c), however, maintains the partnership paradigm and the service provider as a partner. Since Code Sec. 707(a)(2)(A) was added after Code Sec. 707(c)(2)(A), Code Sec. 707(c) cannot be the exclusive means to characterize the relationship of a partner providing services to a partnership for a fixed fee and may provide a basis for the IRS to permit certain partners to be treated as employees with respect to at least their fixed compensation portion. In light of Ritter, the IRS is reviewing the situation and future guidance may be issued.

The author understands that senior people in the Treasury and the IRS are sympathetic to the plight of the holder of a small profits interest performing traditional employee services for largely fixed compensation. Tax practitioners should be aware of the potential issues associated with attempting to classify a partner as an employee. Hopefully the IRS and Treasury receive constructive comments, including comments and analysis from the ABA Tax Section, as how to address the situation in a rational manner that permits at least the smaller interest members whose compensation is largely fixed to be treated as employees with respect to such compensation.

**ENDNOTES**

1. As used in this article, a profits interest is an interest in a partnership or LLC as described in Rev. Proc. 93-27, 1993-2 CB 343, as supplemented by Rev. Proc. 2001-43, 2001-2 CB 191.
2. Individuals who have been employees all of their life often find it difficult to impose the self-discipline not to spend the amounts received and to make timely and sufficient quarterly payments. The result of such failure can be very stressful and disruptive to such person and the person’s family and is unlikely to result in endearment of the individual toward the LLC. This lack of endearment or affirmative creation of animosity (the grant of an interest in the LLC was supposed to be an incentive) is particularly true if the individual did not clearly understand that he or she was going to be self-employed as a result and have the quarterly payment and other obligations.
3. An employee has no filing obligations with respect to FICA taxes. For income taxes, there are withholding on the payments to the employee and the employee’s W-2 at the end of each year shows taxable compensation and the amount withheld is to be applied against the employee’s income tax liability on form 1040. The effort to comply with the federal tax obligations of an employee is much less than that required of a self-employed person.
5. Ritter, DC-NM, 919 F.3d 202d 1140.
8. Clifford Warren, special counsel to the IRS associate chief counsel (passthroughs and special industries) speaking at a Practicing Law Institute seminar in New York titled “Tax Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures, and Other Strategic Alliances” on May 20, 2014 said: “I would expect guidance on this issue [dual partner/employee status]. There is a lot at stake, it’s a very tough issue,” 2014 TNT 89-2, Doc. 2014-12612.
9. One respected tax commentator, James B. Sowell, in 2001 previously characterized the evolution of
the law as in four states in an excellent article. See James B. Sowell, Partner as Employees: A Proposal for Analyzing Partner Compensation, 2001 TNT 10-109, Doc. 2001-1502.

10 Supra note 5.

11 Reg. §301.7701-2.

12 See, for example, T. Robinson, CA-3, 60-1 ustc ¶9152, 273 F2d 503; H.K. Theater Corp., CA-8, 56-2 ustc ¶9972, 236 F2d 502; E. Doak, CA-4, 56-2 ustc ¶9708, 234 F2d 704.

13 Id.


15 Id., at 917.


17 Now Code Sec. 707(a)(1).

18 C.C. Wilson, CTCls, 67-1 ustc ¶93378, 376 F2d 280, 179 CTCls 725.

19 Id., at 752.

20 Supra note 12.

21 Wilson involved whether the managing partner could exclude meals and lodging provided by a partnership (husband and wife) on a ranch. The Court of Claims relied on the 1939 Code without considering Code Sec. 707’s application or effect.

22 GCM 34173 (July 25, 1969).

23 A. Armstrong v. Phinney, CA-5, 68-1 ustc ¶93555, 394 F2d 661.

24 Id., at 664.


26 H.H. Wegener, 41 BTA 857, Dec. 11,065, aff’d, CA-5, 41-1 ustc ¶93830, 110 F2d 49.

27 In this case, the IRS was arguing the taxpayer received amounts other than in his capacity as a partner. The taxpayer had reported two-thirds of the amount received for drilling as income but one-third (his partnership share) as a return of invested capital.

28 Wegener, supra note 26, 41 BTA 857, at 863.


33 GCM 34001 cites Reg. §1.701-1(c), but the quoted language is found in Reg. §1.707-1(c).

34 Id., at 9.

35 Code Sec. 706(a).


37 E.T. Pratt, CA-6, 77-1 ustc ¶93479, 550 F2d 1023.

38 Supra note 23, at 66.


40 It is hard for the author to see that the investment advisory services provided by the “partner” were not within the scope of the partnership. However, the unique nature of the arrangement, the fact the partner paid his own expenses, and the kinds of services that were of an independent contractor nature, which the partner was providing to others for a fee, carried the day.

41 Code Sec. 761(b).

42 Reg. §31.3401(c)(1)-b.

43 Reg. §31.3401(c)(1)-c.

44 In the context of a profits interest, it may be difficult for many to visualize the services for which the individual receives the profits interest as being the services that makes a person an employee after becoming a partner. However, a small interest partner who does not have entrepreneurial risk and who functions as a common law employee may in fact be in that position.


47 Reg. §1.707-1(c).

48 Supra note 5.

49 Id., at 17.

50 In McCladrey’s view, found in 2014 TNT 139-59, Tax Analysts Doc. 2014-17879 (July 21, 2014), “The IRS’ acceptance of the partnership’s treatment of the partners as dual capacity partner-employee arguably speaks louder than the court’s gratuitous dicta that such treatment was improper.”


54 Reg. §5.4.9490H01(a)(15).

55 Code Sec. 761(b).

56 Reg. §31.3401(c)(1)-b.

57 Reg. §31.3401(c)(1)-c.


59 Not all of the gain will be capital gain, as Code Sec. 751 “hot assets” will give rise to ordinary income, but in most cases the vast majority of the gain will be treated as capital gain on the sale or disposition of a partnership interest.

60 The contrary argument would be that the service provider has a dual status and is being treated as an employee with respect to certain services of an employee nature and by virtue of receiving a K-1 reflecting an allocation of profits above the “fixed compensation” the parties are treating the service provider as a partner.

61 Proposed Reg. §1.125-(g)(2).

62 See Code Secs. 312(d)(1) and (2) and 6051.

63 “Employees are nevertheless entitled to credit for the amount of income and FICA taxes withheld whether or not the employer pays over the withheld taxes to the government.” Saltzman, IRS PRACTICE AND PROCEDURE ¶17.06[2].

64 AICPA, Professional Standards, Vol. 2.

65 Code Sec. 6664. See also Noel P. Brock, Treating Partners as Employees: Risks to Consider, J. ACCOUNTANCY, Vol. 218 (2014).


67 Reg. §301.7701-2(c)(2)(iv)(b).

68 Temporary Reg. §301.7701-27(c)(2)(iv)(A) specifically provides that the wholly owned LLC subsidiary is disregarded for purposes of the self-employment tax. That means that guaranteed payments from the wholly owned subsidiary is a guaranteed payment from the LLC and therefore subject to the self-employment tax.

69 Guaranteed payments from a partnership engaged in a trade or business are subject to self-employment tax. Reg. §1.1402(a)-1(b).

70 See GCM 34001 (Dec. 23, 1968). “Since the provisions of the two taxing systems [self-employment tax of subtitle A and the employment taxes of subtitle C] are interrelated and mutually exclusive, . . . contrary to Congressional intent and the structure of the statutes.”


72 While an S corporation is a passthrough entity for federal tax purposes, there may be negative state tax consequences associated with the S corporation that is not faced with an LLC. For example, California and Illinois impose a 1.5-percent entity-level tax on the portion of an S corporation’s taxable income allocable to the state. CA Rev. and Tax Code Sec. 23802(b) and ILCS 5/201(d). While Tennessee imposes 6.5-percent excise tax on both S corporations and most LLCs (Tenn. Code Ann. Sections 67-4-2007, 67-4-2006(a)(2) and (a)(4)) distribution from an S corporation is subject to a six-percent tax while a distribution from an LLC is not (Tenn. Code Ann. section 67-2-101(6) and 67-2-102).

73 Code Sec. 707(c).