NEW YORK
CITY BAR

COMMITTEE ON TAXATION OF BUSINESS ENTITIES

MICHAEL J. MILLER
CHAIR
WORLDWIDE PLAZA
825 EIGHTH AVENUE
FL 37
NEW YORK, NY 10019-7498
Phone: (212) 903-8757
Fax: (212) 974-3059
mmiller@rhtax.com

June 18, 2014

The Honorable Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: New York City Bar Report Offering New Proposed Guidance on the Treatment of a Partner as an Employee for Federal Tax Purposes

Dear Assistant Secretary Mazur and Commissioner Koskinen:

On behalf of the New York City Bar, as reported by the Committee on Taxation of Business Entities, I am pleased to submit this report offering proposed guidance on the treatment of a partner as an employee for federal tax purposes.

Under the current Treasury Regulations, an individual cannot be both a partner and an employee of the same partnership. Because the tax consequences to the individual can vary greatly depending on her classification, individuals and their tax advisors have devised mechanisms to change the characterization of the individual from a partner to an employee for different purposes. These mechanisms, however, add unnecessary complexity and expense, and in some instances, uncertainty as to whether the intended outcome will be respected. Moreover, the authority for a single classification as either a partner or an employee is dated and circumstances have changed. With the explosion in the use of limited liability companies in recent years, we believe it is time to re-examine the basic premise and provide new guidance allowing certain partners to be treated as employees for federal tax purposes.

The Committee proposes that a partnership be allowed to elect to treat individual partners whose share of partnership profits is 10% or less as employees with respect to fixed compensation paid to them if, but for such share of partnership profits, the relationship between the partner and the partnership would be that of an employee with an employer. Once made, the election would be effective for all qualified payments made to all such partners in the electing partnership. Such treatment would greatly simplify tax reporting and compliance, without adversely affecting the fisc, and would eliminate the need for alternative structures to try to achieve the same results. The proposed changes can be implemented through Treasury Regulations.

We are pleased to discuss any questions you may have. Please feel free to contact the undersigned at (212) 903-8757 or via e-mail at mmiller@rhtax.com.

Very truly yours,

Michael J. Miller

Michael J. Miller
Chair

Enclosure

cc: William J. Wilkins, Chief Counsel
Internal Revenue Service
Victoria Judson, Associate Chief Counsel (Tax Exempt & Government Entities)
Internal Revenue Service
Drita Tonuzi, Associate Chief Counsel (Procedure & Administration)
Internal Revenue Service
Curtis G. Wilson, Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

NEW YORK CITY BAR ASSOCIATION
Report Offering New Proposed Guidance on the Treatment of a Partner as an Employee for Federal Tax Purposes
As Reported by the Committee on Taxation of Business Entities
June 18, 2014

This report, which is submitted on behalf of the New York City Bar Association by its Committee on Taxation of Business Entities,[1] proposes new guidance, relating to the treatment of certain partners as employees for federal tax purposes.[2]

Under the current Treasury Department and Internal Revenue Service (collectively, the "IRS") rules, an individual cannot be both a partner and an employee of the same partnership. Because the tax consequences to the individual can vary greatly depending on her classification, individuals and their tax advisors have devised mechanisms to change the characterization of the individual from a partner to an employee for different purposes. These mechanisms, however, add unnecessary complexity and expense, and in some instances, uncertainty as to whether the intended outcome will be respected. Moreover, the authority for a single classification as either a partner or an employee is dated and circumstances have changed. With the explosion in the use of limited liability companies in recent years, we believe it is time to re-examine the basic premise and provide new guidance allowing certain partners to be treated as employees for federal tax purposes.

I. Executive Summary

The Committee proposes that a partnership be allowed to elect to treat individual partners whose share of partnership profits is 10% or less as employees with respect to fixed

[1] The authors of this report are Alan J. Tarr, John P. Barrie, Jill Darrow, Hillel Jacobson and Mark Stone. Helpful comments were provided by Stephen Foley and John C. Dworkin.
[2] As used in this report, a partnership means an entity or arrangement that is treated as a partnership for federal income tax purposes, and a partner is a member of a partnership. IRC § 761(a), (b). Unless otherwise indicated, all Section references are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

compensation paid to them if, but for such share of partnership profits, the relationship between the partner and the partnership would be that of an employee with an employer. Once made, the election would be effective for all qualified payments made to all such partners in the electing partnership. Such treatment would greatly simplify tax reporting and compliance, without adversely affecting the fisc, and would eliminate the need for alternative structures to try to achieve the same results. The tax treatment of such alternative structures is not always clear. Requiring their use not only adds complexity and additional costs, but is also a trap for the unwary. The proposed changes can be implemented through Treasury Regulations.

II. Proposed New Guidance

Proposal. The Committee recommends that the IRS adopt a new rule pursuant to which a partnership may irrevocably elect, on behalf of itself and its partners, to treat qualifying payments for services provided to the partnership by its qualifying partners as wages for federal tax purposes if, but for being a partner, the partner would be treated as an employee of the partnership with respect to such services. For this purpose, a "qualifying payment" is a guaranteed payment under Section 707(c) or a non-partner payment under Section 707(a), and a "qualifying partner" is an individual with a 10% or smaller interest in partnership profits during the taxable year.

The election would be effective for all qualified payments made by the partnership to qualifying partners during and after the taxable year. The election could be revoked by the partnership only with the consent of the IRS. While the election is in effect, qualified partners would be treated as employees with respect to qualified payments for all tax purposes, including withholding, employment taxes and benefits. The Committee believes that such treatment is simple and straight forward, and should not impose much, if any, additional cost on the

Government. Alternatively, if the IRS finds there would be more than a *de minimis* cost, the treatment could be limited (*e.g.*, to reporting, withholding and employment taxes).

In particular, the Committee proposes that Treasury Regulations § 1-707-1(c) be amended to treat qualified payments to qualified partners of electing partnerships as wages, and that Treasury Regulations § 301.7701-2(c)(2)(iv)(B) be conformed to the proposal to provide that payments by a disregarded entity[3] of a partnership to a partner for services provided by the partner in her capacity as an employee of the disregarded entity are treated in the same manner as if such payments were made by the partnership under the proposal. Even if the proposal is not adopted, Treasury Regulations § 301.7701-2(c)(2)(iv)(B) should be clarified so that the same payments are not treated both as wages from the disregarded entity (which is treated as a separate corporation for this purpose) and as self-employment income to the partner from the partnership.

Purpose. The Committee understands that many partnerships currently treat fixed compensation paid to a partner as wages.[4] Some partners sign employment agreements just like employees. Some partnerships may simply forget to eliminate withholding when an employee becomes a partner. More knowledgeable partnerships have used other structures to try to obtain the same result. The Committee believes that the proposal would simplify the law and conform to the desired treatment, while not adversely affecting the fisc. Treating payments for services as wages would require the partnership to withhold income and employment taxes and pay the employer share of employment taxes. Withholding not only collects a greater proportion of the taxes due as compared to partners' payments of estimated taxes, but also accelerates the

[3] Pursuant to Treas. Reg. § 301.7701-3(b)(2)(ii), a domestic business entity that has a single owner and that is an "eligible entity" will be disregarded as an entity separate from its owner, unless it elects to be classified as an association.

[4] *See, e.g.,* Partnership Income and Expenses, BNA-TPG 2013 Form 1065, 5.4 (2013) ("It is not uncommon to see partnerships pay partners as employees, withhold taxes, and issue W-2 forms at the end of the year."); Brock, "Partners as Employees? Properly Reporting Partner Compensation," Tax Advisor (Nov. 2013) at http://www.aicpa.org/publications/taxadviser/2013/november/pages/brock_nov2013.aspx.

payments to the government.[5] Moreover, the proposal eliminates any tax deferral where the partnership has a taxable year other than the calendar year.[6]

In addition, partnerships frequently incentivize key employees by granting profits interests.[7] A profits interest does not share in net losses of the partnership.[8] Moreover, many of those profits interests do not share more than a *de minimis* amount of profit except upon a sale of the partnership. In such cases, the proposal mitigates some of the tax compliance burdens for the profits interest holders, who generally lack familiarity with partnership tax reporting and the requirement to make estimated tax payments, by transferring the tax payment and reporting obligations from the partners to the electing partnership with respect to the qualified payments for services.

In short, the proposal harmonizes the tax treatment and reporting by electing partnerships of qualified payments, which are in the nature of wages but happen to be paid to partners, with the tax treatment and reporting of compensation paid to non-partner employees.

<u>10% Partner Limitation.</u> One major purpose of the proposal is to mitigate the compliance burdens created when individuals who are accustomed to receiving salary payments subject to withholding become partners and receive qualified payments. When an individual receives wages, the tax compliance and reporting burden falls primarily on the employer. In the case of a partner, however, the partner becomes responsible for quarterly estimated tax payments, including both income and self-employment tax. Wage-earners who become partners

[5] *See*, Twight, Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change, 14 Cato Journal 359 (Winter 1995). *See also* Statement of Randolph Paul, Data Relating to Withholding Provisions of 1942 Revenue Act (Aug. 22, 1942) at http://freedom-school.com/tax-matters/withholding-tax-1942-pgs-16-30.pdf; S. Rep. No. 494, 97th Cong., 2d Sess. 228 (1982). Withholding on wages, which generally constitute the bulk of an individual's income, does not face the same equity issues with respect to over-withholding that plagued the short-lived withholding on interest and dividends of domestic taxpayers.

[6] *See* Treas. Regs. § 1.707-1(c).

[7] For purposes of this report, a profits interest has the meaning set forth in Rev. Proc. 93-27, 1993-2 C.B. 343.

[8] IRC § 704(b).

are likely to be unfamiliar with a Schedule K-1, the self-employment tax and the requirement to pay estimated taxes, and, unless they budget for taxes, these partners may incur significant penalties for late estimated tax payments. These compliance burdens are greater for partners whose share of partnership profits is small, especially when compared to their qualified payments for services to the partnership; such qualified payments represent the partner's primary source of income from the partnership.

For this reason, the Committee believes that it may be appropriate to limit the elective system of reporting proposed herein to partners whose interest in partnership profits (over and above any guaranteed payment) is relatively small.

The Committee considered various percentages (*e.g.*, 1%, 2% and 5%), but decided that 10% is a reasonable limitation. On the one hand, the percentage should not be so high as to apply to partners for whom the compliance burdens are not likely to be onerous, who are more likely to be deriving significant income from the partnership in addition to the applicable payments, or who in any event are receiving significant partnership allocations (in addition to guaranteed payments) that are properly reported on a Schedule K-1. On the other hand, the percentage should not be so low as to exclude partners who would – and should – benefit from wage reporting. The Committee believes that the IRS should determine the appropriate percentage limitation, and suggests 10% as a reasonable compromise between these competing considerations.

III. Current Law

Can a Partner Be an Employee of the Partnership?

1939 Code. Prior to 1954, partnerships were viewed under the "aggregate" theory as having no separate legal existence apart from its partners. As such, it would have been impossible for a partner to be employed by the partnership. The service provider could not be both an employer and an employee.[9]

1954 Code. With the enactment of the 1954 Code, the treatment of a partnership became more complicated; a partnership is treated as an entity for certain purposes, but remains an aggregate of the partners for others. Generally, the 1954 Code adopted an entity characterization for transactions between a partner and the partnership.[10]

Section 707(a)(1). Based on the enactment of Section 707(a),[11] which treats a partner who renders services to the partnership other than in her capacity as a partner in the same manner as one who is not a partner, the Fifth Circuit in *Armstrong v. Phinney* held that, following the enactment of the 1954 Code, "it is now possible for a partner to stand in any one of a number of relationships with his partnership, including … employee-employer."[12]

The IRS, however, refused to follow *Armstrong* and continued to hold that a partner cannot be an employee of the partnership.[13] First, the IRS determined that wages of an employee under Section 3121(a) and self-employment income of a partner under Section 1401(a) are mutually exclusive; the same income cannot be subject to both employment tax and self-employment tax. The IRS then relied on the Treasury Regulations defining an employment relationship to extend the holding to income from the same source – *i.e.*, to all income from the

[9] *See Commissioner v. Doak*, 234 F.2d 704 (4th Cir. 1956) (partner may not be an employee of his partnership); *Commissioner v. Moran*, 236 F.2d 595 (8th Cir. 1956) (same); *Commissioner v. Robinson*, 273 F.2d 503 (3d Cir. 1959) (cert. denied) (same); Rev. Rul. 53-80, 1953-1 C.B. 62 (same).
[10] H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 67 (1954).
[11] Now Section 707(a)(1).
[12] 394 F.2d 661, 664 (5th Cir. 1968) (with respect to treating a partner as an employee for purposes of the exclusion for meals and lodging under § 119). The Fifth Circuit disregarded *Wilson v. United States*, 376 F.2d 280 (Ct. Cl. 1967), which relied on the 1939 Code without any consideration of the applicability or effect of § 707.
[13] *See, e.g.*, Rev. Rul. 69-184, 1969-1 C.B. 256, Rev. Rul. 71-502, 1971-2 C.B. 199; GCM 34001 (Dec. 23, 1968), GCM 34173 (July 25, 1969).

same partnership. Lastly, the IRS disagreed with the Fifth Circuit's determination that Section 707(a) required a different conclusion.[14]

> 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.[15]

Put simply, "[p]artnership remuneration is not 'wages' subject to FICA, FUTA, and income tax withholding."[16] Instead, payments to the service provider are treated the same as if they were the partner's distributive share, and as a result are subject to self-employment tax under Section 1402.[17] Although this position was cited by the District Court in *Riether v. United States*,[18] neither the IRS nor the court found that the treatment of the fixed compensation as wages reported on a Form W-2 was improper.

<u>Section 707(c)</u>. Pursuant to Section 707(c), guaranteed payments – that is, payments made by the partnership to a partner for services that are determined without regard to the income of the partnership (and are not covered by Section 707(a)) are considered made to a person who is not a member of the partnership, but only for purposes of Sections 61(a) and 162(a).[19] The Treasury Regulations treat such payments as part of the partner's distributive

[14] GCM 34001 (Dec. 23, 1968), GCM 34173 (July 25, 1969).
[15] Rev. Rul. 69-184 (to qualify as an employee for employment tax purposes, a worker must be classified (1) as not a bona fide member of the partnership and (2) as an employee under the common law control test).
[16] *Id.*
[17] *See id.*; GCM 34001 (Dec. 23, 1968).
[18] 919 F. Supp.2d 1140 (D.N.M. 2012) (with respect to the self-employment tax).
[19] Although *Armstrong* also held that a partner receiving meals and lodging as guaranteed payments is entitled to the § 119 exclusion, that determination is based on an interpretation that the reference to § 61 incorporates by reference the exclusions from § 61 gross income. See also *Carey v. United States*, 427 F.2d (Ct. Cl. 1970); *Miller v. Commissioner*, 52 T.C. 752 (1969), acq. 1972-2 C.B. 2. Since employment taxes and self-employment taxes are not related to § 61 or 162, such an argument is not relevant here. *Cf. Kampel v. Commissioner*, 634 F.2d 708 (2d Cir. 1980) and *Zahler v. Commissioner*, T.C. Memo 1987-112 (with respect to the 30% limitation under § 911(b) for purposes of the maximum tax on earned income under former § 1348).

share of income subject to self-employment tax, and not as wages of an employee of the partnership subject to withholding.[20]

Section 707(a)(2). Enacted in 1984, Section 707(a)(2) treats the performance of services by a partner to the partnership as occurring under Section 707(a)(1) if there is a related direct or indirect allocation and distribution to the partner and, when viewed together, the performance of the services and the allocation and distribution are more properly treated as occurring between partnership and a partner acting other than in her capacity as a partner. Since the effect is merely to treat the transaction under Section 707(a)(1), Section 707(a)(2) does not itself affect the characterization of a partner. Moreover, the purpose of Section 707(a)(2) was to close a loophole in Section 707(a) that may have allowed a deduction for payments that should be capitalized.[21]

Is a Service Provider a Partner or Employee? As discussed in Part IV, below, a service provider's tax treatment differs based upon her classification as a partner or an employee. Because the IRS will no longer issue private letter rulings as to whether a service provider is a partner or employee,[22] the determination is left to judicial interpretation of the Code and common law.

Partner. A partner is simply defined as a member of a partnership.[23] A partnership includes any business entity "through or by means of which any business ... is carried on, which is not... a corporation or a trust or estate,"[24] and which has at least two non-disregarded members.[25] A business entity, in turn, is any entity that carries on a business

[20] Treas. Regs. § 1.707-1(c).
[21] S. Prt. No. 169, 98th Cong., 2d Sess. 225 (1984).
[22] Rev. Proc. 2014-3 § 3.01(83), 2014-1 I.R.B. 111.
[23] IRC § 761(b).
[24] IRC § 761(a).
[25] Treas. Regs. § 301.7701-2(c)(1).

activity; it encompasses joint ventures and other contractual arrangements if the participants intend to carry on a trade, business, or financial operation and divide the profits therefrom.[26]

Although the check-the-box regulations will distinguish whether a business entity is a partnership or a corporation (or a disregarded entity), the existence of a business entity for federal income tax purposes depends on the intent of the parties – did the parties, in good faith and acting with a business purpose, intend to join together and divide the profits from the venture as co-owners.[27]

Absent an election to be taxed as a corporation, a domestic unincorporated business entity with two or more non-disregarded members is characterized as a partnership.[28]

Generally, a corporation is a business entity that either is required to be treated as a corporation for federal tax purposes (such as a domestic corporation, an insurance company or a state-chartered bank), or elects to be treated as a corporation under the check-the-box regulations.[29]

A trust, in contrast, is an arrangement whereby trustees take title to property "for the purpose of protecting or conserving it for the beneficiaries" of the trust.[30] Generally, an arrangement will be treated as a trust for federal tax purposes if it can be shown that the beneficiaries do not share in the responsibilities assigned to the trustees – *i.e.*, the protection or conservation of the trust's corpus – and therefore are not associates in a joint enterprise for the

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[26] Treas. Regs. § 301.7701-1(a).
[27] *See Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946).
[28] Treas. Regs. § 301.7701-3(b)(1)(A). If such entity had only one member, it would be disregarded as an entity separate from its owner. Treas. Regs. § 301.7701-3(b)(1)(B). The same rules apply to foreign entities if at least one member does not have limited liability under the laws of the jurisdiction in which the entity was formed. If each member of the foreign entity has limited liability, it is treated as a corporation for federal income tax purposes unless it elects to be treated as a partnership. Treas. Regs. § 301.7701-3(b)(2).
[29] Treas. Regs. § 301.7701-2(b).
[30] Treas. Regs. § 301.7701-4(a).

conduct of business for profit.[31] Business trusts and certain investment trusts, however, are not classified as corporations or partnerships for federal tax purposes because they are not created to protect or conserve property for its beneficiaries, but rather to carry on a profit-making business.[32]

<u>Employee</u>. Whether a service provider will be considered an employee for purposes of the Federal Insurance Contribution Act ("FICA"), the Federal Unemployment Tax Act ("FUTA"), and federal income tax withholding is generally based on common law principles.[33] An employee-employer relationship is deemed to exist if the service recipient has the right to control and direct the service provider as to both the results to be achieved, as well as the means by which those results are achieved.[34] Revenue Ruling 87-41 describes 20 factors that aid in this determination, including factors relating to the employer's control (*e.g.*, instructions, training, setting hours, setting order of work, requiring reports, right to discharge), the employee's ability to have a loss (*e.g.*, hiring of assistance, providing tools, investment, payment of expenses), and the permanence of the position (e.g., working for more than one person, holding oneself out to the public as being available).[35] The factors are only guides for determining whether an individual is an employee. The degree of importance of each factor depends on the occupation and factual context in which the services are performed.[36] The courts have employed similar and sometimes additional factors.[37]

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[31] *Id.*

[32] Treas. Regs. § 301.7701-4(b), (c).

[33] IRC §§ 3121(d)(2), 3306(i), 3401(c). In addition, certain statutes deem certain service providers to be employees or non-employees. *See, e.g.*, IRC §§ 3121(d)(3) (treating certain agent-drivers, commissioner drivers, life insurance salesmen, home workers and traveling or city salesmen as employees), 3121(b) (treating certain listed services as not constituting employment), 3508 (treating qualified real estate agents and direct sellers as non-employees).

[34] Treas. Regs. §§ 31.3121(d)-1(c)(2), 31.3306(i)-1(b), 31.3401(c)-1(b).

[35] 1987-1 C.B. 296.

[36] *Id.*

[37] *See, e.g., Levine v. Commissioner*, T.C. Memo 2005-86; *Kumpel v. Commissioner*, T.C. Memo 2003-265; *In re Rasbury*, 130 Bank. Rep. 990 (Bktcy. Ct. AL 1991), *aff'd*, 141 Bank. Rep. 752 (DC AL 1992).

Dual Status. Notwithstanding the foregoing, Section 3508 expressly permits a qualified real estate agent or direct seller to be both an independent contractor (with respect to services described in Section 3508) and an employee (with respect to other services, as determined under common law) of the same service recipient.[38] This is precedent for the proposed dual classification.

IV. Federal Tax Differences Between Partners and Employees

Federal tax law treats partners and employees differently in various ways, including the following:

Timing of Income. An employee is subject to tax on compensation income when she actually or constructively receives payment.[39] The timing of a partner's recognition of compensation income, however, varies depending on the manner in which the partner earns the income from the partnership. A partner is taxable upon her distributive share of partnership income and guaranteed payments from the partnership at the end of the partnership's taxable year, regardless of the timing of payment.[40] As a result, if the partnership's tax year differs from the partner's tax year, the partner can defer income recognition.[41] If, however, a payment is treated as being made to a partner other than in her capacity as a member of the partnership under Section 707(a)(1), the partner earns compensation income in the partner's year of receipt without regard to the partnership's tax year.[42]

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[38] *See* Prop. Treas. Regs. § 31.3508-1(j).

[39] *See, e.g.*, Treas. Regs. §§ 31.3121(a)-2(b); IRC §451(a); Treas. Regs. §§ 1.451-2, 1.446-1(c)(1)(i).

[40] IRC § 706(a); Treas. Regs. § 1.707-1(c). Basis adjustments prevent the partner from recognizing income again when her distributive share of income is distributed. IRC §§ 705(a), 731(a); Treas. Regs. § 1.731-1(a)(i).

[41] Treas. Regs. §§ 1.706-1(a)(2), 1.707-1(c).

[42] IRC § 707(a)(1); Treas. Regs. § 1.707-1(a). Because both the partner and the partnership are on the partner's tax year for § 707(a)(1) payments, the partnership's deduction may be deferred. Although § 707(a)(1) payments are "considered as occurring between the partnership and one who is not a partner", the Code treats the partner and partnership as "related" for purposes of deducting expenses. IRC § 267(a)(2), (e)(1)(B); Rev. Rul. 81-301, 1981-2 C.B. 144.

Character of Income. An employee's compensation for personal services is always ordinary income.[43] However, the character of a partner's income depends on the capacity in which the partner is entitled to the payment from the partnership. The character of a partner's distributive share of partnership income is determined at the partnership level, and may be either capital gain, ordinary income or a combination of both.[44] Guaranteed payments under Section 707(c)[45] and non-partner payments under Section 707(a)(1),[46] for services constitute ordinary income.

Withholding and Reporting. Generally, an employee's compensation is characterized as "wages" subject to employer withholding and reporting requirements, among other rules.[47] The employer bears the responsibility to comply with federal tax obligations – to report wages and non-wage compensation and withhold income and FICA taxes, and to pay the employer's portion of FICA and FUTA taxes.[48] The employee merely files a Form 1040 following the close of the taxable year.

A partner, on the other hand, is not an employee of the partnership and her compensation from the partnership is not "wages".[49] Instead, the partnership files an annual information returns on Form 1065 and sends a Schedule K-1 to each partner.[50] Partners are generally required to report their income from the partnership on Form 1040, including Forms 1040-SE

[43] In order to be capital, gain (or loss) must satisfy requirements of §§ 1221 and 1222, which require a "sale or exchange" of "property." *See Id.*; IRC § 1221(a)(4); Treas. Regs. § 1.1221-1(d). Personal services are not property, and compensation for personal services is not a sale or exchange.
[44] IRC §§ 702, 704.
[45] Treas. Regs. § 1.707-1(c); IRS Pub. 541, Partnerships, 7 (2013).
[46] IRC §§ 707(a)(1), 61(a); Treas. Regs. § 1.707-1(a)(1).
[47] IRC §§ 3121(a) (FICA), 3401(a) (income tax withholding), and 3306(b) (FUTA) provide three separate definitions of "wages," which include most cash and non-cash remuneration for services; employer requirements include §§ 3102 (deduction); 3402(a) (withholding), and 6051 (employer statement).
[48] IRC § 6051; Treas. Regs. § 1.6051-1; IRC §§ 6011, 6041(a), (d); Treas. Regs. § 1.6041-2.
[49] Rev. Rul. 69-184, 1969-1 C.B. 256; Treas. Regs. § 1.707-1(c).
[50] IRC §§ 6031, 6072; Treas. Regs. §§ 1.6031(a)-1, 1.6031(b)-1T(a)(1), (a)(3).

(self-employment) and 8959 (the additional Medicare tax), and remuneration for services is generally reportable as income from self-employment.[51] Partners must make quarterly estimated tax payments,[52] and may be subject to a penalty if insufficient payments are made.[53]

Social Security and Medicare Taxes. Service partners and employees generally owe social security and Medicare taxes on their service income. However, the governing provisions are not identical. Wages to an employee are subject to FICA, while partners' net earnings from self-employment are subject to the self-employment tax.[54] Generally, employees and employers each owe half of the FICA taxes.[55] The employer generally may deduct its half of the FICA tax payments as a business expense.[56] Partners owe all of the self-employment tax, but partners are generally entitled to a deduction for half of the self-employment tax paid.[57]

Both FICA and the self-employment tax have two basic components: (1) the Old-Age, Survivors, and Disability Insurance ("OASDI" or "social security") tax and (2) the Hospital Insurance ("HI" or "Medicare") tax. The social security tax only applies up to the social security wage base ($117,000 for 2014), while basic Medicare taxes apply to all of the employee's wages and 92.35% of the partner's earnings from self-employment.[58]

[51] "Net earnings from self-employment" generally includes trade or business income, less deductions. IRC §§ 1402(a), (c), 61(a), 162.
[52] IRC § 6654(a).
[53] *Id.* The IRS may waive the penalty in some circumstances. *See* IRC § 6654(e)(3).
[54] IRC §§ 3101, 3102, 3111, 1401, 1402.
[55] *Id.* The FICA tax rate is 6.2% (OASDI) on wages up to the social security wage base, plus 1.45% (HI) on all wages, payable by each of the employee and the employer. The additional 0.9% Medicare tax on employees is discussed below.
[56] IRC § 162(a)(1).
[57] IRC §§ 1401, 1402. The self-employment tax rate is 12.4% (OASDI) on 92.35% of self-employment income up to the social security wage base, plus 2.90% (HI) on 92.35% of all self-employment income. The 92.35% reflects the deductibility of one-half the tax. IRC §§ 1402(a)(12), 164(f) (deduction); Treas. Regs. § 1.1402(a)-1(a)(2). The additional 0.9% Medicare tax is discussed below.
[58] IRC §§ 3101, 3102, 1401(a), (b), 1402(a), (b).

An employee or a partner is also subject to an additional 0.9% Medicare tax on wages or self-employment income in excess of the applicable threshold.[59] In the case of an employee, the employer must withhold the additional tax,[60] but there is no employer counterpart to the additional Medicare tax. Partners must include the additional tax in their estimated tax payments,[61] but cannot deduct any portion of the additional tax.[62]

Business Expense Deductions. If an employee incurs an expense in connection with her employment, such expense is deductible as a miscellaneous itemized deduction, subject to the 2% of adjusted gross income floor under Section 67.[63] Accordingly, employees are only allowed to deduct unreimbursed employee expenses (*e.g.*, expenses for business travel and lodging, continuing education, work uniforms and professional dues), to the extent such expenses along with other miscellaneous itemized deductions exceed 2% of the employee's adjusted gross income.[64] However, the 2% floor does not apply to a partner's expense in connection with her partnership business.[65] While partnership expenses generally are deducted on the partnership's return, partners may deduct or exclude unreimbursed partnership business expenses on their individual returns, assuming such expenses are ordinary and necessary business expenses and the partnership practice is not to reimburse partners for such expenses.[66]

Employee Benefits. A taxpayer's income includes the value of compensation regardless of form, including benefits such as insurance premiums, transportation, meals, lodging and any

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[59] IRC §§ 3101(b)(2), 1401(b)(2).
[60] IRC § 3102(f).
[61] IRC §6654(f)(2).
[62] IRC §§ 164(f), 1402(a)(12)(B).
[63] Treas. Regs. § 1.67-1T(a)(1)(i).
[64] IRC §§ 62(a)(1), 67(a); Treas. Regs. §1.67-1T.
[65] IRC §§ 162(a), 1402(a).
[66] *See, e.g.*, Tech. Adv. Mem. 9316003. *See also* MCKEE, NELSON & WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ("MCKEE"), ¶9.01[2], n. 14 (Thomson Reuters/Tax & Accounting, 4th ed. 2007 & Supp. 2014-1).

other form of property or services compensation, except to the extent excluded by law.[67] Although the Code and Treasury Regulations allow partners and employees to exclude some partnership and employer-provided benefits to the same extent, the taxation of other benefits is not identical and, in those cases, generally is more favorable to employees. The cost of such benefits to the government, however, is minor compared to the savings based on having taxes withheld by the partnership rather than relying on estimated tax payments from the partners.

Retirement Benefits. Pension benefits available to partners and employees are generally the same. For example, in Section 401, the definition of "employee" includes "an individual who is a self-employed individual for such taxable year."[68]

Cafeteria Plans. Cafeteria plans allow participating employees to choose between two or more taxable and non-taxable benefits, subject to qualification requirements.[69] Because the selection of a non-taxable benefit from a cafeteria plan does not trigger constructive receipt,[70] it allows an employee to convert otherwise taxable income into non-taxable benefits.[71] Partners, however, are not eligible to participate in cafeteria plans.[72]

Fringe Benefits. The Code and Treasury Regulations allow employees to exclude certain employer-provided statutory fringe benefits from taxable income.[73] Many fringe benefits cover all persons who perform services, including partners.[74] Accordingly, service partners may

[67] Treas. Regs. §§ 1.61-1(a), 1.61-21(a).
[68] IRC § 401(c)(1).
[69] IRC § 125(a), (d)(1)(B); Prop. Treas. Regs. § 1.125-1(a).
[70] IRC § 125(a); *see* Prop. Treas. Regs. § 1.125-1(b)(1).
[71] *See, e.g.*, Rev. Proc. 2013-35 § 3.15, 2013-47 I.R.B. 537.
[72] IRC § 125(d)(1)(A); FSA 200031003. *See* Prop. Treas. Regs. § 1.125-1(g)(2)(i) (which specifically excludes partners).
[73] IRC §§ 132, 61(a)(1); Treas. Regs. §1.61-21(a)(1); MCKEE at ¶2.04[2][a].
[74] Treas. Regs. §§ 1.132-1(a), (b)(1), (2). Such Treasury Regulations consider partners to be "employees" for no-additional-cost services, qualified employee discounts, working condition fringe benefits, and de minimis fringe benefits. The § 132(a)(6)-(8) exclusions were enacted later and there are no regulations under these sections; partners may or may not be eligible to exclude these benefits. See James B. Sowell, "Partners as Employees: A Proposal for Analyzing Partner Compensation," Tax Analysts Doc. 2001-1502 375, 377 n.23. (Jan. 15, 2001).

exclude such partnership-provided fringe benefits from their taxable income.[75] Also, partnerships generally may not deduct expenses incurred in providing fringe benefits to partners, except to the extent that such benefits are treated as guaranteed payments (and are otherwise deductible expenses).[76]

Qualified Transportation Fringe Benefits. Employees may exclude a variety of employer-funded transportation costs, including employer-provided transportation in commuter highway vehicles, transit passes, qualified parking, or qualified bicycle commuting reimbursements. Such deductions are limited to $100 for transit passes and $175 for qualified parking, adjusted for inflation.[77] But partners, as self-employed individuals, cannot exclude qualified transportation fringe benefits.[78] At most, partners may be able to exclude transportation costs that constitute *de minimis* or working condition fringe benefits.[79] Under the *de minimis* fringe benefit rules, a partner may exclude from income the value of transit passes provided by the partnership up to $21 a month.[80]

Meals and Lodging. Under Section 119, employees are allowed to exclude certain employer-provided meals and lodging.[81] Excludible meals generally are provided on the business premises of the employer and are furnished for the convenience of the employer.[82] Excludible lodging generally is furnished on the business premises of the employer, for the

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[75] Treas. Regs. §§ 1.132-1(b)(1), -1(b)(2)(ii).
[76] IRC § 162(l); Rev. Rul. 91-26 (Situation 1), 1991-1 C.B. 184; IRC §§ 162, 263.
[77] IRC §§ 132(f); Treas. Regs. § 1.132-9.
[78] IRC § 132(f)(5)(E), (d), (e); Treas. Regs. § 1.132-9, Q/A24.
[79] Treas. Regs. §§ 1.132-6(d)(1), (2).
[80] Treas. Regs. § 1.132-6(d)(1). Also, *de minimis* fringe benefits are subject to conditions, including an "occasional" requirement. Treas. Regs. § 1.132-6(d)(2). If transportation costs paid by the partnership exceed the value or frequency thresholds, no amount is considered to be *de minimis* and the partner must include all of the cost of the transportation in her income (not just the excess over the threshold). IRC § 132(e); Treas. Regs. § 1.132-6(d)(4).
[81] IRC § 119(a).
[82] Treas. Regs. § 1.119-1(a)(1).

convenience of the employer, and the employee must be required to accept the lodging as a condition of employment.[83]

In *Armstrong*, the Fifth Circuit determined that a service partner who received compensation in-kind for services performed in a non-partner capacity under Section 707(a) could be an employee for purposes of Section 119.[84] As discussed above, the IRS does not agree.[85] Service partners may be entitled to exclude occasional meal advances as *de minimis* fringe benefits, similar to qualified transportation benefits.[86]

Group-Term Life Insurance. An employee may exclude from her gross income the cost of employer-funded group term life insurance on up to $50,000 of insurance on her life if the plan otherwise qualifies.[87] The Treasury Regulations define an "employee" for this purpose as a person having an employment relationship for purposes of income tax withholding, certain statutory employees and a former employee.[88] Partners are not included in the definition. Partners who were formerly employees of the partnership, however, can continue to include the cost of the group-term life insurance that was provided because of her former services as an employee.[89] In addition, it may be possible for service partners who receive non-partner compensation within the meaning of Section 707(a), to exclude payments the partnership pays for group-term-life insurance under the logic of *Armstrong*.[90]

Health Insurance. An employee's compensation generally does not include amounts an employer pays for accident and health insurance premiums.[91] Although neither the

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[83] Treas. Regs. § 1.119-1(b).
[84] *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968).
[85] *See* FSA 200031003.
[86] Treas. Regs. § 1.132-6(d)(2).
[87] IRC § 79.
[88] Treas. Regs. § 1.79-0.
[89] Id.
[90] *See* MCKEE, at ¶14.02[4][b], n. 199.
[91] IRC § 106(a).

Code nor the Treasury Regulations define an "employee" for this purpose, the IRS position is that partners are not included.[92] A partner generally may not exclude amounts the partnership pays for health and accident insurance.[93]

Amounts paid by a partnership for accident and health insurance premiums on behalf of a service partner constitute guaranteed payments under Section 707(c) to the extent such payments are compensation determined without regard to partnership income.[94] However, the partner may deduct 100% of the premiums the partnership pays on her behalf (assuming they are characterized as guaranteed payments and that the partner reports net earnings from self-employment on her Schedule K-1).[95] Such deduction, however, does not apply for purposes of calculating the partner's self-employment tax.[96] Employees do not have to include employer-funded accident or health insurance premiums as income for purposes of calculating FICA taxes, since there is no provision equivalent to Section 162(l)(4) in the employment context.

Also, an employee who is an eligible individual with a high deductible health plan can exclude qualifying employer-funded contributions to an employee's Health Savings Account, but a partner cannot.[97]

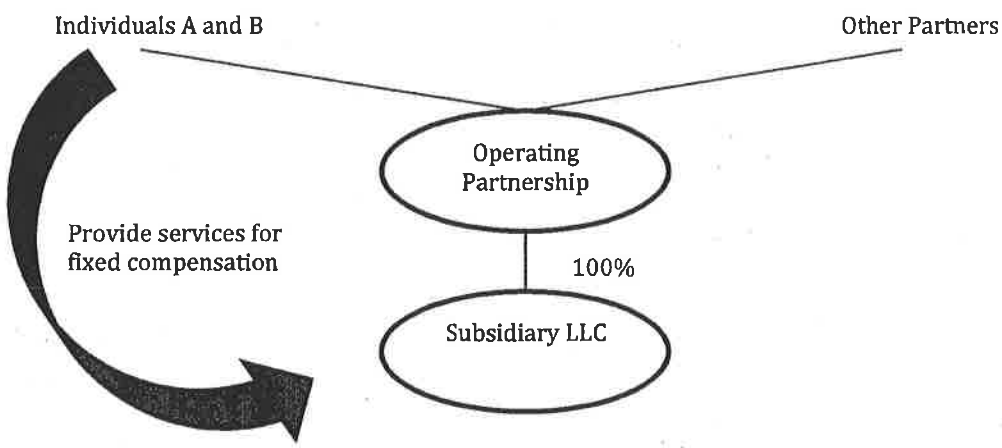
V. Structures Used

Taxpayers have employed various structures that are intended to permit reporting a partner's fixed compensation from a partnership as wages. Some of these structures are complicated and impose additional costs. Others may or may not achieve the desired results. With the enactment of Section 6662(i), which imposes a 40% penalty on an underpayment of tax

[92] *See* Rev. Rul. 91-26 (Situation 1), 1991-1 C.B. 184.
[93] *Id.*
[94] *Id.*
[95] *Id.* IRS Pub. 535, Business Expenses (2013).
[96] IRC § 162(l)(4).
[97] *See* IRC §§ 223, 106(d); Notice 2005-8, 2005-4 I.R.B. 368.

attributable to a nondisclosed transaction that lacks economic substance (within the meaning of Section 7701(o)), without any exception for reasonable cause, the stakes are even higher.

Use of Single Member LLC Subsidiary. Some taxpayers have formed a wholly-owned domestic limited liability company subsidiary of the operating partnership to employ the employees, including partners of the operating partnership who provide services.



Although the wholly-owned subsidiary is generally disregarded as an entity separate from the operating partnership for federal tax purposes, Treasury Regulations § 301.7701-2(c)(2)(iv)(B) provides that such subsidiary is treated as a corporation with respect to federal employment taxes, including federal income tax withholding, FICA and FUTA. As a result, the wholly-owned subsidiary withholds federal income tax and withholds and pays FICA and FUTA with respect to its employees, including employees who are also partners in the parent partnership.

The problem with this structure is that the subsidiary is disregarded for federal income tax purposes, which includes the self-employment tax.[98] In fact, Treasury Regulations §

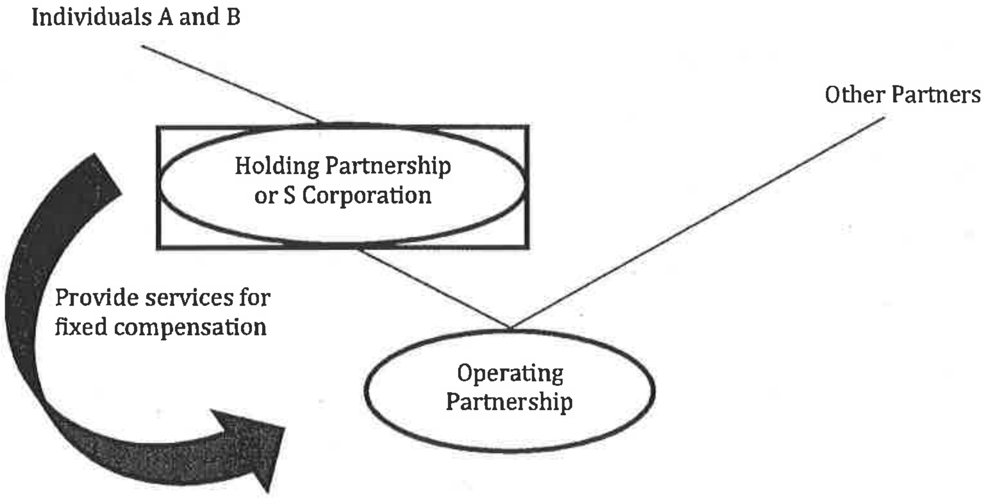
[98] The income tax provisions of Subtitle A of the Code are set forth in §§ 1 through 1563, which include §§ 1401 through 1403 (the self-employment tax).

301.7701-2T(c)(2)(iv)(A) expressly provides that the wholly-owned subsidiary is disregarded for purposes of Chapter 2 – the self-employment tax. In such case, the employee-partner will also be subject to self-employment tax on the same compensation, which for income and self-employment tax purposes is treated as a guaranteed payment to her in her capacity as a partner in the operating partnership.[99]

This double counting must be corrected. FICA and the self-employment tax are mutually exclusive; it was never intended that an individual be subject to both FICA and self-employment tax on the same compensation.[100] Section 1402(b), which reduces the amount of self-employment net income subject to the OASDI portion of the self-employment tax by the amount of wages, does not solve the problem. At a minimum, the individual would still be paying the HI portion of the self-employment tax. For example, assume in 2014 individual A is a partner in the operating partnership and performs services for the wholly-owned limited liability company subsidiary of the operating partnership for which A receives $117,000 of wages. The subsidiary would withhold the employee portion of the FICA tax and pay the employer portion of the FICA tax on $117,000 with respect to A. In addition, A would have to pay self-employment tax on $117,000 at the HI rates. That aggregate tax is equivalent to the self-employment tax A would pay if she had $334,000 of self-employment income.

<u>Use of a Holding Company for the Partner's Interest</u>. Some taxpayers work directly for the operating partnership, but hold their partnership interest in the operating partnership through a holding partnership or an S corporation.

[99] Guaranteed payments from a partnership that is engaged in a trade or business are subject to self-employment tax. Treas. Regs. § 1.1402(a)-1(b). The exception for limited partners under § 1402(a)(13) by its terms does not apply to guaranteed payments.
[100] *See* GCM 34001 (Dec. 23, 1968).

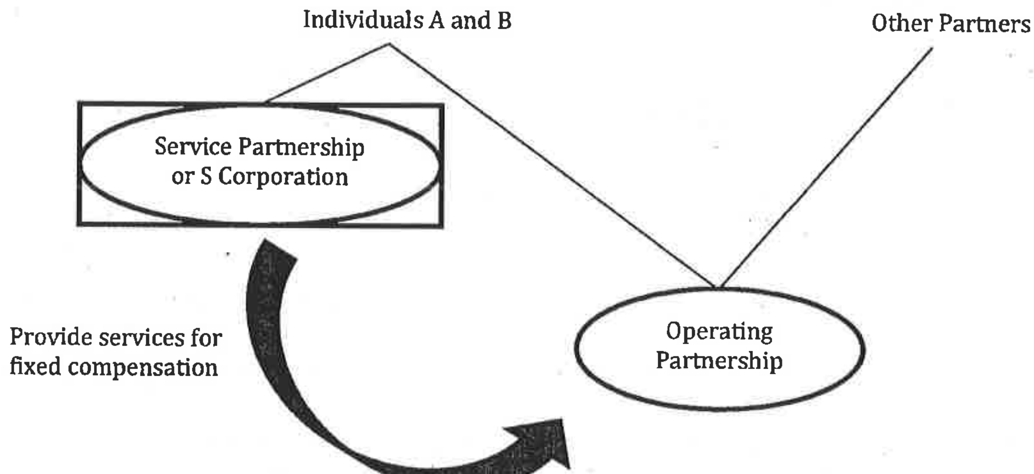


Using a disregarded entity to hold the individual's partnership interest should not make a difference under current law. In the case of a partnership holding company, depending on the particular facts and circumstances, there may be questions whether that partnership should be viewed as an aggregate or entity for this purpose [101] or should be disregarded under the partnership anti-abuse rules.[102] Although S corporations are generally pass-through entities like partnerships, S corporations are treated differently for employment tax purposes. A shareholder of an S corporation may be an employee of the corporation.[103] As a result, using as S corporation as the holding company does not have the same issues as a partnership. S

[101] *See generally* McKee at ¶1.02.
[102] Treas. Regs. § 1.701-2(e) allows the IRS to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or Treasury Regulations thereunder. The examples in the Treasury Regulation apply to prevent a partner from obtaining a benefit through a partnership that the partner would not be entitled to directly (*e.g.*, by applying the limitations on interest deductions in § 163(e)(5) to a corporate partner's share of the partnership debt, by applying the extraordinary dividend provision of § 1059(a) to a corporate partner's share of dividends received by the partnership and by determining the controlled foreign corporation status of a foreign subsidiary by looking to the ownership of the partnership that owns the foreign subsidiary, rather than the partnership's ownership).
[103] *See, e.g.*, IRC §§ 1371(a), 1372.

corporations, however, may be subject to additional state or local income tax.[104] In addition, requiring the use of a holding company to achieve the desired characterization is more cumbersome and imposes additional administrative costs.

Use of Separate Entity to Provide Services. Some taxpayers may own their interests in the operating partnership directly, but provide services through another entity.



Issues similar to those discussed above with respect to a holding entity also apply here. In addition, using a separate service-providing entity could shift the cost of various benefits from the operating partnership to the service-providing entity. For example, if the individual provides services as an employee of the service providing entity, which is an independent contractor of the operating partnership, the employer share of the FICA tax with respect to the individual becomes an obligation of the service providing entity, rather than the partnership. If a gross up is not provided, the ultimate economics to the individual would be adversely affected. The same may be true of other benefits to which the individual would have been entitled as an employee of the partnership.

[104] For example, California and Illinois impose a 1.5% entity level tax on the portion of an S corporation's taxable income allocable to the state, and New York City and the District of Columbia tax S corporations in the same manner as C corporations. CA Rev. and Tax Code § 23802(b); ILCS 5/201(d); NYC Admin. Code § 11-602(8)(ii); NYC Rules § 11-27(a); DC Code §§ 47-1801.04(10), 47-1807.02.

VI. Form of Guidance

The Committee believes that its proposals can be adopted through changes to applicable Treasury Regulations, implemented in the first instance through a Notice announcing and describing the forthcoming amendments. No statutory change would be necessary. Section 707(a)(1) clearly contemplates that a partnership may treat a partner as not a partner: when "a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this Section, be considered as occurring between the partnership and one who is not a partner." Section 707(c), relating to guaranteed payments, provides that the "payments to a partner for services [to the extent determined without regard to the income of the partnership]... shall be considered as made to one who is not a member of the partnership, but only for the purposes of Section 61(a) (relating to gross income)...."

There is nothing in the legislative history that would prohibit a partner from being treated as an employee with respect to qualified payments for services provided by him. The change in language from the House Report, which initially viewed a partner receiving guaranteed payments "like any other employee who is not a partner",[105] to the language in the Senate Report that was ultimately adopted, treating guaranteed payments as being made "to one who is not a partner",[106] merely recognized that in certain instances the individual may be acting as an independent contractor. As discuss above, an individual who is engaged to provide services to a partnership, and who otherwise satisfies the definition of an "employee," should not be precluded from being an employee merely because that person is, or becomes, a partner of the partnership.

[105] H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A226-227 (1954).
[106] S. Rep. No. 1662, 83d Cong., 2d Sess. 386-387 (1954).

The proposal will not only clarify the law, but also make it easier to administer. The IRS has, from time to time, adopted rules to reflect tax policy and simplification considerations.[107] The Committee believes similar considerations should be given here.[108]

Clearly, certain Treasury Regulations will need to be amended. For example, Treasury Regulations § 1.707-1(c) currently states that "guaranteed payments are regarded as a partner's distributive share of ordinary income" and that a "partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source ...." This regulation would need an amendment to provide for the recommended situations when employee status would be respected.

Because the proposal simplifies the reporting and compliance obligations for the qualified partners, the Committee believes the change should be effective from and after the date of the Notice, rather than waiting for final regulations to be promulgated.

Treasury Regulations § 301.7701-2(c)(iv) (and the related Temporary Treasury Regulation) will also need to be conformed to the proposal. Even if the proposal is not adopted, such regulations need to be amended to eliminate the potential double employment taxes on the same compensation. Such amendment should be retroactive, to correct an otherwise improper result.

VII. Effect on State and Local Taxes

Although a discussion of state and local taxes is beyond the scope of this report, the Committee notes that the proposal may impact the state and local jurisdictions which cannot tax the partner. Generally, states impose income tax on guaranteed payments made to a non-resident

[107] *See, e.g.*, Treas. Regs. § 1.368-1(e) (continuity of interest regulations in the context of reorganizations); Treas. Regs. § 301.7701-3 (check-the-box regulations relating to the classification of business entities).
[108] *Cf. Reither v. United States*, 919 F. Supp.2d 1140 (D.N.M. 2012) (IRS did not challenge treatment of fixed compensation as wages).

partner for services in the same manner as they tax the partner's distributive share of partnership income (*i.e.*, based on the portion of the partnership's income that is allocable to the non-resident partner).[109] If the guaranteed payment were transformed into wages, it would only be taxable to a non-resident partner in the jurisdiction where the services were performed.[110] In each case, the jurisdiction in which the partner is resident can fully tax the partner on all of her income, subject to a credit for taxes paid to other states. If desired, a state could disregard any revision pursuant to the proposal hereunder and continue to treat the recharacterized income as part of the partner's distributive share of partnership income for state and local tax purposes.

VIII. Conclusion

The Committee has endeavored to make recommendations to clarify and simplify the treatment of fixed compensation paid by a partnership to a partner for services rendered to or for the benefit of the partnership. We appreciate the IRS's consideration of our recommendations, and would be pleased to discuss them with the appropriate persons.

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[109] *See generally* HELLERSTEIN & HELLERSTEIN, STATE TAXATION, Ch. 20 (Warren Gorham & Lamont 3d ed.) ("HELLERSTEIN"). *See, e.g.*, CA Rev. & Tax Code § 17854; NY Tax Law §§ 631(a)(1), 632(a)(1).
[110] *See generally* HELLERSTEIN, Ch. 20.