BDO KNOWS:
COMPENSATION AND BENEFITS

SUBJECT

IRS CLARIFIES EMPLOYMENT TAX TREATMENT FOR PARTNERS IN A PARTNERSHIP OWNING DISREGARDED ENTITIES

SUMMARY

On May 3, 2016, the Internal Revenue Service ("IRS") issued temporary regulations, Section 301.7701-2T, that clarify the employment tax treatment of partners in a partnership that owns a disregarded entity. The temporary regulations state that if a partnership is the owner of the disregarded entity, the disregarded entity is not treated as a corporation for purposes of employing a partner of the partnership. Thus, a partner of a partnership that owns a disregarded entity is subject to the same self-employment tax rules as a partner of a partnership that does not own a disregarded entity.

While the implications for partners that were being treated as employees for payroll taxes are obvious (i.e., they must be treated as self-employed for income tax and FICA purposes), there may also be implications related to participation in certain tax-favored employee benefit programs, such as cafeteria plans, health insurance benefits, and qualified plans.

In order to allow adequate time for partnerships to make appropriate adjustments to payroll and employee benefit plans, these temporary regulations will apply *on the later of*: (1) August 1, 2016; or (2) the first day of the latest starting plan year following May 4, 2016, of an affected plan sponsored by an entity that is disregarded as an entity separate from its owner.

CONTACT:

COMPENSATION AND BENEFITS GROUP

IRA MIRSKY
Senior Director, National Tax Office
(202) 644-5412 / imirsky@bdo.com

CARLISLE TOPPIN
Senior Manager, National Tax Office
(212) 885-8331 / ctoppin@bdo.com

JOAN VINES
Senior Director, National Tax Office
(703) 770-4444 / jvines@bdo.com

PARTNERSHIP GROUP

JEFFREY N. BILSKY
Senior Director, National Tax Office
(404) 979-7193 / jbilsky@bdo.com

DAVID PATCH
Senior Director, National Tax Office
(703) 336-1520 / dpatch@bdo.com

JULIE ROBINS
Senior Director, National Tax Office
(512) 391-3534 / jrobins@bdo.com

DETAILS

Background

Prior to 2009, disregarded entities (e.g. a single member limited liability company) were not responsible for filing and paying employment taxes. Accordingly, until 2009, the employment tax reporting, withholding, and remittance obligations were performed on behalf of most disregarded entities under the name and employer identification number ("EIN") of their single-member owner.[1]

The entity classification regulations were revised, effective January 1, 2009, to provide that a single-member entity that was disregarded for federal income tax purposes by default, would be deemed to have elected to be treated as a corporation for the purposes of federal employment taxes imposed under Subtitle C of the Internal Revenue Code ("Code").[2] As a result, the disregarded entity, rather than the single-member owner, is now considered the employer of the disregarded entity's employees, and is primarily responsible for filing and paying employment taxes imposed by Subtitle C of the Code. The new temporary regulations explain that this change to the entity classification regulations was only for the purpose of employment taxes and certain excise taxes, and did not affect the prohibition under the partnership or self-employment tax rules against owners participating in certain tax-favored employee benefits plans (e.g. qualified retirement plans, health and welfare plans, and fringe benefit plans).[3]

BDO Observations & Next Steps

The new guidance is aimed at clarifying a perceived misinterpretation of existing rules. Based on interpretations of existing regulations, taxpayers may have permitted partners to participate in certain tax-favored employee benefit plans. In addition, these partners may have been treated as though they were subject to employment tax as employees, rather than as self-employed individuals.

With the issuance of these regulations, it is clear that a partner is not eligible to be treated as an employee of a lower-tier disregarded entity that is owned by the partnership. This treatment applies for purposes of either coverage or participation under any qualified retirement plan, health plan, Code Section 125 cafeteria plan, or other tax-advantaged employee fringe benefit arrangement that is sponsored by the disregarded entity. Further, such partners are subject to the same self-employment tax rules as a partner of a partnership that does not own a disregarded entity. Consequently, affected partners and partnerships need to consider the impact of these rules and begin making necessary changes.

By comparison, however, there may continue to be a position in which partners of a partnership that owns a *regarded*, lower-tier corporation could be treated as the employees of the corporation, for employment tax and employee benefit plan purposes.

Potential Modifications to Rev. Rul. 69-184

In addition to clarifying the existing regulations, Treasury noted its belief that the regulations do not alter the holding in Rev. Rul. 69-184, 1969-1 C.B. 256. Under Rev. Rul. 69-184, bona fide members of a partnership are not employees of the partnership, and a partner who devotes time and energy in conducting the trade of business of the partnership, or who provides services to the partnership as an independent contractor, is considered to be self-employed, and is not an employee of the partnership. Treasury also indicated that these regulations do not address application of Rev. Rul. 69-184 in tiered partnership situations.

---

[1] Prior to 2009, disregarded entities could elect to report, remit, and withhold employment taxes on their own account. However, under prior rules, the owner of the disregarded entity remained principally responsible for these employment tax obligations. (See, generally, Notice 99-6.)

[2] Treas. Reg. §301.7701-2(c)(2)(iv)(B). Treas. Reg. §301.7701-2(c)(2)(iv)(C)(2) provides that the general rule of Treas. Reg. §301.7701-2(c)(2)(i) applies for self-employment tax purposes.

[3] Not including the additional taxes imposed under the Affordable Care Act.

Several commentators have requested guidance on the application of Rev. Rul. 69-184 in tiered partnership situations and have suggested modifying Rev. Rul. 69-184 to allow partnerships to treat partners as employees in certain circumstances. For example, requests have included modification of Rev. Rul. 69-184 to allow recipients of small ownership interests as an employee compensatory award or incentive to continue to be treated as an employee.

For partnerships that have wholly owned C corporations where partners are treated as employees of the C corporation for payroll tax and benefit plans, there remains uncertainty in the treatment of certain types of partnership interests, namely profits interests.

Treasury has requested comments on the appropriate application of the principles of Rev. Rul. 69-184 to arrangements involving tiered partnerships; the circumstances in which it may be appropriate to permit partners to also be employees of the partnership; and the impact on employee benefit plans (including, but not limited to, qualified retirement plans, health and welfare plans, and other fringe benefit arrangements) and employment taxes, if Rev. Rul. 69-184 were modified to permit partners to also be treated as employees in certain circumstances.