# Acquisitions, Dispositions & Structuring Techniques Corner

## New Temporary Regulations Target Partnership-Owned Disregarded Entities' Treatment of Partners as Employees

*By Richard M. Lipton and Samuel Pollack*

New temporary regulations (the "New Regulations")[1] address a scenario where a taxpayer is a partner in a partnership that owns an entity that is disregarded for U.S. federal income tax purposes (a "DRE" in a "Partnership/DRE Structure") and where the taxpayer is also an employee of the DRE. Under Rev. Rul. 69-184,[2] a partner in a partnership cannot be an employee of the partnership for employment tax purposes. Instead, partners are taxed on their shares of partnership income as self-employed individuals.[3] However, if there were a DRE underneath the partnership, taxpayers took the position the partner was an employee of the DRE. Although a DRE is disregarded for U.S. federal income tax purposes, a DRE is treated as a corporation for U.S. federal employment tax purposes.[4] If the DRE is a corporation for employment tax purposes, the thinking was that a partner in the partnership that owns the DRE can be an employee of the DRE. The New Regulations target the Partnership/DRE Structure, specifically articulating that the DRE is disregarded in this instance. As a result, the partner is self-employed and not an employee of the DRE.

Although the New Regulations focus on self-employment tax consequences, Treasury states that the purpose of the New Regulations is to prevent partners from participating "in certain tax-favored employee benefit plans."[5] The Treasury makes it sound as though the purpose of the Partnership/DRE Structures used by partnerships was to avail their partners of benefits to which their partners should not have been entitled. However, for the most part, the self-employment tax[6] and other income tax laws with respect to self-employed individuals[7] are designed to treat employment and self-employment equally. More likely, the objective in using Partnership/DRE Structures was to streamline payroll and to allow a partnership to provide equity-based compensation to employees without said compensation ending the employment relationship and causing an employee to become a self-employed partner.[8] It may also be the case that the Partnership/

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DRE Structure was being used to avail partners of "limited partner" status by walling off the services provided by a partner to the partnership from services provided in the capacity of employee (not as partners participating in the business of the partnership). While, generally, a partner's distributive share of a partnership's income is treated as income from self-employment, there is an exception to this rule for "limited partners."[9] Recent case law has sided with the IRS in holding that limited liability is not the sole requirement for "limited partner" status and that a partner who manages or provides services to the partnership in the capacity of a partner cannot be a limited partner.[10] Partners in a Partnership/DRE Structure may have taken the position that because their services provided to the partnership were all in the capacity of an employee and not in their capacity as a partner, the partners should have been treated as limited partners in the partnership.

*The New Regulations clarify ... that a DRE is disregarded for self-employment tax purposes and ... the DRE's status as a corporation for employment tax purposes does not prevent its owner ... from being self-employed.*

Whatever taxpayers' motivation in using the Partnership/DRE Structure was, the key issue is whether a partner in a Partnership/DRE Structure is treated as an "employee." In the preamble to the New Regulations, Treasury attributes taxpayers' position to a mistaken interpretation of regulations that were finalized in 2007 (the "2007 Regulations"). Below, we explain Treasury's approach, identifying the "mistake" taxpayers had made and the clarification that the New Regulations provide. We also consider whether a partner must be treated as an employee of a DRE and, therefore, the New Regulations are invalid.

## Analysis of the New Regulations

The Treasury's logic and reasoning in the New Regulations, at first glance, appears to be crystal clear. To start with, as mentioned above, the IRS held in Rev. Rul. 69-184, that a taxpayer cannot be an employee of a partnership in which the taxpayer is a partner. Then, in 1996, Treasury finalized regulations that invented DREs, which were disregarded for all U.S. federal tax purposes.[11] In 2007, Treasury backtracked on the treatment of DREs, finalizing regulations that included Reg. §301.7701-2(c)(iv)(B), which treated DREs as corporations for employment tax purposes. The 2007 Regulations included an example[12] where LLCA is an eligible entity owned by individual A and LLCA is a DRE. The example explains that with respect to all of its employees other than A and for employment tax purposes, generally, LLCA is treated as a corporation. In other words, for the purpose of the provisions of Subtitle C of the Internal Revenue Code (the "Code"), LLCA is a corporation. However, the tax on self-employment income is governed under Subtitle A of the Code. Therefore, for the purpose of the self-employment tax, the example explains: LLCA is not treated as a corporation and A is treated as being self-employed. This result was flagged in the preamble to the 2007 final regulations, which stated[13]:

> The final regulations clarify that an owner of a disregarded entity treated as a sole proprietorship is subject to taxes under the Self-Employment Contributions Act (SECA) (section 1401 *et seq.*). Additionally, the final regulations retain the example illustrating that an individual owner of a disregarded entity continues to be treated as self-employed for purposes of SECA taxes, and not as an employee of a disregarded entity for employment tax purposes.

The 2007 Regulation addresses the situation in which the DRE is owned directly by an individual. The New Regulations expand this concept to a DRE owned indirectly by an individual through a partnership.

The Treasury had understood that a partner in a partnership that owned a DRE would also be treated as self-employed because both conclusions turn on whether or not the DRE is treated as a corporation or not for the purpose of the self-employment tax. The New Regulations spell this understanding out as an operative rule, stating[14]:

> Section 301.7701-2(c)(2)(i) applies to taxes imposed under subtitle A, including Chapter 2—Tax on Self-Employment Income. Thus, an entity that is treated in the same manner as a sole proprietorship under §301.7701-2(a) is not treated as a corporation for purposes of employing its owner; instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of its owner. The owner will be subject to self-employment tax on self-employment income with respect to the entity's activities. Also, if a partnership is the owner of an

entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2 is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2.

The New Regulations appear merely to supply a clarification of the 2007 Regulations. Under the 2007 Regulations, a DRE is disregarded for Subtitle A purposes and, therefore, neither a single owner of a DRE nor a partner in a partnership owning a DRE can be an employee of the DRE for any Subtitle A purpose. Self-employment taxes and tax-favored employee benefit plans are provisions under Subtitle A,[15] so neither the single owner nor the partner are employees for those purposes.

## Potential Issue with the New Regulations

The problem with the above analysis, however, is the fact that the Code states in Subtitle A, specifically, in Code Sec. 1402(d) that the term "employee" has "the same meaning as when used in chapter 21" (*i.e.,* Code Secs. 3101–3128). In other words, if under Code Sec. 3121(d), an individual is an employee, then, the individual is an employee for self-employment tax purposes as well. Therefore, if a DRE's owner may be its employee under Code Sec. 3121(d), the owner of a DRE also should be an employee of the DRE for self-employment tax purposes. For partnerships, as mentioned above, the IRS has ruled in Rev. Rul. 69-184 that a partner in a partnership is not an employee for employment tax purposes. It is arguable whether this ruling still holds water,[16] but presuming for the moment that Rev. Rul. 69-184 is ironclad, when a partnership owns a DRE, the question arises whether the treatment of the DRE as a corporation for employment tax purposes also causes the partner to be an employee of the DRE.

Of course, the Code cannot be overridden by a regulation, so, arguably, any regulation promulgated by Treasury may not distinguish between employment taxes and self-employment taxes to make an individual an employee in one case and not an employee in the other. The 2007 Regulations appear to create such a bifurcation. Specifically, the 2007 Regulations stated that a DRE is a corporation for purposes of Subtitle C, which means that the DRE's owner may be its employee for Subtitle C purposes. Therefore, under Code Sec. 1402(d), the owner may also be an employee for self-employment tax purposes. The example in the 2007 Regulations contradicted this outcome, providing that an owner of a DRE cannot be an employee of the DRE for self-employment tax purposes, but this means that the DRE is treated as a corporation for some purposes but not others. When the Code and an example in a regulation conflict, the Code is followed and the example is disregarded.[17]

The New Regulations up the ante, providing that a sole proprietor of a DRE and partners in a partnership that owns a DRE cannot be employees of the DRE for self-employment tax purposes. This provision of the New Regulations now, arguably, directly contradicts Code Sec. 1402(d). Code Sec. 1402(d) reflects the clear intent to base the distinction between an employee and a self-employed person on the principles of employment tax (Subtitle C of the Code). The New Regulations reverse that intent, basing the distinction between an employee and a self-employed person on the income tax provisions in Subtitle A. If Treasury wants a DRE to be treated as a corporation for employment tax purposes, arguably, Treasury should have to accept the consequences of that characterization and allow a DRE's owner to be employed by the DRE.

On the other hand, Treasury's authority to administer entity classification through the check-the-box regime has been upheld in a number of cases.[18] Spring-boarding from those victories, Treasury has gone on to take a cherry-picking approach to the check-the-box regime, treating DREs differently for various different purposes of the Code.[19] Based on what Treasury may justifiably perceive as unbridled discretion to treat DREs in any way it pleases, Treasury could counter that its intent in the New Regulations is to treat a DRE as a corporation for employment tax purposes, except with respect to the definition of the term employee in Code Sec. 3121(d).[20]

While at some point it may become within taxpayer's best interest to disagree with Treasury and the IRS over the extent of their authority to pick and choose when and for what purpose a DRE is treated as a corporation, this may not be the most worthy battleground, from a practical standpoint. Perhaps the most important point to make about the New Regulations is that they do not impact tiered partnerships[21] and virtually anything you could have done with a Partnership/DRE Structure, you can do with a tiered partnership. While this does add

complexity, as the second-tier partnership will be subject to the provisions of Subchapter K instead of being a DRE, this added complexity may be worthwhile, especially for businesses that had used the Partnership/DRE Structure and now may otherwise be required to undertake a full overhaul of their payroll and compensation structure.

## Conclusion

The New Regulations clarify what had already been Treasury's position in the 2007 Regulations, that a DRE is disregarded for self-employment tax purposes and, therefore, whether the DRE is owned by an individual or by a partnership, the DRE's status as a corporation for employment tax purposes does not prevent its owner or the partners of its owner from being self-employed. Nevertheless, the flaw that had existed in the 2007 Regulations continues in the New Regulations, specifically, that the Code calls for the term "employee," for self-employment tax purposes, to be defined under the employment tax provisions. The Treasury believes that its intent is that a DRE generally be treated as a corporation for employment tax purposes, except with respect to the definition of the term "employee," although this intent is difficult to square with the language in the Code. In any event, partnerships that had used the Partnership/DRE Structure may want to look into using a tiered partnership-structuring alternative.

### ENDNOTES

1 T.D. 9766, May 4, 2016.

2 Rev. Rul. 69-184, 1969-1 CB 256.

3 *See* Code Sec. 1402(a).

4 Reg. §301.7701-2(c)(2)(iv).

5 *Id.*; T.D. 9766 (May 4, 2016).

6 Self-employment tax is a tax in addition to income tax that is paid on income from self-employment. *See* Code Sec. 1401(a). The tax is designed to mirror employment taxes imposed under the Federal Insurance Contributions Act ("FICA") (*i.e.*, a 12.4-percent Social Security tax and a 2.9-percent to 3.8-percent Medicare Tax). *See* Code Secs. 1401, 3101 and 3111.

7 Self-employed individuals may participate in qualified pension, profit-sharing and stock-bonus plans, subject to a few additional limitations. *See* Code Sec. 401(c)(1); *see also* Code Secs.404(a)(8), 4972(c)(4) for additional limitations. For nonqualified deferred compensation plans, the same rules that apply to employee compensation generally apply to partner compensation. *See* Notice 2005-1, 2005-1 CB 274. Unlike employees, self-employed individuals must include cost of employer-provided coverage under an accident or health plan, and certain benefits received under such plans; however, the partners may generally deduct the same amount under Code Sec. 162(l). Certain generally immaterial fringe benefits are not excluded from income, if provided to self-employed individuals, such as those described under Code Sec. 79 (term life insurance up to $50,000 in coverage), Code Sec. 119 (meals and lodging furnished for convenience of employer) and Code Sec. 125 (cafeteria plans).

8 As a prime example, a service provider may receive an unvested profits interest in a partnership as tax-free compensation, under Rev. Proc. 2001-43, 1993-2 CB 343. However, to comply with the revenue procedure, the partnership must treat the recipient of the interest as a partner, beginning from the time that the unvested right is granted. Thus, to receive the unvested interest tax free, a service provider would generally need to forfeit employee status.

9 Code Sec. 1402(a)(13).

10 *Renkemeyer, Campbell and Weaver LLP*, 136 TC 137, Dec. 58,543 (2011); *Riether*, 919 FSupp2d 1140 (D. N.M. 2012); *see also* CCA 201436049 (Sept. 5, 2014).

11 *See* T.D. 8632 (Dec. 17, 1996); *see also* Notice of Proposed Rulemaking, 61 FR 21989 (May 13, 1996).

12 Reg. §301.7701-2(c)(2)(iv)(D).

13 T.D. 9356 (Aug. 15, 2007).

14 T.D. 9766 (May 4, 2016).

15 *See supra* notes 6–8.

16 The ruling is supported *in dicta* by numerous cases leading up to the issuance of the revenue ruling. *T. Robinson*, CA-3, 60-1 USTC ¶9152, 273 F2d 503 (1959); *W.T. Briggs*, CA-10, 56-2 USTC ¶10,020, 238 F2d 53 (1956); *E. Doak*, CA-4, 56-2 USTC ¶9708, 234 F2d 704 (1956); *C.C. Wilson*, CtCls, 67-1 USTC ¶9378, 376 F2d 280, 179 CtCls 725 (1967). However, there had also been cases in opposition, holding that partners may be employed by their partnerships. *Armstrong v. Phinney*, CA-5, 68-1 USTC ¶9355, 394 F2d 661 (1968); *G.A. Papineau*, 16 TC 130, Dec. 18,044 (1951); *L.B. Wolfe*, 14 TCM 791, Dec. 21,135(M), TC Memo. 1955-198. More recently, *E.T. Pratt*, CA-5, 77-1 USTC ¶9347, 550 F2d 1023 (1977), may be seen as supporting a position that a partnership may not employ a partner; however, that case was decided before the promulgation of Code Sec. 707(a)(2). *See* Deficit Reduction Act of 1984 (P.L. 98–369), 98 Stat. 494.

17 *C.f.*, *D.E. Brown*, CA-10, 348 F3d 1200, 1210–1211 (2003) ("Examples set forth in regulations remain persuasive authority so long as they do not conflict with the regulations themselves"); *W.A. Cook*, CA-7, 2001-2 USTC ¶60,422, 269 F3d 854, 858 (2001) (same).

18 *See, e.g.*, *S.P. McNamee v. Dep't Treas.*, CA-2, 2007-1 USTC ¶50,515, 488 F3d 100 (2007); *F.A. Littriello*, DC-KY, 95 AFTR2d 2005-2581 (2005), *aff'd*, CA-6, 2007-1 USTC ¶50,426, 484 F3d 372 (2007).

19 *See* Reg. §301.7701-2(c)(2)(iii) (DRE regarded for certain income tax purposes); Reg. §301.7701-2(c)(2)(iv) (DRE is treated as corporation for employment tax purposes except with respect to backup withholding); Reg. §301.7701-2(c)(2)(v) (DRE treated as a corporation for some excise tax purposes and not for others); Proposed Reg. §§1.6038A-1 and 1.6038A-2 (treating certain DREs as corporations for certain formation reporting purposes).

20 This contention would be supported by the organization of the New Regulations, as they are placed in the section that discusses the exceptions to treatment of a DRE as a corporation for employment tax purposes. *See* Reg. §301.7701-2(c)(2)(iv)(B).

21 *See* T.D. 9766 (May 4, 2016).