Dual-ing With the IRS Over the Employment Status of Partners

by Andrew L. Oringer, Sarah A. Burke, and Michael J. Binko

Andrew L. Oringer

Sarah A. Burke

Michael J. Binko

Andrew L. Oringer is a partner in and the co-chair of, and Sarah A. Burke and Michael J. Binko are associates in, the Employee Benefits and Executive Compensation Department at Dechert LLP. The authors gratefully acknowledge the assistance of Jeffrey S. Sion, a tax partner at Dechert LLP, in preparing this article.

In this article, the authors discuss the effect of a regulatory preamble on the long-standing controversy over whether an individual who is a partner may, for a portion of the service provider's compensation, also be considered an employee for income tax purposes.

Introduction

A question has arisen over the years regarding whether, for some compensation, a partner can be considered an employee for tax purposes. This is known as the "dual status" question.

In the past, Treasury and the IRS's position has been that a service provider generally cannot have dual status for purposes of the code: Once the service provider is a partner for tax purposes, all compensation arises in the context of the partner-partnership relationship, leaving none to be characterized as wages from employment. This position is expressed starkly in Rev. Rul. 69-184,[1] which tersely concludes: "Bona fide members of a partnership are not employees of the partnership," and thus, "remuneration received by a partner from a partnership is not 'wages' with respect to 'employment.'"[2]

Effects of the partner-nonemployee result can be significant for the service provider as well as the service recipient. For example, a partner is not subject to wage withholding or to the provisions of FICA, and the partnership does not pay FICA

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

[2] The determination of whether a service provider is to be classified as an "employee" for purposes of FICA, the Federal Unemployment Tax Act, and income tax withholding is based on common law principles. Basically, an employee-employer relationship may exist if the person for whom services are performed has the right to control and direct the individual who performs the services, not only regarding the result to be accomplished by the work but also the details and means by which that result is accomplished. *See, e.g.,* sections 3121(d), 3306(i), and 3401(c); reg. sections 31.3121(d)-1(c)(2), 31.3306(i)-1(b), and 31.3401(c)-1(b); *See also* ILM 200117003 (Apr. 27, 2001). The IRS has also published a list of 20 factors it identified as indicating whether sufficient control is present to establish an employee-employer relationship under the common law. *See* Rev. Rul. 87-41, 1987-1 C.B. 296. A partner, by contrast, is defined as a member in a partnership. Sections 761(b), 7701(a)(2). In determining whether a partnership exists for U.S. federal tax purposes, courts have applied various factors including intent, contributions, and control. *See, e.g., Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946); and *Luna v. Commissioner*, 42 T.C. 1067 (1964).

taxes on the partner's income. Also, the partner is subject to the application of the Self Employed Contributions Act (SECA) (which effectively subsumes both the employee and the employer portions of FICA taxes), and neither the partner nor the partnership will have access to some tax benefits that are limited to employees and their employers.

Perhaps the greatest practical effect of the regulatory rejection of the possibility of dual status is the complexity and other dislocation for service providers, especially those that may be less sophisticated. When personnel unaccustomed to "partner" status under the code obtain partnership interests, they receive a Schedule K-1 (Form 1065) reporting their taxable earnings rather than the familiar Form W-2. They will need to attend to a far more complicated tax return, possibly need professional tax preparation for the first time, and will have to make estimated tax payments because they will fall outside of the traditional tax-withholding regime.[3] To be sure, adverse SECA consequences[4] and a loss of favorable tax treatment of some employee benefits may be significant,[5] but the general loss of the familiar tax-related trappings of an employee may be even more relevant as a practical matter.

With inconsistent judicial treatment and a lack of express official reaffirmation of the 1969 ruling by the IRS, questions persist about the viability of the dual-status position.[6] To some, the question became whether there are circumstances under which a partner may receive some but not all compensation in the capacity of an employee. An intuitively appealing example would involve a lower-level employee receiving a small profits interest or other grant conferring a current partnership interest. Indeed, some partnerships may have taken the position, whether as a planning or defensive manner, that such dual-status treatment may be appropriate, at least under specific facts.[7]

In informal settings, IRS personnel seem consistently to have confirmed the view that there can be no dual status, and the IRS seems to have pursued that view as a matter of general litigation strategy.[8] However, research discloses no official pronouncement before 2016 weighing in on whether the 1969 ruling continues to apply generally to all of a partner's compensation, without considering the particular facts and circumstances of any specific situation.

Significant developments to the dual-status debate came in May 2016 when Treasury and the IRS released temporary and proposed regulations[9] to the effect that an upper-tier partnership's use of a disregarded entity (DRE) purportedly to give rise to an employment relationship with a partner of the partnership will be considered insufficient to confer employee status on the partner. Especially noteworthy to those focused on the dual-status question, the preamble to the DRE regulations expressly reaffirms the position taken in the 1969 ruling that dual status is unavailable under the code.[10] That

[3] The removal of the service provider from the code's efficient overall withholding system is a downside to the rejection of dual status, even from the government's perspective.

[4] The service provider may seek reimbursement regarding the additional SECA burden, if the service provider is even aware of this issue, and any reimbursement would generally be taxable. The service recipient may be willing to consider reimbursement because it would be relieved of its own FICA burden, a result generally not being sought when the decision is made to grant compensatory equity interests.

[5] These and related concerns were discussed in section I of the description of American Bar Association Section of Taxation, "Options for Tax Reform in the Partnership Tax Provisions of the Internal Revenue Code" (Dec. 2, 2011).

[6] *See generally* James B. Sowell, "Partners as Employees: A Proposal Analyzing Partner Compensation," *Tax Notes*, July 23, 2012, p. 395; and Gary C. Karch, "Equity Compensation By Partnership Operating Businesses," 74 *Taxes* 722 (Dec. 1996).

[7] Attempts have been made to structure affiliated groups so that an individual may be an employee of one affiliate while being a partner of another. *See, e.g.*, 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). For example, "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," and, "some taxpayers may own their interests in the operating partnership directly, but provide services through another entity." *Id.* at 19-22.

[8] *See, e.g.*, *Wilson v. United States*, 376 F.2d 280 (Ct. Cl. 1967); and *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968). However, in 2015, in proceedings involving the case of *Sands v. Commissioner*, Dkt. No. 5650-15 (May 8, 2015), a petition was filed in the U.S. Tax Court challenging the IRS's determination that SECA taxes apply to an individual's distributive share of trade or business income from a limited partnership. The petitioner argued that the distributive share of the limited partners in the limited partnership qualified for the exclusion from SECA provided in section 1402(a)(13) for the years at issue. In its answer, the IRS admitted error and asked the court to grant the petitioner's requested relief.

[9] "Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity," 81 F.R. 26,693 (May 4, 2016).

[10] DRE preamble, 81 F.R. at 26,693.

documented reaffirmation is sobering to those who might want to continue taking the dual-status position. As discussed below, however, the news is not all bad, and proponents of a dual-status approach should be buoyed by what may well be the first official statement by Treasury or the IRS, also contained in the DRE preamble, to the effect that some reexamination of the issue may be appropriate.

This article is not meant to take a position on whether the rejection of dual status in the DRE preamble is correct or appropriate. Rather, the point is to identify and discuss the effect of the DRE preamble on the long-standing controversy surrounding whether a service provider who is a partner may, for a portion of the service provider's compensation, have the dual status of also being an employee.

Legal Background

With the addition of section 707(a) and (c) to the code, Congress established tax rules governing aspects of the relationship between a partnership and its partners. Section 707(a) provides that a transaction between a partnership and a partner who engaged with the partnership other than in his capacity as a partner would be considered to occur between the partnership and a non-partner.[11] Section 707(c) provides that payments made without regard to income of the partnership for services or capital, that is, "guaranteed payments," would be considered to be made between the partnership and a non-partner.[12] Later rulemaking and enactments clarified that guaranteed payments could not be made to a partner in his capacity as an employee. Specifically, guaranteed payments cannot be wages for FICA purposes,[13] and, as a corollary, guaranteed payments are subject to SECA tax.[14] Despite those clarifications of guaranteed payments under section 707(c), the treatment of "other" payments made under section 707(a) remained unclear.

Two cases illustrate the inconsistent judicial treatment of the dual-status question under the code. In *Wilson*,[15] a husband and wife were partners in a partnership that owned a ranch. They excluded from their income the cost of groceries and heating fuel paid by the partnership while they were living on the ranch to supervise repair work. The Wilsons argued that these expenses were properly excludable under section 119, which concerns meals or lodging for the convenience of the employee. The Court of Federal Claims disagreed, holding that a "partnership is not a legal entity separate from the partners, and, accordingly, a partnership cannot be regarded as an employer of a partner."[16]

In *Armstrong*,[17] the partnership provided benefits to the manager of a ranch, who was paid a fixed salary and was a 5 percent partner in the partnership that owned the ranch. Those benefits included a home at the ranch, groceries, utilities, maid service, and entertainment for business guests. Taking the position that he was an employee of the partnership, the manager excluded the value of the benefits from his income under section 119. The IRS took the position that a partner could not also be an employee of the partnership and assessed a deficiency. The Fifth Circuit rejected the IRS position and held that under the code, "it is now possible for a partner to stand in any one of a number of relationships with his partnership, including . . . employee-employer."[18] The court reasoned that "it was manifestly the intention of Congress to provide that in any situation not covered by section 707(b)-(c), where a partner sells to or purchases from the partnership or renders services to the partnership and is not acting in his capacity as partner, he is considered to be 'an outsider' or 'one who is not a partner.'"[19] The court generally accepted the notion that Congress accepted the entity theory of partnerships.

[11] Section 707(a) (1954); Sowell, *supra* note 6, at 399; Karch, *supra* note 6, at 725; and NYCBA Report, *supra* note 7, at 6.

[12] Section 707(c).

[13] Reg. section 1.707-1(c).

[14] Section 1402(a)(13); Sowell, *supra* note 6, at 400.

[15] *Wilson*, 376 F.2d 280.

[16] *Id.* at 296.

[17] *Armstrong v. Phinney*, 394 F.2d 661.

[18] *Id.* at 664.

[19] *Id.* at 663.

Later, the IRS staked out its position rejecting the Fifth Circuit's decision in *Armstrong* in guidance that culminated in it issuing the 1969 revenue ruling, which without explanation states that "members of a partnership are not employees," and "remuneration received by a partner from the partnership is not 'wages.'" Before issuing the 1969 ruling, the IRS had indicated some relevant reasoning in two general counsel memoranda. In GCM 34001, under an administrative-feasibility rationale, the IRS reasoned that if the tax law allowed dual-status employees, "the determination of 'wages' . . . would virtually have to be made on a transaction by transaction basis . . . render[ing] [employment taxes] almost impossible to administer." Then, in GCM 34173, the IRS looked to the legislative history of section 707(c) and concluded that Congress did not intend to indicate that partners could also generally be considered employees.

Congress then added section 707(a)(2)(A) to the code. Section 707(a)(2)(A) addresses treatment of some services and transfers of property between a partnership and its partners. For services, section 707(a)(2)(A) provides that under regulations prescribed by the secretary, if a partner performs services for a partnership, there is a related allocation and distribution to the partner, and the performance of such services and the allocation of such distribution, taken together, are properly characterized as a transaction occurring between the partnership and the partner in his or her non-partner capacity, the allocation shall be treated as occurring between the partnership and one who is not a partner.

After the enactment of section 707(a)(2)(A), some questioned how section 707(a)(2)(A) interacted with section 707(c). Whereas section 707(c) applies to guaranteed payments made to partners in their capacity as partners, section 707(a)(2)(A) covers payments for services to partners in their capacity other than partners. The dilemma occurs because if a partner is providing services, but not in her capacity as a partner, she must be acting as either an independent contractor or an employee. Therefore, there appears to be an argument that the addition of section 707(a)(2)(A) meant that Congress intended, at least under some facts, to allow dual status.

However, section 707(a)(2)(A) was enacted as an antiabuse measure in response to concerns about disguised capital expenditures. In elaborating the reasons for the change to the code, the Joint Committee on Taxation's blue book[20] states that "Congress was concerned that partnerships had been used effectively to circumvent the requirement to capitalize certain expenses . . . by making allocations of income and corresponding distributions in place of direct payments for property and services."[21] The blue book does not mention the dual-status question, potentially arguing against the contention that the enactment of section 707(a)(2)(A) supports potential dual status.

More generally, proponents of dual status have nevertheless argued that flatly prohibiting a dual-status rule characterization is archaic. They have noted that the approach ignores modern methods of doing business, especially in light of the proliferation of limited liability companies, disregards the economic reality of the use of equity compensation in employment relationships, and places too much reliance on the aggregate theory of partnerships while the code has continued to move toward the more modern "entity" theory.[22]

The DRE Regulations

One technique used by many partnerships to bolster the employment status of some partners, at least for some of their compensation, involves using a DRE.[23] In a common structure, the partnership would establish an LLC and become its sole member, and the LLC would default to a DRE for income tax purposes.[24] Then, the partner would provide services to the DRE as an employee.[25] This structure took advantage of a perceived structuring opportunity under the so-

[20] Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," 98th Cong. (1984).

[21] *Id.* at 225.

[22] *See, e.g.*, Sowell, *supra* note 6, at 395-396; Karch, *supra* note 6, at 722-723; and NYCBA Report, *supra* note 7, at 1, 3-4.

[23] *See generally* NYCBA Report, *supra* note 7, at 18-20.

[24] *See* DRE preamble, *supra* note 10.

[25] *Id.*

called check-the-box regulations[26] (the classification regulations) for purposes of FICA and SECA taxes.[27]

This structure has no income tax consequences for the partnership because, under the classification regulations, a single-member LLC is generally disregarded as separate from its owner.[28] Regarding FICA and SECA taxes, however, some taxpayers have taken the position that the classification regulations were ambiguous.[29] It is notable that the classification regulations provide that a DRE be treated as a corporation for FICA tax purposes, but not for SECA tax purposes.[30] In an example, the classification regulations conclude that when an individual is the sole owner of an LLC and the LLC had employees to whom it paid "wages" for FICA tax purposes, the LLC is a corporation for FICA tax purposes, but concerning the owner, the LLC is disregarded for SECA tax purposes.[31] Some have seen an ambiguity concerning the treatment of partnerships because the classification regulations provide no similar partnership example and are otherwise silent about partnerships. In light of the omission in the classification regulations, some partnerships may have taken the position that under some facts, individuals could be both partners in the partnership and employees of a DRE owned by the partnership.[32]

To address the foregoing, in May 2016 the IRS released the DRE regulations, which amend the classification regulations, to the effect that the use by an upper-tier partnership of a downstream DRE purportedly to employ a partner of the partnership would be insufficient to confer employee status on the partner. A primary thrust of the DRE regulations is to counter the use of DREs to establish an employment relationship that otherwise might not exist for tax purposes.[33] However, much in the DRE preamble bears more generically on the dual-status question.

In the DRE preamble, the IRS reasoned that "the [classification regulations] did not create a distinction between a disregarded entity owned by an individual (that is, a sole proprietorship) and a disregarded entity owned by a partnership in the application of the self-employment tax rule." This narrow rationale was enough to close the perceived loophole in the FICA and SECA tax issue, but the DRE preamble continued, "The Treasury Department and the IRS do not believe that the [classification regulations] alter the holding of [the 1969 ruling] . . . which provides that: (1) [b]ona fide members of a partnership are not employees of the partnership . . . and (2) such a partner who devotes time and energy 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 employee." Thus, the preamble specifically reaffirmed Treasury and the IRS's view that the 1969 ruling remains good authority.

In addition to an official reaffirmation of the IRS's position in the 1969 ruling, the DRE preamble is significant because the IRS indicated that it might be ready to recognize circumstances in which dual status is appropriate. The preamble limited the scope of the DRE regulations to situations in which a DRE is owned by a partnership. Then, the IRS expressly excluded from the reach of the DRE regulations the question whether the 1969 ruling applied to tiered partnership situations. Recognizing commentators' requests for additional guidance on tiered partnerships, yet rebuking the failure of those commentators to provide suggestions and analysis on the issue, the IRS ultimately solicited "comments on the appropriate application of the principles of [the 1969 ruling] to tiered partnership situations, the circumstances in which it may be appropriate to permit partners to

[26] Reg. section 301.7701-2.

[27] DRE preamble, *supra* note 10.

[28] Reg. section 301.7701-2(c)(2)(i).

[29] *See* DRE preamble, *supra* note 10.

[30] Reg. section 301.7701-2(c)(2)(iv)(B).

[31] Reg. section 301.7701-2(c)(2)(iv)(D)(*i*)-(*iii*).

[32] *See* DRE preamble, *supra* note 10.

[33] *See id.* at 26,694-95; Reg. section 301.7701-2T(c)(2)(iv)(C)(2).

also be employees of the partnership, and the impact on employee benefit plans . . . and on employment taxes if [the 1969 ruling] were to be modified to permit partners to also be employees in certain circumstances."[34]

Dual Status — Bad and Good News

If the DRE regulations had established (or reconfirmed, depending on your perspective) the rule that DREs should be ignored in this context and left it at that, the underlying dual-status analysis might not have been implicated. In this regard, the DRE regulations could have provided that DREs are not to be taken into account for purposes of determining a partner's employment status for a portion of the partner's compensation and could have been silent about what the correct tax analysis of the partner's compensation is, leaving that to be resolved under existing law, whatever that may be. Indeed, the language in the DRE regulations does precisely that.

Critically, though, that is not the end of the inquiry because, as discussed above, the DRE preamble steps right into the underlying legal analysis surrounding dual status. As noted above, the preamble specifically reaffirmed the 1969 ruling. This development may be extremely relevant to the dual-status debate because it runs counter to any notion that the 1969 ruling may have somehow ebbed in precedential value.

The news here is both bad and good for those who believe that dual-status characterization is viable. On the negative side, the DRE preamble, instead of leaving the underlying dual-status analysis to the vagaries of current law, strongly supports the 1969 ruling, thereby standing in opposition to the notion that under current law, dual status is not a viable position. Under this view, it would seem that, as many believe, none of a partner's compensation may ever be viewed as wages under current law.

To those who agree with that position, the preamble's reliance on the principle that dual status is not viable may not be overly significant. But, given the lack of recent official commentary regarding the extent of the continuing viability of the 1969 ruling, the DRE preamble is extremely significant to those who believe that (even if the 1969 ruling was a correct statement of the law when issued) the dual-status question remains unanswered. It would seem that the playing field has changed, at least somewhat, for those who believe in the potential validity of the dual-status approach in appropriate circumstances.

So that is indeed some bad news for dual-status proponents. The good news, however, is that for what may be the first time, Treasury and the IRS have effectively acknowledged that the position that no partner can ever have the dual status of an employee may not be the optimal approach. The DRE preamble therefore expressly solicits comments on "the appropriate application of the principles of [the 1969 ruling] to tiered partnership situations, 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 . . . and on employment taxes if [the 1969 ruling] were to be modified to permit partners to also be employees in certain circumstances."[35] Arguably, this development reflects a conflicted regulatory view that there is indeed a place for a dual-status approach, but the rules for determining when to permit dual status (when to permit some compensation to a partner to be considered wages) are difficult to establish without opening the door to perceived potential abuse. While it appears that Treasury and the IRS seem to be struggling with this conundrum, it seems that increased flexibility regarding dual status is possible if practitioners can offer a viable way forward.

Conclusion

The express reaffirmation of the 1969 ruling in the DRE preamble is unfortunate for dual-status proponents. The result of a rejection of dual status has negatives for taxpayers that would seem sympathetic here. Service providers are commonly dislocated by partner status, bear the burden of increased SECA (compared with FICA)

[34] *Id.* at 26,694. The preamble notes that the NYCBA report discussed these issues. Also, a July 6, 1999, letter from the ABA to the House Committee on Ways and Means suggested a safe harbor under which some income attributable to capital would escape SECA taxation.

[35] *Id.* at 26,694.

taxation, and lose favorable tax treatment of some employee benefits. The good news is that Treasury and the IRS seem willing to entertain proposals from the market directed at finding situations in which allowing dual status may make sense, even from the government's perspective. We hope that the market will respond. ■