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Profits Interests, Disregarded Entities and the Self-Employment Trap

By Thomas M. Asmar

Profits interests and other equity incentives continue to be issued to employees of limited liability companies (LLCs). This practice may have unintended adverse consequences unless managed properly considering that issuing equity to an employee of a partnership or LLC (which is taxed as a partnership) may result in that employee becoming reclassified as a partner for tax purposes, particularly in light of recent Treasury guidance.

The U.S. Department of Treasury issued regulations addressing self-employment taxes which generally became effective on Jan. 1, 2017, covering an individual who is both a partner of a partnership and an employee of an entity that is wholly owned by that partnership, which entity is disregarded as separate from its owner for tax purposes (referred to as a "disregarded entity" or "DRE"). Under those circumstances, that individual would be subject to the same self-employment tax rules as a partner, and consequently, the more onerous tax withholding and reporting obligations and restrictions on participation in certain tax-favored employee benefit plans as a partner.

Previously it was unclear whether issuing equity to an employee of a DRE and retaining the "employee" status of the recipient would be respected by the IRS. As a result of the recent regulations, companies that have used this structure may need to take action to retain the "employee" status of their equity recipients and, going forward, companies should consider other tiered partnership structures to accomplish their goals.

Background

Historically, the IRS has ruled that a partner cannot also be an employee of the partnership. Issuing equity to employees of a partnership may cause those employees to become partners for tax purposes and may have unintended consequences.

Self-Employment Tax. Employees are responsible for paying one-half of FICA taxes due on wages (which is withheld) and the employer for the remaining one-half of FICA tax. For guaranteed payments, partners must pay self-employment tax which is generally equal to the employee and employer portions of FICA tax, with the employer-equivalent portion of self-employment tax deductible on the partner's individual income tax return.

Tax Reporting and Withholding. For employees, wages are reported on Form W-2 and are subject to income tax and FICA tax withholding. Compensation payments to partners are reported as "guaranteed payments" on Schedule K-1, with partners making quarterly estimated tax payments on both income tax and self-employment tax.

State Tax Returns. Employees are subject to tax in the state in which the employee works or resides. Partners are subject to tax in each state in which the partnership does business.

Benefit Plans. Employees typically pay for health insurance premiums on a pre-tax basis through cafeteria plans. Only employees may participate in cafeteria plans and flexible spending accounts and dependent care assistance programs — including partners may result in complete disqualification of the plan. Partners pay for their health insurance premiums on an after-tax basis. In addition, eligibility requirements of 401(k) plans vary as to whether partners may participate. There are other differences in how employer-provided life insurance coverage, long-term disability coverage, meals and lodging and fringe benefits are taxed for employees and partners.

The Regulations

Under the regulations, if a partner performs services for a DRE, then the partner of that partnership cannot be treated as an employee of that DRE

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for federal employment tax purposes — rather, this person would be treated as self-employed and a partner for tax purposes. Prior to the regulations, many companies treated this person as an employee of the DRE for tax purposes. The regulations generally became effective on Jan. 1, 2017, for employee benefit plans covering participants whose employment status became affected by the regulations.

For example, if Holdings LLC owns 100 percent of OpCo and employees of OpCo were issued equity in Holdings LLC, the regulations do not permit employee-equity holders in Holdings LLC to be treated as members of Holdings LLC (i.e., partners), on one hand, and employees of OpCo, on the other hand.

Other Tiered Partnership Structures

The regulations do not address the partner-employee issue with respect to other types of tiered partnership structures.

Some companies have used a structure in which employees of a DRE hold equity in a separate entity that is taxed as a partnership (Management HoldCo) and which holds corresponding equity in the parent entity (Holdings LLC). Under this structure, it is intended that Management HoldCo would be a member of Holdings LLC while the employee-equity holders at OpCo would be treated as partners of Management HoldCo and employees of OpCo for tax purposes. This approach is not free from risk as partners of Management HoldCo may be subject to self-employment taxes under certain circumstances depending on the structure of Management HoldCo and companies should consult with their tax advisors before implementing this design.

Comments

Private equity firms have increasingly adopted LLC holding company structures for their portfolio companies and many start-ups are structured as LLCs with equity issued to the employees of an operating subsidiary. If the holding LLC has issued equity directly to employees of that entity or any of its wholly-owned subsidiaries, those employees may need to be reclassified as partners and the company may need to change its tax reporting and withholding obligations, payroll process and employee benefit plan participation requirements to comply with the regulations.

Partnerships and LLCs should determine whether any of their partners or members are treated as employees of their subsidiaries. Until further IRS guidance is issued, companies should exercise caution when issuing equity incentives to employees in a partnership or LLC structure now that the IRS has eliminated one of the commonly used approaches for treating individuals who hold equity in a partnership or LLC as employees.


ASMAR

Thomas M. Asmar *is counsel in the Executive Compensation and Benefits group at Skadden, Arps, Slate, Meagher & Flom LLP.*