Should you treat a partner as an employee?

In today's competitive environment, offering employees an equity interest in your business can be a powerful tool for attracting, retaining and motivating quality talent. If your business is organized as a partnership, however, there are some tax traps you should avoid.

Once an employee becomes a partner, the IRS takes the position that you can no longer treat him or her as an employee for tax purposes. This has several significant tax implications, however.

Employment taxes

Employees pay half of the Social Security and Medicare taxes on their wages, through withholdings from their paychecks. The employer pays the other half. Partners, on the other hand, are treated as being self-employed — they pay the full amount of "self-employment" taxes through quarterly estimates.

Often, when employees receive partnership interests, the partnership continues to treat them as employees for tax purposes, withholding employment taxes from their wages and paying the employer's share. The problem with this practice is that, because a partner is responsible for the full amount of employment taxes, the partnership's payment of a portion of those taxes will likely be treated as a guaranteed payment to the partner. That payment would then be included in income and trigger *additional* employment taxes. Any employment taxes *not* paid by the partnership on a partner's behalf are the partner's responsibility.

Treating a partner as an employee can also result in overpayment of employment taxes. Suppose your partnership pays half of a partner's employment taxes and the partner also has other self-employment activities — for example, interests in other partnerships or sole proprietorships. If those activities generate losses, the losses will offset the partner's earnings from your partnership, reducing or even eliminating self-employment taxes.

Unvested profits interests

Partnerships sometimes grant unvested profits interests to employees or other service providers. Generally, these interests aren't taxable until they vest. But if certain conditions are met, a safe harbor allows recipients to elect to pay the tax when the interest is granted rather than when it vests. Because profits interests often have low or zero value when granted, the election produces significant tax savings.

One of the conditions is that the partnership treat the recipient as the owner of the partnership interest for tax purposes from the grant date forward. However, if you continue to treat recipients as employees for employment tax purposes, you'll likely disqualify them from the safe harbor.

Employee benefits

Partners and employees are treated differently for purposes of many benefit plans. For example, employees are entitled to exclude the value of certain employer-provided health, welfare and fringe benefits from income, while partners must include the value in their income (although they may be entitled to a self-employed health insurance deduction). And partners are prohibited from participating in a cafeteria plan.

In addition, continuing to treat a partner as an employee for benefits purposes may trigger unwanted tax consequences or even disqualify a cafeteria plan.

Plan carefully

If your business is contemplating offering partnership interests to your employees, consider the tax implications and potential impact on your benefit plans. Furthermore, consider techniques that will allow you to continue treating partners as employees for employment tax purposes. For example, you might create a tiered partnership structure and offer employees of a lower-tier partnership interests in an upper-tier partnership. Because employees aren't partners in the partnership that employs them, many of the problems discussed above can be avoided.

The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com