Compensation - Comparison of Partnership-Taxed Organizations to Other Forms of Enterprise

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1. **General Compensation Concepts**. Employee compensation is generally taxed to the employee as ordinary income (IRC § 61), is deductible by the employer as an ordinary business expense (IRC § 162), is subject to income tax withholding from the employee's gross compensation and the withholding for the payment by the employee of the employee's share of FICA (Social Security) and Medicare taxes (IRC § 3121 (v) (2)), is subject to the payment by the employer of unemployment tax (IRC § 3306(r)(2)), and is subject to the payment by the employer of the employer's share of FICA and Medicare taxes. In applying these fairly well understood rules, other concepts come into play:

a. **Constructive Receipt**. Since employees are generally on the cash basis of accounting, receipt is the tax-triggering event. If the employee can simply take the money or property because it is available to the employee without substantial restriction, the employee will be deemed to have constructively received it at that time (IRC § 451(a); Regs. § 1.451-2(a)).

b. **Economic Benefit**. If the employee receives some economic benefit (even if not in cash), the employee is taxed on it. For example, a promise to pay compensation in the future can be taxed presently if the promise can be fairly valued. IRC § 61, *Com'r v. Smith*, 324 U.S. 177 (1945). Thus, fringe benefits and similar benefits are taxable unless a statutory exception applies.

c. **Statutory Exceptions**. There are numerous statutory exceptions which delay or eliminate tax on certain benefits or which make certain benefits not subject to FICA or not subject to withholding rules. Compensation planning generally deals with trying to use such exceptions. We won't be dealing with them in any depth here; rather, we will limit our review to basic conceptual issues.

d. **Some Examples of Compensation Planning Programs**. Some of the types of compensation planning which might be available for use in appropriate circumstances include those listed below; however, as noted below, not all planning methods will be available or if available, will be as favorable, particularly for owner-employees, if the employer is a sole proprietor or is taxed as a partnership (partnerships, both limited partnerships and general partnerships (including limited liability partnerships), and almost all limited liability companies), or is a small business corporation with an S-election in place (an S-corporation). For such employers, the owner-employees (which would include a sole proprietor, partner, or member in a partnership-taxed organization, or a 2%-or- greater shareholder of an S-corporation) may not be able to benefit from a program, even though their other employees could. Many compensation

programs are mostly aimed at corporate employers without an S-election (a C-corporation). Some typical compensation or benefit programs to consider are:

(1) Cash bonuses (available to all).

(2) Stock bonuses (available for corporations; other forms of equity bonus compensation may be available for partnership-taxed organizations).

(3) Qualified retirement plans (available for all but with different limits and rules for S-corporations and partnership-taxed organizations; for example, to give rise to a plan contribution income of a partnership-taxed entity must be income from self-employment derived from a trade or business in which the member's or partner's personal services are a material income producing factor. See IRC § 401(c)(2)(A)(i).

(4) Employee stock ownership plans (see IRC § 4975(e)(7)) (a type of qualified plan) (only applies to corporations, but special restrictions apply to S-corporations under IRC § 409(p) and Regs. § 1.409(p)-1). There is, however, a special exemption from unrelated business income tax for ESOPs of S corps. See IRC ' 512(e)(3).

(5) Statutory (IRC §§ 421, 422) incentive stock options (only corporations).

(6) Nonstatutory stock options (corporations; but can be similar equity options for partnership-taxed organizations).

(7) Phantom stock (stock appreciation) plans (corporations; but can be similar plan for partnership-taxed organizations).

(8) Deferred compensation with "rabbi trust" (available to all but not useful for owner-employees of S-corporation or partnership-taxed organization).

(9) Health plans (available to all; premiums are includable in the owner-employee's income (see IRC § 106) but subject to a 100% business expense deduction under IRC § 162(l)(1)(B) for owner-employees of sole proprietor, S-corporation (2% or more shareholder), or partnership-taxed organization).

(10) Medical reimbursement plans (available; no income exclusion applies for owner-employees of sole proprietor, S-corporation, or partnership-taxed organization, but will be deductible on personal return by owner-employee within limits; may avoid FICA wage treatment for S-corporation owner-employee if meet conditions).

(11) Cafeteria-type cash or benefit plans under IRC § 125 (available; but owner-employees of sole proprietorship, S-corporation (2% or more shareholder), or partnership-taxed organization may not participate).

(12) Life insurance plans (no owner-employee group term exclusion under IRC § 79 is available for proprietorship, S-corporation, or partnership-taxed organization).

(13) Disability insurance plans (available, but deductions limited for owner-employees of sole proprietorship, S-corporation, and partnership-taxed organization).

(14) Dependent care plans under IRC § 129(e)(3) (limited participation (no more than 25%) for owner-employees, including 5% owners of S-corporation or C-corporation) (IRC § 129(d)(4)).

(15) Unfunded severance pay plans (available).

(16) Golden parachute plans (corporations only, adverse tax result).

(17) Meal plans for employer convenience under IRC § 119 (not for owner-employees of sole proprietorship, partnership).

(18) Transit passes (not for sole proprietor, owner-employees of S-corporation (2% or more shareholder), or partnership (IRC § 132(f)(5)(E); Regs. § 1.132-9(b), Q&A 24(a)); limited to the lower de minimis fringe benefit amount for owner-employees of S-corporation or owner-employees of partnership-taxed organization (Regs. § 1.132-9(b), Q&A 24(b) -- if over $21, full value is included in income)). Although the value may be excludable by the service provider, if qualified, the cost may not be deductible by the employer. IRC § 274(a)(4) after 2017.

(19) Vacation benefits, holidays, and sick leave (available; taxable to recipient employee).

(20) Working condition benefits (often otherwise deductible for the service provider under IRC §§ 162 or 167 if paid directly by the service provider) (see Regs. § 1.132-1(b)(2)(ii)) (available to all); these include such things as business use of automobile (with substantiation) (Regs. §§ 1.132-5(a)(1); 1.61-21(a)(1)); business use portion of company paid nondeductible country club dues (Regs. § 1.132-5(5)); job-related education (Regs. § 1.132-1(f)) or job placement service (Rev. Rul. 92-69, 1992-2 CB 51). Also, the use of on-premises athletic facilities (available tax free to partners, spouses, and children) (IRC § 132(j)(4); Regs. § 1.132-1(b)(3)).

(21) Educational assistance programs under IRC § 127 (up to $5,250 per year) (limited availability for partners or either S or C-corporation shareholders, so that no more than 5% of cost of annual benefits is for owners of more than 5% of stock or profits interests) (IRC § 127(b)(1), (c)(2), (c)(3), IRC § 401(c)(1)).

(22) Certain other de minimis fringe benefits (not for sole proprietor but may be used by owner-employees of S-corporation or partners providing services); these include such things as tax-free supper money or local transportation for occasional overtime (Regs. §§ 1-132-1(b)(4), 1.132-6(d)(2)); traditional birthday holiday, family crisis, or retirement noncash gifts (Regs. § 1.132-6(e)); H. Rept. No. 99-426 P.L. 99-514, p. 105); no additional cost services and qualified employee discounts (Regs. § 132-1(b)(1)).

e. **S-Corporations**. Most of these programs can be used, at least in some way, by S-corporations. Beginning in 2002, S-corporation shareholders may borrow from their plan accounts under defined contribution-type qualified retirement plans, a benefit not available to them earlier. S-corporations (with a single level of taxation) tend to push for lower-end compensation amounts and lack the incentive that C-corporations (with a potential double level of taxation) have to try to maximize the deduction for compensation.

(1) Some S-corporation shareholders minimize compensation income and maximize dividend income because the dividends are not subject to tax withholding (quarterly estimated tax may be required, however) or to FICA taxes. This tactic is limited by the requirement that compensation be reasonable. Rev. Rul. 74-44, 1974-1 C.B. 287; *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Dunn & Clark v. Com'r*, 853 F. Supp. 365 (D. Idaho 1994); *Joly v. Com'r*, T.C. Memo 1998-361 (1998); See also *Watson v. U.S.*, 105 AFTR2d 2010-908 (DC IA 2010) (involving accountants); *Watson, P.C. v. U.S.*, 668 F.3d 1008 (8th Cir. 2012) (accountant). Claiming that although an officer, the person is not an employee will not work. *Veterinary Surgical Consultants, P.C. v. Com'r*, 117 TC 141 (2001), and T.C. Memo 2003-48. See Fact Sheet 2008-25, (http://www.irs.gov/newsroom/article/0,,id=200293,00.html) (August 2008).

(2) Also, unreasonable compensation to shift income among shareholders, particularly family members, may be reallocated by the Service under IRC § 1366(e).

(3) Limits on S-corporation shareholder employee benefits or deductions may not apply to nonshareholder employees, however (including spouses and family members). The S-corp shareholders holding more than 2% of the stock are treated as if they were partners for most benefit planning purposes. See IRC § 1372.

f. **Partnership-taxed Organizations - Generally**. Organizations taxed as partnerships raise special problems because for tax purposes, partnerships are not always treated as an entity separate from its owners. This tension between "entity" and "aggregate" treatment runs throughout the partnership tax rules which sometimes follow an entity approach and sometimes an aggregate approach. Partnership-taxed organizations are, like S-corporations, subject to a single tax level, but, unlike S-corporations with partnerships, compensation for owners who provide services is generally on quite a different model. Let's examine partnership issues some more.

2. **Key Partnership Issues**. Many companies desire to use equity interests for compensation. The rules are quite different for partnerships and other partnership-taxed organizations than for corporations. Also, general rules on partnership taxation tend to create special concerns.

a. **Partnership Interests for Services - General Tax Results**. The two major factors determining the tax results from contributing services to a partnership in exchange for a partnership interest are the type of partnership interest to be received, capital or pure profits, and whether the interest is vested or restricted. If the receipt of a partnership interest is treated as

compensation, the partnership would deduct the value of the interest as a business expense deduction or would capitalize it as appropriate. IRC §§ 162, 263; Treas. Regs. § 1.721-1(b)(1).

(1) Capital Interest Vested. Where an unrestricted interest in capital is received by the service partner in exchange for either past or future services, it will be taxable as compensation IRC § 707(c); Treas. Regs. § 1.721-1(b)(1) and (2). Proposed regulations would clarify that a partnership capital or profits interest transferred for services is IRC § 83 property subject to that Section. See proposed regulations §§ 1.83-3, 1.83-6, 1.704-1, 1.706-3, 1.707-1, 1.721, 1.761-1, and Notice 2005-43, 2005-24 IRB (these treat both capital and profits interests as subject to IRC § 83).

(a) Another issue where a capital interest (whether vested or restricted) is used as compensation for services, is whether the partnership itself must recognize gain. There is a split of view points on whether the transaction (i) should be treated as a distribution by the partnership of an undivided interest in its properties to the service provider (with gain to the partnership, and an increase in the partnership's basis in its assets), or (ii) should be treated like a deemed cash payment to the service provider which is then reinvested in the partnership.

(b) The latter is the better view and is consistent with the treatment of corporations under IRC § 1032, which is reasonable where the language of IRC § 721 is very similar. Regulation § 1.83-6(b) (Property transferor recognizes gain except to the extent IRC § 1032 applies, which is a section applicable to corporations, not partnerships), which some argue is against this, does not contemplate partnerships at all, as is seen by comparing § 1.83-6(d), which was promulgated at the same time and does not contemplate partnerships. The Service has, in a different but somewhat analogous situation, reached the conclusion that the grant of a nonvested pure profits interest (*i.e.*, not a capital interest) partnership interest for services does not create gain for the partner or the partnership (which potentially could cause taxation to its members or partners) either at grant or on vesting. Rev. Proc. 2001-43, 2001-34 IRB, clarifying Rev. Proc. 93-27, 1993-2 C.B. 343. Nevertheless, the issue remains open for a vested or unvested capital interest.

(2) Capital Interest Restricted. There are two mostly parallel but somewhat different paths of authority with respect to the taxation of the receipt of restricted capital interests in exchange for services. The first path consists of the older rules under IRC §§ 721 and 61. The second path applies IRC § 83. The second, IRC § 83, path seems to be the path most likely to apply.

(a) Proposed regulation Prop. Reg. § 1.721-1-(b)(1)(i) would apply IRC § 83 after June 30, 1969, but this regulation has never been finally adopted. As cited above with respect to vested capital interests, other proposed regulations have been promulgated which treat profits and capital interests as subject to IRC § 83. Courts have for some time been applying IRC § 83 anyway (*Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd* 703 F.2d 485 (10th Cir. 1983) (in dicta, and with a confusing analysis, this case seems to indicate § 83 will apply); *Campbell v. Commissioner*, T.C. Memo 1990-162*, rev'd on other grounds*, 943 F.2d 815 (8th Cir. 1991)), so it may be that IRC § 83 will apply, although the

law is not fully clear. See also, however, Rev. Proc. 2001-43, 2001-2 CB 191, dealing with profits interests and relieving taxpayers of the need to make a Section 83(b) election under certain circumstances. Notice 2005-43, 2005-24 IRB includes a draft revenue procedure allowing a safe harbor election to value the partnership interest under IRC § 83 for income inclusion by the transferee and for deduction by the partnership at the liquidation value of the interest.

(i) Under IRC § 83, gain is not postponed due to the restriction unless it involves a substantial risk of forfeiture or restriction on transferability. Conditioning receipt upon future performance of substantial services is enough to constitute a substantial risk of forfeiture. Treas. Regs. § 1.83-3 (c)(1). Under IRC § 721 any substantial restriction would postpone income recognition; under IRC § 83 there are only the two exceptions which allow postponement.

(ii) Under IRC § 721 the restrictions on the property might reduce its value; not so under IRC § 83 where value is determined without regard to the restriction, other than a restriction which by its terms will never lapse.

(iii) Under IRC § 721 different recognition and valuation dates are possible (value may be determined at transfer but recognized at the time the restriction lapses), but under IRC § 83 valuation and recognition occur at the same time. Also, under IRC § 83 the partnership's deductions would be taken when the partner is required to report the income recognized from receipt of the partnership interest.

(b) Under IRC § 83, the taxpayer can choose when to have the interest taxed where it is subject to a substantial risk of forfeiture.

(i) Absent an election, IRC § 83(a) provides for postponement of the income until the risk lapses, at which time the then value (not the potentially lower earlier value at grant) is recognized as compensation income. The company receives a corresponding deduction (or capitalized item in some cases) when the income is realized by the service partner. See IRC §§ 83(a), 83(c)(2), and Reg. § 1.83-3(d).

1) If on a hypothetical transfer of the interest the transferee would not be subject to the risk, there will be no postponement at all, but the interest will be "transferable" and taxed immediately.

2) Also, on an actual transfer event subject to the risk, the postponement will then cease, and the service partner is taxed on the amount realized (less anything the partner paid for the interest). Reg. §§ 1.83-1(c) and 1.83-4(b)(1).

3) If the transfer of the nonvested interest is a gift rather than a sale, the service partner recognizes income on the arms-length disposition by the recipient as if the service partner continued to hold it. Reg. § 1.83-1(b)(1)(ii).

4) If the service partner holds the nonvested interest at death, income with respect to a decedent will result for the estate or beneficiary. Reg. § 1.83-1(d).

5) If the service partner forfeits the interest under the risk of forfeiture (*e.g.*, by not providing the required services), the partner will recognize ordinary gain or loss in the difference between anything received for the interest on forfeiture and anything paid for the interest. Reg. § 1.83-1(b)(2).

(ii) However, the partner can choose to elect under IRC § 83(b) to have the interest taxed as compensation immediately (at what is hoped to be its then lower value). The partnership receives its deduction (or capitalized item) early, as well. See IRC §§ 162 or 212 on deductibility.

1) On a later sale by the partner of the interest, sale or exchange capital gain treatment would apply (long term if the holding period is met) with the compensation income being taken into account in determining basis. Normal partnership interest basis adjustments would apply, too (although ignored in the IRC § 83 regulations).

2) On a forfeiture of the restricted interest, capital loss treatment will apply to the difference between the amount paid for the interest and the amount realized on its forfeiture. The compensation income earlier recognized is not taken into account, however, and neither are normal partnership interest basis adjustments. Further, any sale or disposition in contemplation of a forfeiture or which is in substance a forfeiture, gets the same treatment. Reg. § 1.83-2(a)(2). Reg. § 1.83-2(a). This is a problem not only for the partner, but for the company and the other partners, as well. The company had taken an earlier compensation deduction (or capitalization basis increase in an asset) and now must include in income that amount. Reg. § 1.83-6(c). Where the amount had been capitalized, any deduction would have come in the form of future depreciation; but on the forfeiture, the partnership will obtain a useless basis in the forfeited interest in the amount of the income recognized, turning a relatively poor original result into a rather miserable current result.

(3) Profits Interest. Receipt of a profits interest is generally taxable if the profits interest has value. *Sol Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974). If the valuation is based upon what would be received upon an immediate liquidation, the value at the time of receipt would likely be zero. *St. John v. U.S.*, 84-1 USTC | 9158 (C.D. Ill, 1983); *Kenroy v. Commissioner*, T.C. Memo 1984-232. Other valuation procedures tend to speculate as to the future profits of the enterprise. The Tax Court in the case of *Campbell v. Commissioner*, T.C. Memo 1990-162 took the view that Treas. Reg. § 1.721-1(b)(1) does not exempt a profits interest from income and that the *Sol Diamond* case is to be followed, but that despite *St. John* and *Kenroy*, the profits interest is to be valued by discounting the anticipated cash distributions and tax benefits as described in the syndication disclosure documents. The Tax Court was reversed by the Eighth Circuit in *Campbell v. Comm'r*, 943 F.2d 815 (8th Cir. 1991) which held that the value of the profits interest in that case was speculative. It did this after the Service conceded the point and argued, for the first

time on appeal, that the interest should be taxed as being received for services received as an employee for another, related, employer, rather than as a partner in the partnership.

(a) After the *Campbell* loss, the Service ruled in Rev. Proc. 93-27, 1993-2 C.B. 343, that the receipt of a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner is not generally treated as a taxable event, unless the profits interest relates to a substantially certain and predictable stream of income from partnership assets, the partner disposes of the interest within two years of receipt, or the interest received is in a publicly traded partnership. The Service may still be willing to argue over the issue of the capacity in which the interest is received, as a partner or as an employee of a related organization.

(b) In a clarification to Rev. Proc. 93-27, the Service in Rev. Proc. 2001-43, 2001-34 IRB, held that where the conditions of Rev. Proc. 93-27 are met and where the additional conditions of Rev. Proc. 2001-43 are met, neither the partner nor the partnership will recognize gain on the grant of or on the vesting of a profits interest for a service provider, and that an IRC § 83(b) election to postpone gain is not necessary. The additional conditions under Rev. Proc. 2001-43 are:

(i) The partnership and service provider must both treat such provider as a partner from the date of grant (not vesting) and the provider takes into account the appropriate distributive share for the entire period the provider holds such interest. Note: this does not seem realistic in many situations where until the interest vests the partnership may not want to treat the provider as a partner.

(ii) On the grant of the interest or when it vests, neither the partnership nor any partner takes any deduction for compensation, wages, etc., for the value of the interest.

(iii) The issue of gain recognition by the partnership, or income to service provider, remains an open one in all other circumstances, and an IRC § 83(b) election could be appropriate.

b. **Employee or Service Member Treatment**. There are significant differences between employees providing services and members of a limited liability company (or general partners) providing services to the company.

(1) Capacity. Members of limited liability companies or general partners of partnerships, acting in that capacity, are partners and treated as such, rather than as employees. IRC § 707(a), (c); Rev. Rul. 69-184, 1969-1 C.B. 256; GCM 34001(12/23/69); GCM 34173 (7/25/69). However, under IRC § 707, a member or general partner might be treated as a third party, nonpartner if there are guaranteed payments or in an abusive situation (*e.g.*, disguised compensation to avoid capitalization).

(2) Self Employment Taxes. The self-employment tax (Old Age Survivor and Disability Insurance or OASDI) is the self-employed equivalent of the FICA Social Security tax relating to employees. Also, the Medicare tax applies to both self-employed persons

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and employees. Where the FICA tax and Medicare tax are split between an employer's share and an employee's share, the OASDI and Medicare tax for self-employment are entirely the worker's burden. Both the FICA and OASDI taxes cap out at income levels which vary year by year, but the Medicare tax applies to all employment or self-employment income without limit; it is 2.9% on the first $200,000 single or $250,000 joint, and 3.8% on the excess. IRC § 1401(b). There is a 7.65% deduction against the net income from self-employment. IRC § 164(f)(1). The first $400 of self-employment income is exempt, and taking into account the deduction, this means $433.13 of earnings are allowed before the self-employment tax applies (92.35% of $433.13 = $400).

The Federal Unemployment Tax Act (FUTA) tax of 6%, less a credit for state tax up to 5.4%) of the first $7,000 of income applies to employers but not to the self-employed.

Partners other than limited partners, and LLC members other than those who are passive like limited partners, are treated as self-employed persons and are thus subject to the self-employment tax on their net earnings from self-employment, whether or not distributed.

(a) Members of limited liability companies and general partners pay self-employment tax on such member's or partner's distributive share from a trade or business. IRC §§ 1401, 1402(a). This includes both the employer and employee halves of tax, but the "employee" half is deductible. IRC § 164(f).

(b) The key issue for partners and LLC members is what is included in self-employment income, and what is not. The starting place is the partner's or member's distributive share of the company's partnership taxable income or loss. This income may derive from the individual's personal services, or it may not; thus, it is quite possible to have the self-employment tax apply to income which would not be subject to FICA if the individual were an employee. Also, guaranteed payments by the partnership to the partner for services or for the use of capital (*e.g.*, like interest) are included as self-employment income, too.

(c) Limited partners' passive distributive shares are not subject to self-employment tax (other than guaranteed payments for services actually rendered). Members of a limited liability company who are like limited partners may be treated the same way. Prop. Reg. §1.1402(a)-2(b) (1/13/97) defines limited partners for this purpose as one without personal liability as a partner and without authority to contract, and who does not participate in the business for more than 500 hours in a tax year.

The proposed regulations (Prop. Reg. §1.1402(a)-2(b) (1/13/97), etc.) were proposed in 1997, were prevented from becoming final by Congress, and have never been withdrawn. They were not published as reliance regulations (expressly allowing reliance upon them until finalized), but still they have the effect of a statement of government position as to the meaning or the Internal Revue Code. The IRC does not define "limited partner" although the term is used in the Code to create an exception to self employment tax. Some basis for interpreting and applying the language of the Code is needed. Further, Treas. Reg. § 1.6662-4(d)(3)(iii) (2003) states that proposed regulations are substantial authority for avoiding accuracy-related penalties for understating tax liabilities.

It has been noted that the proposed regulations are the best guidance as to the meaning of the term "limited partner" for self employment tax purposes. See Timothy R. Koski, Self-Employment Tax and Limited Liability Companies: When Are LLC Earnings Subject to Self-Employment Tax?, Taxes, Sept. 2005, at 33, 34 (describing the proposed regulations and their purposes; the regulations have not been finalized and neither Congress nor the IRS has issued any other definitive guidance, leaving the proposed regulations as "the most definitive guidance available" on how to apply the limited partner exception of IRC § 1402(a)(13) to LLCs.

Also, the Tax Court has reasoned about the meaning of the statutory term in functional terms quite like the proposed regulations. See Laura E. Erdman, NOTE: Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base, 70 Wash & Lee L. Rev. 2389 (at 2431) Fall, 2013, discussing *Renkemeyer, Campbell & Weaver, LLP v. Com'r*, 136 T.C. 137, 148- 49 (2011). In that note, Ms. Erdman observes, "Some say the court's 'functional' approach-looking at whether a partner actively participated in the partnership and whether income from the partnership is predominantly 'of an investment nature'-closely resembles the 1997 proposed regulations' functional approach. Though the *Renkemeyer* Court mentioned the proposed regulations, it did not directly affirm or dismiss them, stating only that without final regulations, the court felt obliged 'to interpret the statute without elaboration."

She also, in that note, reports that "Following the *Renkemeyer* decision, IRS special counsel Dianna Miosi, while speaking at the May 2011 American Bar Association Section of Taxation meeting, stated that taxpayers 'can rely' on the 1997 proposed regulations". (See Monte A. Jackel, Has Politics Trumped Policy?, 131 Tax Notes 745, 746 (May 16, 2011) (describing Miosi's statements)). Still, she notes "conservative practitioners argue that 'can' rely does not mean 'should' rely and question advising clients based on Miosi's comments", which, being a mere oral statement, could be disclaimed later by the government.

See also, *Elkins v. Com'r*, 81 TC 669 (1983) (reliance on proposed regulations should not, in at least some circumstances, particularly where there are retroactive changes to them, be detrimental to taxpayer); Chief Counsel Advice 201436049 (takes functional approach in denying exemption for partners with non-investment type income from management fees for investment company).

(d) Separate classes of interest might be used, under the proposed regulations, to allow limited partner treatment for some part the interest of a member of an LLC with management authority. Let's look at the key provisions of these proposed regulations relating to the dual interest issue. Prop. Reg. § 1.1402(a)-2(h)(3) permits members such as this member with management authority to be taxed as a limited partner when:

(i) They own two classes of equity interest, *i.e.*, at least one class of "general partner" interest for individuals having personal liability or contractual authority, and at least one other "investment class." The investment class members may not participate for 500 hours a year.

(ii) A substantial portion of the interests in a "bona fide investment class" is continuously owned by passive partners (members) with rights and obligations identical to other holders of this interest. According to Prop. Reg. § 1.1402(a)-

2(h)(6)(iv), a substantial portion is determined on all of the relevant facts and circumstances. However, ownership of 20% or more of a specific class of interest is considered substantial.

(iii) The proposed regulations do not allow limited partner treatment of members of any service organization in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. Prop. Reg. § 1.1402(a)-2(h)(5).

(e) The next step is to see what income is excluded for purposes of the self-employment tax.

First, the bad news: self-employment income is not reduced by these things:

- – operating loss carrybacks or carryovers
- – nonbusiness deductions
- – health insurance deduction for the self-employed (under § 162(1)(4))
- – personal exemptions
- – standard deduction
- – foreign expropriation loss
- – contributions to qualified retirement plans

Second, the good news: such income does not include these things (among some others):

- – Certain partner retirement income under a written plan
- – dividends and interest on investments (interest in the normal course of business, *e.g.*, on accounts receivable, would be included, however)
- – gains (or loss) on noninventory property or not held for sale to customers
- – rents from real estate held for income (not in ordinary course by dealer) or value growth (except where held by a dealer for sale) where services are not provided for occupants' convenience

(f) Note that certain retirement payments to members under a written plan are also excluded. IRC § 1402(a)(10); Reg. § 1.1402(a)-17. However, contributions to *qualified* retirement plans are not excluded. To qualify for the retirement payments exclusion, the retirement payments must be bona fide retirement payments, to partners or classes of partners generally (in some cases a class of one will be sufficient), made on a periodic basis, continuing at least until the partner's death, the partner performs no services for the partnership business in the partnership's tax year, the partnership and partners have no other obligations to the retired

partner in the partnership tax year ending in the retired partner's tax year (other than benefits for health or on death), and the retired partner's share of capital is paid to the partner before the close of the partnership's tax year.

(g) Also, note that rents and capital gain exceptions apply for general partners or active members of an LLC where the company has invested in investment real estate, that is, an investment for rental income and capital gain income and which is not an active trade or business.

Thus, partners or members in the typical investment partnership or LLC may not suffer from the self-employment tax, but those in a trade or business will.

(h) The regulations help in understanding the self employment tax treatment of general partners or active members of an LLC where the company has invested in investment real estate, that is, an investment for rental income and capital gain income and which is not an active trade or business. An apartment house in the normal situation would be such an investment, but a hotel or guest house or self-storage warehouse facility involve services for the convenience of the occupant and would be a trade or business, as would the activities of a dealer or developer of real estate. Investment partnership rents and gains are excluded from self employment income but income from a trade or business (within the meaning of IRC section 1402(c) and Reg. ' 1.1402(c)-1), including of a dealer in real estate, is not so excluded. Reg. '' 1.1402(a)-1(a)and (b) ("net earnings from self-employment"), 1.1402(a)-2(d) (net earnings from self-employment include distributive share from any trade or business carried on by partnership), 1.1402(a)-4(a) and (d) (in trade or business only that portion of income not classifiable as rentals from real estate, and the expenses attributable to such portion, are included in determining net earnings from self-employment), 1.1402(a)-4(a) and (d), 1.1402(a)-6(a) (exclude any gain or loss from the sale or exchange of a capital asset (not inventory); immaterial whether capital gain or loss or ordinary gain or loss).

(3) No Withholding. Partners and members file quarterly estimated tax returns (IRC §§ 6654, 6655) and (except for foreign partners under IRC § 1446) are not subject to withholding. Partners cannot elect to have tax withholding apply to their distributions or compensation under a voluntary withholding agreement under IRC § 3401(p), since they are not employees. See Rev. Rul. 69-184, 1969-1 C.B. 256.

(4) Timing. Partners and members are taxed on their shares whether or not distributed. IRC §§ 701, 702. Employees are generally taxed on receipt or constructive receipt. IRC § 61(a)(1). A partner or member includes income in his or her taxable year that includes the last day of the partnership or company taxable year. IRC § 706(a). There may be some deferral if there are different taxable years (although this situation is not too likely to occur); such deferral is not available to an employee who includes the income in the year received.

(5) Character. The partner's or member's income will have its character (as capital or ordinary) determined by the partnership or company. IRC § 702(b). Employee compensation is always ordinary. Also, the sale of an interest generates capital gain or loss (except for appreciated inventory or accounts receivable) (see IRC §§ 741, 751), while

payments for termination of an employment agreement will be ordinary income whether or not constituting severance pay. See Rev. Rul. 74-252, 1974-1 C.B. 287.

(6) Reporting. Partners and members receive K-l forms (Schedule K-1 to Form 1065), rather than W-2 or 1099 forms.

c. **Selected Benefit Issues**. Certain "employment" benefits are treated differently for service partners than for true employees. An overview of possible tax-favored benefits is provided at 1.d. above. Let's review some of these a little more closely.

(1) Fringe Benefits. As described at 1.d. above, some tax-favored benefits are more restrictive for partners and members and some are not available at all.

(a) For example, partnerships and limited liability companies do not qualify for: incentive stock options, cafeteria plans, $50,000 group term life cost exclusion. On the other hand, the golden parachute excise tax (and deduction limitation) rules (IRC § 280G) do not apply with respect to partnerships or limited liability companies on a change in control (this is, of course, a good thing for partnership-taxed organizations).

(b) While employees generally are not taxed on health insurance premiums (IRC § 106), the value of health insurance is included in income by the partner or member as a guaranteed payment and is deductible by the company. The member or partner may receive a deduction in calculating adjusted gross income (*i.e.*, an "above-the-line" deduction) of 100% of the amount paid. IRC § 162(1)(1)(B). The deduction does not apply for self employment tax calculations.

(c) Meals and lodging on employer premises are probably not excludable by a partner or member. (This is despite *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968), which case the Service will not follow. GCM 34173 (7/25/69)). De minimis fringe benefit status if meals are to allow overtime work, might possibly allow an exclusion of such amounts for partners or members. IRC § 132(e); Reg. § 1.132-1(b)(4); Reg. § 1.132-6(d)(2).

(d) Members and partners cannot receive transportation benefits, such as parking ($260 per month for 2018), transit passes and van pools, bicycle commuting reimbursement ($20 per month); rather, they only may receive nontaxable transit passes up to $21 per month as a de minimis fringe benefit. IRC § 132(e); Reg. ' 1.132-1(b)(4); Reg. § 1.132-6(d)(1).

(2) Retirement Plans. Partnerships and limited liability companies can adopt qualified plans very much like those of corporate employers. However, there are some significant differences because partners and members of limited liability companies taxable as partnerships are treated as self employed.

(a) Loans. A loan to a self-employed individual from a qualified plan generally qualifies as a prohibited transaction subject to serious penalty excise taxes. ERISA § 408(d). However, an exception allows such loans to be made to owner-employees under rules similar to loans to employees under corporate plans.

(b) Deduction. The maximum amount deductible for a retirement contribution for a self-employed individual is limited to the 25% of individual's net self-employment "earned income." IRC § 404(a)(8). Earned income is, essentially, earnings from personal services derived from the trade or business establishing the plan. IRC §§ 401(c)(2) and 401(d). The provisions of IRC § 401(c)(2) require the employer to compute the deductible limit by determining the partner's earned income after taking into account the partner's share of the employer's qualified plan deduction. In calculating the deduction, the employer also takes into account the deduction for one-half of the self-employment tax under IRC § 164(f). These items reduce the deductibility limit. The deductibility limit does not apply, however, to elective deferrals under the 401(k) feature of a plan. IRC § 404(n). (The elective deferral contribution for 2018 could be as much as $18,500.) On the other hand, the partner's qualified plan deduction does not reduce the partner's earned income for self-employment taxes. All this requires an algebraic formula to calculate, but the benefits under such plans can be excellent.

(c) Options. Although incentive stock options under IRC §§ 421 and 422 (which allow taxation upon sale of the stock acquired under the option) are not available to partnership-taxed organizations, nonqualified options should be available and be taxed pursuant to Reg. § 1.83-7. The result is that there should be no tax on the grant of the option, but the service provider will be taxed upon the exercise of the option on the spread between the fair market value of the interest received over the exercise price. The partnership or limited liability company itself should not (under the better view described at 2.a.(1) (a) and (b). above) recognize gain on the grant of a capital interest, and this rule should apply here, as well, but the matter is not clear, as described above, in connection with capital interests for services.

d. **Deferred Compensation**. In addition to the usual deferred compensation rules (see, *e.g*., IRC §§ 83 and 409A), certain partnerships and foreign corporations ("nonqualified entities") are subject to some strong tax limitations regarding the use of deferred compensation. IRC § 457A, effective for services rendered after 2008. A partnership taxed organization subject to these rules is any partnership unless substantially all of its income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and organizations which are exempt from income tax under the Code. See Notice 2009-8, 2009-4 IRB. Deferred compensation is as defined in the onerous IRC § 409A (which may also apply separately to certain deferred compensation arrangements). Any compensation which is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income of the service provider when there is no substantial risk of forfeiture of the rights to such compensation, and such a risk of forfeiture will only exist where compensation is conditioned on the future performance of substantial services, or in some cases (investment funds, *e.g.*) on disposition of an investment asset where the compensation is determined solely by gain on its disposition. In addition to early inclusion in income, the tax will be increased by a stiff interest factor (underpayment rate under IRC § 6621 plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred, or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture), and also by an additional 20% of the compensation. This onerous

treatment is very similar to that under IRC § 409A which applies to certain forms of deferred compensation and modifications, accelerations, etc. related to such deferred compensation.

e. **Carried Interest Restrictions**. After 2017, there are restrictions on what are called carried interests designed to compensate certain kinds of investors and developers at favorable capital gains rates. Under the rules effective after 2017, only if the relevant capital asset was held for more than three years will long term capital gains rates apply to a partnership interest (including a profits interest) transferred to a partner for the performance of services in a trade or business raising and returning capital in connection with investing in or developing securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing types of investment, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing. IRC § 1061. It appears likely that the relevant capital asset may be either the partnership interest or the capital asset held by the partnership and thus the restriction may be triggered on either a sale of the partnership interest or the allocation of gain in the asset held by the partnership. Further guidance is needed on this issue. The holding period of the partnership is the key for the sale of the asset held by the partnership, and the holding period of the partner (or a related person under look through rules) is the key for a sale of the partnership interest. There are some exclusions. Some interests are not treated as applicable partnership interests, such as (i) those held by an employee of another entity that is conducting a trade or business other than an applicable trade or business and only provides services to the other entity, (ii) those held directly by a corporation (Is this only a C-corp.? Regulations will answer this affirmatively. Notice 2018-18.), (iii) a capital interest commensurate with the capital contributed or the value of such interest subject to tax under IRC § 83 upon receipt or vesting of the interest (how does this apply to mixed capital and profits interests?).