New Regulations Squash Planning Tool for Avoiding Self-Employment Tax and Related Employee Benefit Issues

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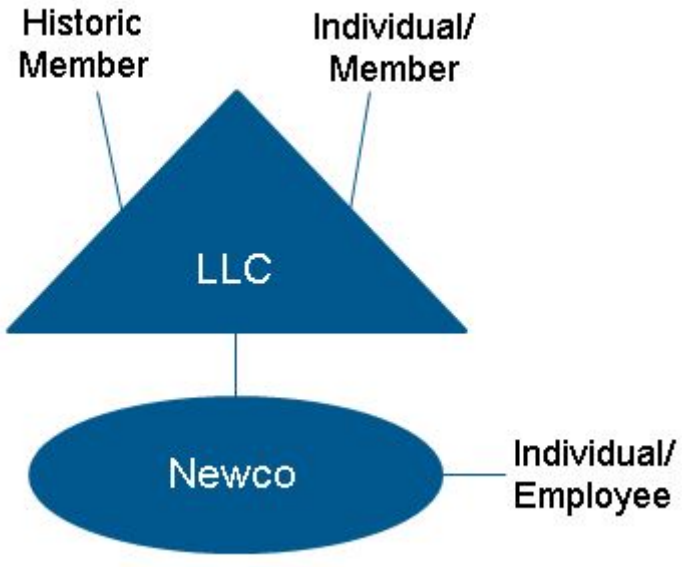
Tax practitioners often face this issue: client is a limited liability company taxed as a partnership for federal income tax purposes (?LLC?), and it wants to issue equity to a current employee (?Individual?) without subjecting Individual to self-employment tax. A problem arises, however, as a result of Rev. Rul. 69-184, 1969-1 C.B. 256, which states that a partner in a partnership cannot also be an employee of that partnership. Practitioners have attempted to bypass this rule by creating a new, wholly-owned subsidiary of LLC (?Newco?) and having LLC contribute all of its assets to Newco in exchange for 100% of Newco?s membership interests. Newco, in turn, would employ Individual while LLC would issue Individual membership interests. Practitioners took the position that Individual could be an equity owner in LLC while maintaining his or her status as an employee of Newco, thereby avoiding self-employment tax on Individual?s salary and preserving his or her eligibility for various employee benefit plans. The resulting structure was as follows:



On May 3, 2016, however, the IRS issued temporary regulations (T.D. 9766) aimed at eliminating this common workaround. The regulations provide that, to the extent a partnership owns a disregarded

entity, the partnership?s partners are not employees of the disregarded entity for employment tax purposes; rather, they are subject to self-employment tax.

By way of background, a business entity that has a single owner is treated as a disregarded entity for federal income tax purposes under Treasury Regulation Section 301.7701-2(c)(2)(i). As an exception to that rule, Treasury Regulation Section 301.7701-2(c)(2)(iv)(B) provides that a disregarded entity is treated as a corporation for federal employment tax purposes. As such, a disregarded entity is treated as the employer of its employees for federal employment tax purposes even though its status for federal income tax purposes is ignored.

The Treasury Regulations are clear in setting forth that the exception for disregarded entities in the context of employment taxes does not extend to self-employment taxes. Specifically, Treasury Regulation Section 301.7701-2(c)(2)(iv)(C)(2) states that the owner of a disregarded entity that is treated the same as a sole proprietorship is subject to self-employment income tax. The Treasury Regulations go on to provide an example in Section 301.7701-2(c)(2)(iv)(D) of the disparate employment and self-employment tax treatment of a disregarded entity with employees. The example involves a disregarded entity that is owned by an individual and pays wages to several employees. While the disregarded entity is subject to employment taxes with respect to its employees, the individual owner of the disregarded entity is subject to self-employment taxes on the net earnings of the entity?s activities.

Prior to May 3, 2016, the Treasury Regulations were silent, however, as to the treatment of partners in a partnership owning a disregarded entity, and this silence gave rise to the perceived planning opportunity referenced above. Nevertheless, the newly-issued temporary regulation specifically states that ?[a] partner of a partnership that owns an entity that is disregarded as an entity separate from its owner?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?? Thus, in our example above, the status of Newco is now ignored, and any wages paid to Individual by Newco will be attributed to LLC in determining Individual?s income subject to self-employment tax.

This temporary regulation affects not only partners? liability for self-employment taxes, but also their ability to participate in certain employee benefit plans offered by disregarded entities. Self-employed individuals and partners, generally, may not purchase qualified benefits, such as health, dental and vision coverage, on a pre-tax basis through an Internal Revenue Code Section 125 cafeteria plan. In addition, self-employed individuals and partners are not eligible for the exclusion from gross income of employer-provided accident and health plans under Internal Revenue Code Sections 105 and 106.

The IRS acknowledged that partnerships will need time to make necessary payroll and benefit plan adjustments, likely due to the widespread use of disregarded entity employers as a means of avoiding self-employment tax. For that reason, the effective date of the temporary regulation is the later of (i) August 1, 2016 or (ii) the first day of the latest-starting plan year following May 4, 2019, of an affected plan sponsored by a disregarded entity. Prior to finalization of the temporary regulation, the IRS has requested comments on the application of Rev. Rul. 69-184 to tiered partnerships and circumstances in which it may be appropriate to permit partners also to be employees of the partnership.

To the extent that you are a partner, member or employee of a business entity or series of business entities that made use of the planning opportunity discussed above, you will need to take note of this newly-issued regulation and make appropriate payroll and benefit adjustments. While this regulation is only temporary, it solidifies the position of the IRS with respect to partners of partnerships owning disregarded entities and their liability for self-employment tax. Williams Mullen will continue to monitor this temporary regulation, the comments that are issued with respect to it, and its finalization by the IRS.

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