

# Are partners employees? What the IRS says about taxing partnerships

On June 28, the Internal Revenue Service finalized Treasury regulations relating to the [tax treatment of partners](#) (T.D. 9869).



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These regulations confirm that owners of an entity treated as a partnership for federal income tax purposes, including limited liability companies, cannot be treated as employees for purposes of employment taxes and income tax withholding. Instead, an owner is treated as “self-employed” to the extent he or she receives compensation for services rendered to the partnership. This has important [tax consequences](#) for both the owner and the partnership.

For example, because an owner is not an employee, the partnership will not withhold taxes from his or her check or share the responsibility of paying any employment tax. Instead, an owner will be responsible for making estimated income tax payments and paying 15.3% self-employment tax on his or her compensation. Owners must also treat any partnership-paid health insurance premiums as income and are barred from participating in the partnership's cafeteria plan, unlike the partnership's employees. In addition, the partnership must report any owner compensation on Schedule K-1 versus the more traditional Form W-2.

Because many owners prefer to be treated as employees, especially current employees awarded an ownership interest in the company as compensation, partnerships have attempted to develop a work-around to these rules. One popular structure involved the formation of a wholly owned subsidiary to employ the partnership's owners. In this scenario, the subsidiary would be disregarded for federal income tax purposes, allowing the partnership to continue filing a single Form 1065, U.S. Return of Partnership Income, but respected for employment taxes, enabling the partnership to treat its owners as W-2 employees rather than self-employed. The recently finalized Treasury regulations shut down this structure by clarifying that a disregarded entity cannot be used to convert an owner of a partnership into an employee.

Now that the IRS has finalized rules prohibiting this structure, it is important for tax partnerships, including many limited liability companies, to reevaluate how they are treating their owners for federal income tax purposes. To the extent a partnership has owners that would prefer to be treated as employees, or plans to offer an equity interest in the partnership to key employees as an incentive, the business should reach out to an experienced tax attorney to discuss potential structuring alternatives.

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