Client Alert | Employment, Compensation & Benefits

IRS Releases Final and Temporary Regulations on Self-Employment Tax Rules

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Background

Earlier this month, the Internal Revenue Service (the "IRS" or "Agency") released final and temporary regulations (the "Regulations") that clarify the employment tax treatment of partners in a partnership that owns a disregarded entity. Federal regulations (the "CFR") state that, except as otherwise provided, a business entity that has a single owner that is not a corporation under Section 301.7701-2(b) of the CFR is a disregarded entity. While the IRS never intended for there to be a distinction between disregarded entities owned by an individual and those owned by a partnership, the Agency has recognized that certain parties have read the CFR to permit the treatment of partners in a partnership that own a disregarded entity, as employees of the disregarded entity. These Regulations are meant to clarify that such partners cannot also be treated as employees of such a disregarded entity.

The New Regulations

Generally, the effect of these Regulations is to prevent partners that work for a disregarded entity owned by a partnership from participating in such disregarded entity's employee benefit plans and that such partners are subject to the self-employment tax rules. The IRS has clarified that the "rule that the entity is disregarded for self-employment tax purposes applies to partners in the same way that it applies to a sole proprietor owner…the partners are subject to the same self-employment tax rules as partners in a partnership that does not own a disregarded entity." The temporary Regulations will apply on 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 an entity that is disregarded as an entity separate from its owner.

Importantly, the Regulations do not address the application of IRS Revenue Ruling 69-184[1] (which, the IRS has in effect re-affirmed in the Regulations) in tiered partnership situations. That said, the IRS has requested comments in the Regulations on the appropriate application of the principles of Rev. Rul. 69-184 to tiered partnership situations, and the impact on employee benefit plans and on employment taxes if partners were permitted to also be employees in select circumstances. Additionally, the IRS also requested comment on the circumstances in which it may be appropriate to permit partners to also be treated as employees of the partnership and specifically mentioned management incentive compensation as an area for future consideration.

[1] Rev. Rul. 69-184 generally provides that 1) bona fide members of a partnership are not employees of the partnership within the meaning of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages, and 2) such a partner who devotes time and energy in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual, rather than an employee.

Going Forward

As the Regulations do not affect the use of tiered partnerships, we do not expect these Regulations to change practices for most private equity structures. We do expect to see private equity sponsors to continue to use management aggregator LP structures in their transactions so as to clearly fit within the tiered partnership structure and recommend continued focus on partner/employee distinctions when structuring transactions.

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