For anyone working in a partnership, making the leap from employee to partner is often a great career accomplishment. But from a tax standpoint, the achievement brings with it a number of new—and significant—tax considerations, particularly in the compensation and benefits arena. Both employers and employees should be aware of, and appropriately address, such considerations to avoid potentially costly consequences, effectively turning a great achievement into a compliance nightmare.

Some of the most common compensation and benefits issues encountered by partnerships include:

**Tax Reporting**

While an employee of a partnership, an individual’s wages are subject to federal and state (where applicable) income and employment tax withholding (e.g., Medicare and Social Security) and reporting (Form W-2). But when the individual becomes a partner, his or her compensation is no longer subject to employer withholding of these taxes, since the individual is no longer considered an “employee” of the company. Rather, the individual must typically make quarterly estimated tax payments (often federal and state) to the appropriate taxing authorities. Additionally, the individual must pay self-employment tax, which is equal to the employee and employer portions of Social Security and Medicare tax.

This partnership income is reported on the individual’s Schedule K-1, and the individual does not receive a Form W-2 for income earned while a partner (though the individual should receive both a Form W-2 and Schedule K-1 if he or she becomes a partner in the middle of a tax year). For partnerships that operate in multiple states, the change to partner status causes the individual to have income tax liability (and related filing obligations) in all the various states in which the partnership does business (though there could be some relief through filing a “composite” return).

Procedures for addressing tax reporting and withholding mistakes for partners that are erroneously classified as employees would include reclassifying any income that was treated as employee wages to be partnership income. This approach may require corrected Forms W-2 to zero out amounts paid to the partner that should not have been treated as wages, seeking refunds for amounts that were incorrectly withheld for income and employment taxes, and ensuring that the amounts are reported properly on the partner’s Schedule K-1 and classified correctly on the partnership’s tax return. If discovered by the IRS, they could argue that the issuance of a partnership profits interest should be fully taxable upon vesting at the fair market value, as the partnership would not satisfy Rev. Proc. 2001–43 (which permits the granting of a profits interest to be a nontaxable event for the partner and the partnership).

**Health, Welfare and Fringe Benefits**

Employees generally are able to pay for their portion of insurance premiums for healthcare and related benefits from their wages with pre–tax dollars through a cafeteria plan. Similarly, employers pay their share of the employee’s premiums through a cafeteria plan. However, partners are not able to participate in cafeteria plans, so this favorable tax treatment is not available (including participation in healthcare “flexible spending accounts” on a pre–tax basis). Further, some employee welfare or fringe benefits are entirely unavailable to partners, such as educational assistance, qualified employee discounts and working condition fringe benefits.

Payments of these medical premiums by employers are generally treated as “guaranteed payments” for tax reporting purposes.
(Schedule K–1) because they are made without regard to the partnership’s income. The partner, however, may ultimately be allowed to deduct amounts he or she pays for these benefits on his or her tax return.

Although IRS audits of cafeteria plans are relatively uncommon, a violation of the cafeteria plan rules, even if only concerning a single participant, can cause all cafeteria plan participants to lose the pre–tax cafeteria benefit (i.e., be taxed on everything they contributed tax–free)—potentially retroactive to the oldest open tax year. The most conservative approach to addressing this issue when it is discovered after the fact would likely be to “cancel” the partner’s participation retroactively and treat all the partner’s tax–free cafeteria benefits (e.g., insurance premiums paid by the partnership, tax–free FSA contributions, etc.) as taxable to the partner (e.g., guaranteed payments). This approach can be burdensome for partnerships where the error spans multiple years because it may require corrected tax returns (by both the partnership and partner) for prior years. There are some more aggressive potential alternatives, but such aggressive approaches may expose the partnership to potential tax liability if the issue is raised by the IRS.

Retirement Plans

A partner may generally participate in 401(k) and related retirement plans. However, the tax treatment of the partner’s participation is not entirely the same as when the partner was an employee. For example, a partnership’s matching contribution to a partner’s 401(k) is generally treated as a guaranteed payment and would be subject to self–employment taxes (but not income taxes).

Similar to erroneous pre–tax health and welfare benefits for partners, the general approach to addressing incorrectly classified 401(k) contributions by a partner would to re–classify those amounts as appropriately taxable (e.g., matching contributions as guaranteed payments). This approach can also require corrected tax returns because of the additional taxes to the partner.

The Compensation & Benefits professionals at Alvarez & Marsal have extensive experience in identifying and correcting these types of partnership compliance issues, and can assist with creating processes to avoid these types of issues going forward.

Related Insights:

IRS Releases Proposed Regulations on Partnership Interests [2]

On December 20, 2018, the Internal Revenue Service (the “IRS”) and the Treasury Department released proposed regulations (the “Proposed Regulations”) under Section 864(c)(8), a provision providing for U.S. federal taxation of a foreign partner’s gain on the sale or exchange of certain partnership interests.

The Increased Value of the Nonqualified Deferred Compensation Plan [3]

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act of 2017 (TCJA), bringing about the most sweeping changes to the Internal Revenue Code since 1986. Total rewards professionals are now reconsidering the value of various compensation vehicles and employee benefits programs.

Retention in Market Cycles: Keeping the Talent Needed in Cyclical Industries [4]

Every industry, at some point, will experience a downturn. Those companies that strategically plan for these events, foreseen or unforeseen, are more likely to survive and thrive in a difficult market. In some respects, all industries are cyclical, differentiated only in their severity and the duration of the cycles.

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