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BUSINESS PLANNING

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PARTNER OR EMPLOYEE?

When an employee of a corporation acquires shares of that corporation's stock, his tax status as an employee does not change. When an employee of a partnership or a limited liability company acquires an interest in the employer, it's a little more complicated.

Yesterday Steve was a valued employee of MMD, a limited liability company. This morning he acquired a 1% interest in MMD and became a member of the LLC. For the payroll period starting today, is Steve still an employee of MMD? In a word, no.

For federal and California tax purposes, LLCs generally are treated as partnerships and LLC members are treated as partners. The IRS takes the position that a partner cannot be an employee of the partnership, and most courts that have faced the issue agree. That position, while inconvenient for the partner, is consistent with tax law and with the California laws that apply to LLCs and partnerships.

Steve will be treated for tax purposes as a partner and not as an employee. Starting today, his pay will be treated as guaranteed payments (a type of partnership distribution) from

MMD and not as wages. The guaranteed payments will not be subject to wage withholding. Steve will be subject to the estimated tax regime and to self-employment tax. MMD will no longer pay the employer's portion of Steve's FICA and Medicare tax. Instead, Steve will pay "both halves" of these taxes and will be entitled to deduct half of what he pays.

Steve tells MMD's managers that he wants MMD to continue the wage withholding and to continue to pay the employer portion of his FICA and Medicare tax. Steve and his wife are concerned that they won't save enough to make adequate quarterly estimated tax payments. They don't want to incur additional accounting fees. However, Steve is happy to learn that when MMD sells its business, most of his gain will be long-term capital gain if he holds his interest for a year.

If MMD continues to treat Steve as an employee for employment tax purposes, tax authorities have little reason to complain, because amounts approximately equal to Steve's tax obligation are paid when due or sooner. MMD should not pay any of Steve's self-employment tax as FICA or Medicare taxes. Steve will not be able to credit the excess FICA and Medicare taxes against the self-employment tax that he owes. Instead, Steve should have the payroll service "over-withhold" federal income tax each pay period in amounts sufficient to cover Steve's self-employment tax obligation for the year.

However, employment taxes are not the only issue. Steve must be properly characterized for employee census purposes or the tax qualification of MMD's qualified employee benefit plans could be threatened. As a partner, Steve must pay for some of his accident and health insurance premiums with after-tax dollars. He will not be able to exclude from income his partnership-provided meals and lodg

ing while traveling on partnership business. He cannot exclude from income benefits under MMD's cafeteria plan or his share of MMD's group life insurance premium.

There are ways to give Steve the upside in MMD without changing his status as an employee. No method is perfect, and each has advantages and disadvantages. One way is to organize a corporation that provides management services to MMD; Steve would acquire a membership interest in MMD and would become an employee of the corporation and cease to be an employee of MMD. Another way is to give Steve an option to buy a membership interest in MMD, perhaps exercisable only if MMD sells its business.

We can help you work through the issues involved in providing equity interests to employees of partnerships and LLCs.

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