December 9, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on potential changes to Rev. Rul. 69-184

Dear Commissioner Rettig:

Enclosed please find comments on the impact of potential changes to Rev. Rul. 69-184 and specifically the regulations that would be implicated if “dual status” (treatment of certain partners as employees) is allowed. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

[Signature]
Tom Callahan
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Jeffrey Van Hove, Senior Advisor, Office of Tax Policy, Department of the Treasury
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Bryan Rimmke, Attorney-Advisor, Department of the Treasury
Carol A. Weiser, Benefits Tax Counsel, Department of the Treasury
Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service
William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service
Victoria A Judson, Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes), Internal Revenue Service
Holly Porter, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Janine Cook, Deputy Associate Chief Counsel, Employee Benefits, Exempt Organizations and Employment Taxes, Internal Revenue Service
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ABA SECTION OF TAXATION
COMMENTS ON REV. RUL. 69-184

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Leigh Griffith, Kurt Lawson, and Jeanne Sullivan of the Section’s Committee on Government Submissions. Substantive contributions were made by Yelena Fertman Gray, Andrew Liazos, Shane Morris, Helen Morrison, Andrew Oringer and Sean Sullivan. The Comments were reviewed by Katherine Kennedy, Jennifer Alexander, and Edward J. Leyden. The Comments were further reviewed by Catherine Engell, Adam M. Cohen, and Eric B. Sloan, Vice Chair for Government Relations for the Section.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: December 9, 2019
EXECUTIVE SUMMARY

Many provisions of the Code apply differently to employees and independent contractors. These include most of the employment tax provisions and some of the provisions dealing with employee benefits and executive compensation. However, as the U.S. Department of the Treasury (“Treasury”) has observed, “[c]urrent law does not consistently favor employee or independent contractor status.”

Employment status for these purposes is determined based on the common law. Partners of a partnership and members of an LLC generally are treated as independent contractors under the common law when they perform services for the partnership or LLC, because, in the past, the nature of their relationship with the partnership or LLC made it hard to satisfy the common-law test to be treated as employee. And, at least since 1969, when it issued Rev. Rul. 69-184, the Internal Revenue Service (the “Service”) has taken the position that this means that bona fide partners cannot be employees of the same business.

Treasury and the Service recently suggested that they are reconsidering the Service’s position in Rev. Rul. 69-184, and have requested comments on this issue. In order to provide helpful comments, we have included comments on the regulations that would be implicated if so-called “dual status” (treatment of certain partners as employees) is allowed.

We commend Treasury and the Service for taking this step, and we appreciate the opportunity to provide comments. Specifically, we recommend that Treasury and the Service:

1. Revoke Rev. Rul. 69-184 and recognize the possibility that any individual can be an employee and a bona fide partner of the same partnership with respect to different sources of income from the partnership.

2. Alternatively, modify Rev. Rul. 69-184 and recognize the possibility that an individual can be an employee and a bona fide partner of the same partnership for individuals who hold a small interest in the partnership or

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1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code” or “I.R.C.”), unless otherwise indicated.


3 Unless otherwise indicated, limited liability companies (“LLCs”) are assumed to be treated as tax partnerships, and it is further assumed that (i) an LLC will not elect to be classified as a business entity that is taxable as corporations; (ii) the LLC will not be treated as a disregarded entity separate from its owner; and (iii) references herein to “partnerships” and their “partners” are intended to include LLCs and their members.

LLC (allowing those individuals to be treated as employees), and treat a capital or profits interests of less than ten percent as “small” for this purpose.

3. As a third alternative, issue a revenue procedure that allows an individual who holds a small interest in the partnership or LLC to be treated as an employee, and that treats a capital or profits interests of less than ten percent as small for this purpose. A proposed revenue procedure is appended to these Comments.

4. As a preliminary step – but not an alternative to the recommendations above – we recommend that Treasury and the Service extend voluntary withholding under section 3402(p) to guaranteed payments for services under section 707(c).

As noted above, individuals who are both employees and partners of the same partnership or LLC are referred to in these Comments as having “dual status.”
DISCUSSION

I. BACKGROUND

A. Provisions of the Code That Apply Differently to Employees and Independent contractors


a) Social Security and Medicare

(1) In general

An employee is subject to old age, survivors, and disability insurance (“Social Security”) and Medicare hospital insurance (“Medicare”) taxes, if at all, under the Federal Insurance Contributions Act (“FICA”) tax rules. By contrast, an independent contractor, including a partner or LLC member, is subject to Social Security and Medicare taxes, if at all, under the Self-Employment Contributions Act (“SECA”) tax rules.

Since 1990, the combined tax rates on employees and their employers, on the one hand, and on independent contractors, on the other, have been virtually identical under both FICA and SECA. Before 1983, the tax rates on independent contractors were substantially lower, even though they generally were eligible for the same Social Security and Medicare benefits as employees, but legislation in 1983 mostly eliminated the rate differential.

Certain differences remain between employees, on the one hand, and independent contractors, on the other, and in some cases the differences are substantial:

5 Chapter 21 of the Code.

6 Independent contractors often are called self-employed individual for this purpose, and we use these terms interchangeably in these Comments.

7 268A Stat. 353, as codified and amended at Chapter 2 of the Code.

8 The combined Social Security and Medicare tax rate is the same under both: 15.3% plus an additional 0.9% Medicare tax. I.R.C. §§ 1401, 3101, 3111. Under both, only the first $132,900 of income (in 2019) is subject to Social Security tax, while the entire amount is subject to Medicare tax.

A separate 3.8% tax is imposed on net investment income. I.R.C. § 1411. The tax was designed to parallel the Medicare portion of FICA and SECA taxes, which total 3.8% when the additional 0.9% Medicare tax is included. The tax generally applies to distributive shares of partnership income that are not otherwise subject to SECA taxes if the income is passive income that is not derived from a trade or business (within the meaning of I.R.C. § 162), or income from a trade or business that is a passive activity with respect to the partner (within the meaning of I.R.C. § 469) or a trade or business of trading in financial instruments or commodities (within the meaning of I.R.C. § 475).

• Some relate to the income on which FICA and SECA taxes are imposed, which is called “wages” in the case of FICA (“FICA wages”) and “self-employment income” in the case of SECA (“SECA income”). For example, unlike a contribution on behalf of an employee, which generally is excluded from the employee’s FICA wages,10 a contribution to a health plan, qualified plan or simplified employee pension on behalf of an independent contractor may not be deducted in computing the individual’s SECA income, because it is not considered “attributable to” the individual’s trade or business.11 On the other hand, trade or business expenses may be deducted from SECA income but not FICA wages.

• Some relate to the timing of taxation. For example, there is no rule under SECA that is analogous to the special rule for deferred compensation in section 3121(v)(2).12

• Another relates to the dollar limit on income subject to Social Security tax. In computing Social Security tax on a new employee’s FICA wages, an employer generally may not take into account the fact that the employee already might have received FICA wages in excess of the dollar limit from another employer.13 If this results in an overpayment, the employee is entitled to a refund, but the employer is not.14 Because SECA income is determined entirely at the individual level, there is no similar overpayment problem under SECA.15

• Another relates to the fact that employees are not subject to income or FICA taxes on the portion of FICA taxes that are imposed on and paid by their employer. Because independent contractors pay all of their own SECA taxes, there is no opportunity for such exclusions. They are entitled to special deductions that are

10 I.R.C. § 3121(a)(2), (a)(5); but see I.R.C. § 3121(a)(5)(C), (v)(1) (requiring certain employee elective contributions to be included).

11 I.R.C. § 1402(a); GCM 39807 (Jan. 16, 1990). This is true even though the contributions generally are deductible for income tax purposes. Cf. LaFlamme v. Commissioner, 103 T.C.M. (CCH) 1201 (2012) (self-employed taxpayer may deduct contribution to pension plan when calculating income tax liability, but not when calculating self-employment tax liability). The Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504 (the “SBJA”), § 2042, allowed independent contractors to deduct health insurance costs in determining self-employment income, effective for calendar year 2010 only.


15 See I.R.C. § 1402(b)(1); Treas. Reg. § 1.1402(b)-1(b)(2).
intended to achieve the same economic result as the exclusions, but the deductions are somewhat larger than needed for that purpose.\textsuperscript{16}

(2) Limited partner issue

The SECA income of a general partner generally includes his or her entire distributive share of partnership income or loss described in section 702(a)(8).\textsuperscript{17} This can be true even if he or she does not participate in the management of the partnership, or in any partnership activities, and even if a significant portion of the distributive share represents nothing more than a reasonable return on his or her capital.\textsuperscript{18} To this is added any guaranteed payments for services or for the use of capital.\textsuperscript{19}

By contrast, FICA wages of an employee-shareholder of a corporation are limited to amounts actually paid to him or her as compensation, even if the corporation is an S corporation.\textsuperscript{20} The employment tax treatment of a limited partner is more similar to that of an employee-shareholder than it is to that of a general partner. Specifically, under section 1402(a)(13) (the “limited partner exception”) self-employment income of a limited partner includes only guaranteed payments for services described in section 707(c), and excludes his or her entire distributive share of partnership income.\textsuperscript{21} The legislative history indicates that the limited partner exception was adopted because some business organizations were soliciting investments in limited partnerships as a means to

\textsuperscript{16} I.R.C. §§ 164(f), 1402(a)(12); see Staff of the Joint Committee on Tax’n, Options to Improve Tax Compliance and Reform Tax Expenditures 74-75 (April 12, 2005) (JCX-19-05R) (hereinafter “Options to Improve Tax Compliance”) (“the deduction allowed under present law in calculating SECA taxes is larger than the amount needed to make SECA taxes the economic equivalent of FICA taxes”); S. Smith & L. Smith, Undercharging for Self-Employment Taxes, 2017 Tax Notes Today 935 (May 15, 2017), and Update on Undercharging for Self-Employment Taxes, 2017 Tax Notes Today 1105 (Aug. 28, 2017) (examining issue and suggesting changes).

\textsuperscript{17} I.R.C. § 1402(a); Treas. Reg. §§ 1.1402(a)-(1)(a)(2), 1.1402(a)-(2)(d), 1.1402(c)-(1); Ding v. Commissioner, 74 T.C.M. (CCH) 708 (1997), aff’d, 200 F.3d 587 (9th Cir. 1999); Rev. Rul. 1959-221, 1959-1 C.B. 225.

\textsuperscript{18} See, e.g., Methvin v. Commissioner, 653 Fed. Appx. 616, 616-17 (10th Cir. 2016); CCA 201640014 (June 15, 2016).

\textsuperscript{19} Treas. Reg. § 1.1402(a)-(1)(b); Rev. Rul. 56-675, 1956-2 C.B. 459.

\textsuperscript{20} Rev. Rul. 1959-221. If actual wage payments are low relative to the value of the services being provided, but dividends are high, the Service might seek to recharacterize some of the dividends as wages. See, e.g., Rev. Rul. 1974-44, 1974-1 C.B. 287; David E. Watson, P.C. v. United States, 668 F.3d 1008, 1016-18 (8th Cir.), cert. denied, 568 U.S. 888 (2012).

\textsuperscript{21} Compare I.R.C. § 1402(a) (flush language) with (a)(13). While compensation paid to an employee-shareholder is subject to income and SECA taxes according to the individual’s own method of accounting, a guaranteed payment is subject to income and SECA taxes in the taxable year within or with which ends the partnership taxable year in which the partnership paid or accrued the payment under its method of tax accounting. See I.R.C. § 706(a); Treas. Reg. §§ 1.706-1(a)(1), 1.707-1(c).
obtain social security benefits.\textsuperscript{22} In \textit{Options to Improve Tax Compliance}, the Joint Committee on Taxation suggested that the limited partner exception “reflects State law at the time it was enacted in 1977, under which limited partners ordinarily were not permitted to participate in management of the partnership’s activities without losing their limited liability protection,” and also noted that investors no longer try to join limited partnerships in order to obtain social security benefits because “the wage base and the resulting tax cost to individual taxpayers of accruing benefits has risen, and the value of Social Security benefits to high-income taxpayers has become relatively lower as a percentage of income.”\textsuperscript{23}

In 1997, Treasury and the Service issued Proposed Regulations\textsuperscript{24} that generally would have treated members of an entity classified as a partnership (including LLC members) as limited partners under section 1402(a)(13) unless they (1) had personal liability for the debts of the entity, (2) had authority to contract on behalf of the entity, or (3) participated in the entity’s trade or business for more than 500 hours during the taxable year (or were service partners, and the partnership performed services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting). The Regulations were criticized as a “stealth tax,” and Congress prohibited Treasury and the Service from finalizing them.\textsuperscript{25}

In the absence of guidance, partnerships and LLCs have had to find their own way. Many have concluded that individuals denominated as LLC members may be treated as limited partners under section 1402(a)(13) under some circumstances. The Service appears to take the position that whether LLC members are limited partners for this purpose depends, in part, on their degree of involvement in the management and


\textsuperscript{23} \textit{Options to Improve Tax Compliance}, at 103; accord \textit{Castigliola v. Commissioner}, 113 T.C.M. (CCH) 1296 (2017) (LLC) (“the version of the limited partnership act that Mississippi adopted in 1987 . . . provided that a ‘limited partner’ would lose limited liability protection if ‘in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business’”).


\textsuperscript{25} Sense of the Senate resolution, 143 Cong. Rec. 13297. \textit{See also} Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, § 935. For several years, former President Obama’s budget proposal included a provision that would have imposed SECA tax on the distributive shares of owners of S corporations, limited partnerships, general partnerships, and LLCs if they materially participated in the business. \textit{See}, \textit{e.g.}, The Department of the Treasury’s Office of Tax Policy’s General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals (Feb. 2016).
business activities of the entity. Court decisions generally support this position. Service officials also have stated that the Service will treat LLC members as limited partners under section 1402(a)(13) if they would have qualified under the 1997 Proposed Regulations. On the other hand, Service guidance suggests that limited partners of entities that are organized as state-law limited partnerships always qualify as limited partners for this purpose.

b) Unemployment Insurance

The first $7,000 of wages paid to an employee generally is subject to tax under the Federal Unemployment Tax Act (“FUTA”) rules. Under the integrated federal/state system, part of the tax ordinarily is paid to the state of employment, while part is paid to the federal government; the combined rate is six percent. Independent contractors, including partners and LLC members, are not subject to FUTA tax, but likewise are not eligible to receive any unemployment benefits.

c) Income Tax Withholding

Income taxes on employees are collected mainly through the withholding system, whereas income taxes on independent contractors, including partners and LLC members,

26 See, e.g., ILM 201436049 (May 20, 2014) (LLC) (“Partners perform extensive investment and operational management services for the partnership in their capacity as partners (i.e., acting in the manner of self-employed persons) and Management Company derives its income described in § 702(a)(8) from the investment management services performed by Partners. [Therefore, the] income earned by Partners through Management Company is not income which is basically of an investment nature of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to § 1402(a)(13).”).

27 See, e.g., Renkemeyer, Campbell & Weaver LLP v. Commissioner, 136 T.C. 137, 149 (2011) (LLP) (noting, in dicta, that the exclusion for limited partners in I.R.C. § 1402(a)(13) was intended to apply to “individuals who merely invested in a partnership and who were not actively participating in the partnership’s business operations”); Riether v. United States, 919 F. Supp. 2d 1140, 1159-60 (D.N.M. 2012) (LLC) (citing Renkemeyer). A LB&I Concept Unit entitled “Self-Employment Tax and Partners,” which is available at https://www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf (the “LB&I Concept Unit”), states that “[t]he leading case on this issue is Renkemeyer.”

28 See the LB&I Concept Unit.

29 See the 2018 Instructions for Form 1065, at page 4 (“A limited partner is a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership. Some members of other entities, such as domestic or foreign business trusts or limited liability companies that are classified as partnerships, may be treated as limited partners for certain purposes.”).

30 Chapter 23 of the Code.

31 I.R.C. §§ 3301, 3306(b).

32 Eligibility generally is a matter of state rather than federal law.
are collected mainly through the estimated tax system. Both systems are backed up by information reporting requirements imposed on service-recipients.

A Partnership might be able to “withhold” income taxes for its partners and members, despite the lack of a legal requirement, by paying estimated taxes on their behalf and reducing their other compensation accordingly. State wage payment laws generally apply only to employees, so no special election rules need to be followed. One downside of this approach is that the arrangement is not treated as actual wage withholding for purposes of the various Code provisions designed to ensure that the individual receives credit for the withheld amounts and that they are, in fact, paid over to the Service. The Service has the authority to allow voluntary withholding arrangements under section 3402(p) to be extended to non-wage payments, although so far it has not done so for payments to partners.

2. Employee Benefit and Executive Compensation Provisions

For the most part, the rules governing employee benefits and executive compensation are the same regardless of whether employees or independent contractors, such as partners and LLC members, participate in the plan. However, several noteworthy differences remain. In particular, independent contractors cannot participate in a cafeteria plan or exclude from gross income the value of group term life insurance. These differences are explained in Columns (A) and (B) of Appendix I.

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33 Employees are covered by the estimated tax system. Because of withholding, however, they generally do not have to make any estimated tax payments unless they have substantial non-wage income.

34 Independent contractors whose compensation is reported on Form 1099 MISC also can be subject to backup withholding under I.R.C. § 3406 if they fail to give accurate taxpayer identification numbers to the service-recipient. However, partners and LLC members cannot be, because their compensation is reported on Schedule K-1, and compensation reported on Schedule K-1 is not a “reportable payment” under that section.

35 The drafters of these Comments are aware of many partnerships that do so for at least some partners.

36 E.g., N.Y. Labor Law § 193 (“No employer shall make any deduction from the wages of an employee, except deductions which . . . are made in accordance with the provisions of any law or any rule or regulation issued by any governmental agency including regulations promulgated under paragraph c and paragraph d of this subdivision.”) (emphasis added).

37 See I.R.C. § 31(a)(1) (amount withheld by an employer as tax from an employee’s wages “shall be allowed to the recipient of the income as a credit” against his or her income tax liability for that year); Treas. Reg. § 1.31-1(a) (credit available only “[i]f the tax has actually been withheld at the source”); see also I.R.C. § 6513(b)(1) (employee deemed to have paid income tax only when tax has been “actually deducted and withheld at the source”).

38 See, e.g., I.R.C. § 6672 (the “responsible person” penalty).


41 Treas. Reg. § 1.79-0(b).
3. **Business Expense Provisions**

Independent contractors, including partners and LLC members, face fewer restrictions on their ability to deduct trade or business expenses than employees.

- Most importantly, independent contractors’ trade or business expenses generally are deductible “above-the-line,” *i.e.*, as a direct reduction to their business income reported on Schedule C and thus line 12 of the Form 1040 (for non-partners) or on Schedule E and thus line 17 of the Form 1040 (for partners and LLC members). This reduction also applies for alternative minimum tax purposes. Employees’ trade or business expenses, by contrast, generally are deductible only “below-the-line,” *i.e.*, as itemized expenses reported on Schedule A and thus line 40 of the Form 1040. Before 2018, itemized expenses generally were deductible only to the extent that these expenses exceeded two percent of the employee’s adjusted gross income from all sources. However, Public Law Number 115-97 (the “Act”) disallowed any deductions at all for miscellaneous itemized expenses for tax years beginning after 2017 and before 2026.

- In addition, unlike independent contractors employees may not deduct interest expense incurred in their trade or business of being an employee: such interest is considered a personal expense.

Home office expenses, and rental and depreciation expenses associated with “listed property” are subject to special deduction limits unless the expenses meet certain business use requirements. The limits for employees and independent contractors generally are the same except that, in the case of home office expenses, the employee’s business use also must be “for the convenience of the employer,” and, in the case of

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42 I.R.C. § 62(a)(1); see, *e.g.*, *Quintanilla v. Commissioner*, 111 T.C.M. (CCH) 1017 (2016) (concluding that a production worker on television commercials was an independent contractor and therefore could deduct business expenses on Schedule C without regard to the two-percent floor of I.R.C. § 67).

43 I.R.C. §§ 55, 162.

44 I.R.C. § 62(a)(2).

45 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, 131 Stat. 2054, § 11045 (amending I.R.C. § 67). The two-percent floor and the temporary disallowance do not apply to an employee’s trade or business expenses to the extent that these expenses are reimbursed by his or her employer tax-free under an “accountable plan.” To be an “accountable plan,” the plan must require the employee to account to the employer for any expenditures and return any excess. I.R.C. § 62(a)(2)(A), (c); Treas. Reg. § 1.62-2; *cf.* Treas. Reg. § 1.132-5(a)(1)(v) (similar rules for working-condition fringe benefits).


47 *See generally* I.R.C. §§ 280A, 280F. Generally, in the case of a home office, the space must be used exclusively on a regular basis as the taxpayer’s principal place of business. In the case of listed property, the property must be used predominantly in the taxpayer’s trade or business.

48 *See* I.R.C. § 280A(c)(1).
listed property, such use also must be “required as a condition of employment.” 49 These standards are difficult for many employees to meet. 50 On the other hand, the Supreme Court’s “principal place of business” test also makes it difficult for independent contractors to establish their home office as their principal place of business if they render services elsewhere. 51

4. Rate of Income Tax

A payment to a partner or LLC member for services that is described in section 707(c) (guaranteed payments) or 707(a)(1) (transactions with partners acting other than as partners) is ordinary income and is taxed at ordinary income tax rates. By contrast, the character of any item of partnership or LLC income that is allocated to a partner or member under section 704(a) generally is determined as if the partner or member had received it directly. 52 Thus, trade or business income is taxed at ordinary income tax rates, and capital gain is taxed at capital gains rates.

Subject to various restrictions, for tax years beginning after 2017 and before 2026, section 199A provides for a deduction of up to 20% of the “qualified business income” of noncorporate taxpayers other than employees. 53 For an estimated several million individual partners, there should be a favorable income tax rate difference between employees and partners for the next few years. However, this deduction does not reduce SECA taxes as it does not reduce earned income.

A few special rules apply if an individual receives a profits interest in exchange for services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner. The Service generally does not treat the receipt of such an interest as

49 See I.R.C. § 280F(d)(3)(A); Temp. Treas. Reg. § 1.280F-6T(a)(2). Section 13202 of the Act amended section 280F(d)(4) to remove computer and peripheral equipment from the definition of “listed property,” effective for property placed in service after 2017. The SBJA did the same thing for cell phones beginning in 2011.

50 See, e.g., Rev. Rul. 86-129, 1986-2 C.B. 48 (“the fact that the property will enable the employee to more easily and efficiently perform the duties of employment does not mean the use of the property is required as a condition of employment”).


53 Public Law Number 115-97 § 11011 (adding I.R.C. § 199A). “Qualified business income” generally means income from the conduct of a “qualified trade or business” within the United States, excluding certain categories of (1) investment-related income, such as short- and long-term capital gain, or (2) compensation income, including wage income and guaranteed payments for services described in section 707(c). For individuals in the 32% rate bracket or above, a “qualified trade or business” also generally does not include certain service-oriented businesses such as health, law or consulting, or investment or investment management businesses. Also, for individuals in the 32% rate bracket or above, the deduction is limited to 50% of the individual’s share of the W-2 wages paid by the trade or business (or 25% of the W-2 wages plus 2.5% of the original cost basis of certain tangible property, if greater). See generally Treas. Reg. §§ 1.199A-1 through 1.199A-6.
a taxable event for the service-provider or the partnership unless the interest relates to a limited partnership interest in a publicly traded partnership, a “substantially certain and predictable stream of income from partnership assets” or the partner disposes of the profits interest within two years of receipt. In addition, it generally treats an unvested interest as received (and determines whether it is a profits interest) on the date of grant as long as the partnership and the individual treat the individual as the owner of the interest from that date. The Act did not change these rules. However, in limited circumstances, it requires the recipient of a profits interest in an investment-type fund to treat certain net long-term capital gain realized by the fund or by the recipient when he or she disposes of the interest as short-term capital gain.

B. Use of the Common Law to Distinguish Employees from Independent Contractors

1. General Rules

Unless a statutory exception applies, whether a service-provider is an employee or an independent contractor for tax and employee benefit purposes generally is determined by applying the common law test, which focuses on the service-recipient’s level of control over the way the service-provider does his or her job. Any other approach would be inconsistent with Nationwide Mutual Insurance Co. v. Darden. In Darden, the Supreme Court held that when a federal statute uses the term “employee” but does not “helpfully define” the term, Congress should be presumed to have intended to refer to “the conventional master-servant relationship as understood by common-law agency doctrine.”

Treasury regulations provide that an individual generally is an employee if, under the common law test, the relationship between the individual and the person for whom he or she performs services is the legal relationship of employer and employee. Such a


56 Public Law Number 115-97 § 13309 (adding I.R.C. § 1061); see also Notice 2018-18, 2018-12 I.R.B. 443. Transfers to related persons are subject to rules that may trigger more short-term capital gain than the general rule. See also Comments on the treatment of Applicable Partnership Interests under Section 1061, submitted on March 22, 2019, by the Section of Taxation of the American Bar Association.

57 See I.R.C. § 3121(d) (“‘employee’ means . . . any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee”); Treas. Reg. §§ 31.3121(d)-1(c)(2), 31.3306(i)-1(b), 31.3401(c)-1(b) (using common law test to determine employment status for FICA, FUTA and income tax withholding purposes); Gearhart Resolution, H.R.J. Res. 296, Pub. L. No. 642, 62 Stat. 438 (1948) (endorsing use of common law test to determine employment status for FICA tax purposes).


59 503 U.S. at 322-23 (quoting CCNV v. Reid, 490 U.S. 730, 739-740 (1989)); cf. GCM 35925 (July 26, 1974) (noting that as far back as 1954 the IRS took the position that “the term ‘employee’ as used in [the qualified plan area] means common-law employee”).
relationship generally exists if the person for whom the services are performed “has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.”

Over the years, the Service has identified 20 important factors for determining when the common law test is satisfied. In the 1990s, it began emphasizing that these factors are not the only ones that may be taken into account, or even the best way to approach the classification issue. It has not departed from the basic common law test, which focuses on control. However, it instructs its agents to take all of the facts and circumstances into account in determining whether sufficient control exists, and to organize them according to whether they relate to behavioral control, financial control or the relationship of the parties. Having entrepreneurial risk is one of the most important factors overall to establish partner status. Whether the worker is told when to work by the service-recipient, works on a full-time basis for the service-recipient, works on the business premises of the service recipient, or works at only one location, are considered less important factors.

2. Treatment of Partners

The courts have considered the substance (and not just the form) of a relationship in determining when an individual is properly treated as an employee. The Supreme Court in *Clackamas Gastroenterology Associates, P.C. v. Wells* held that whether a shareholder-director of a professional corporation is an employee must be determined based on all of the facts and circumstances, using the common-law test as directed by *Darden*, in the same way as the test applied for other service-providers. The Court stated that the determination should not be based on the shareholder’s similarity to a partner because partners, too, can be employees under that test.

As one example, the Court noted that “[t]oday there are partnerships that include hundreds of members, some of whom may well qualify as ‘employees’ because control

60 Treas. Reg. §§ 31.3121(d)-1(c)(2), 31.3306(i)-1(b), 31.3401(c)-1(b).

61 Rev. Rul. 87-41, 1987-1 C.B. 296. These factors originally were compiled by the Social Security Administration in determining entitlement to benefits.


63 See id. at 2-4 through 2-6.

64 See, e.g., id. at 2-21 (“The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of services rendered.”); *SuperShuttle DFW, Inc.*, 367 NLRB No. 75 (Jan. 25, 2019) and NLRB General Counsel Advice Memorandum (April 16, 2019) (emphasizing importance of “entrepreneurial opportunity” under common law test applied for National Labor Relations Act purposes).

is concentrated in a small number of managing partners.” However, the Court did not treat participation in management as the touchstone of a partner’s or shareholder-director’s status as a non-employee. Instead, it described the common-law test as requiring the decision-maker to take into account “all of the incidents of the relationship . . . with no one factor being decisive.” It also cited with approval the six factors applied by the EEOC, which included not only participation in management (i.e., “to what extent the individual is able to influence the organization”), but also the degree of supervision (i.e., “to what extent the organization supervises the individual’s work”) and entrepreneurial risk (i.e., “[w]hether the individual shares in the profits, losses, and liabilities of the organization”).

The tests traditionally applied to determine whether an individual is a bona fide partner take into account some of the same factors. However, Clackamas clearly indicates that the tests are different and can lead to different outcomes. Although it dealt with the Americans with Disabilities Act (ADA), the Court’s holding and rationale are consistent with the Regulations on the subject under the Code.

3. Ability to Act in Different Capacities

The common law does not prohibit a worker from being treated as both an employee and an independent contractor or other non-employee of the same entity, if the facts support it. The Service has repeatedly recognized this possibility where the entity is a corporation, and the Regulations permit it. For example, in Rev. Rul. 58-505, the Service ruled that officers of an insurance company who sell policies as independent contractors are officers and thus employees only with respect to their officer compensation, and the Regulations under section 3121 state that a director of a

66 538 U.S. at 446.
67 538 U.S. at 451 (quoting Darden, 503 U.S. at 324).
68 See, e.g., Commissioner v. Culbertson, 337 U.S. 733, 744 (1949) (“Unquestionably a court’s determination that the services contributed by a partner are not ‘vital’ and that he has not participated in ‘management and control of the business’ or contributed ‘original capital’ has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners. But such a determination is not conclusive . . .”).
69 See 538 U.S. at 446 (“asking whether shareholder-directors are partners – rather than asking whether they are employees – simply begs the question”).
70 See Treas. Reg. §§ 31.3401(c)-1(e), 31.3121(d)-1(a)(3) (“If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.”).
corporation acting in his capacity as such is not an employee of the corporation. Many private letter rulings take the same position.

Nor does the common law prohibit a worker from being treated as an employee simply because he or she also is an owner of the entity, even though that makes the employee part of the “master” in the master-servant relationship. The Regulations clearly recognize this. For example, the Regulations under section 83 provide that, once a share of stock received for services vests, any dividends an employee receives are taxed the same way as dividends paid to other owners, rather than as employee compensation. While this might seem to be a natural conclusion in the case of a large entity with multiple owners, because that creates more distance between them and the entity’s employees, the Service has not limited its position to that context. For example, Rev. Rul. 59-2216 concluded that compensation paid by an S corporation to its owners is FICA wages, regardless of the size of the entity.

4. Contrast with Service Guidance on Partners

Despite these rules, for 50 years the Service has taken the position that an individual cannot be both a bona fide partner and an employee of the same partnership, even with respect to different services or streams of income. Rev. Rul. 69-184 states that:

[A b]ona fide member[ ] of a partnership . . . who devotes his time and energies 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 individual who, under the usual common law

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72 Treas. Reg. § 31.3121(d)-1(b); see also, e.g., Treas. Reg. § 1.409A-1(c)(2)(iii), (h)(5) (providing rules for dual status situations).

73 E.g., PLR 199914044 (April 9, 1999) (worker was independent contractor of a firm with respect to work preparing transcripts, and an employee with respect to work attending and recording proceedings); PLR 200033014 (Aug. 18, 2000) (worker was self-employed with respect to work as realtor, and an employee of a firm with respect to work as office manager).

74 Treas. Reg. § 1.83-1(f), Ex. (1).

75 Cf. Leavell v. Commissioner, 104 T.C. 140, 155 (1995) (“The idea that the coach issued orders to [players using wholly owned personal services corporations] in their capacity as corporate officers, which orders they then relayed to themselves as corporate employees, is fanciful.”) (quoting Sargent v. Commissioner, 929 F.2d 1252, 1261 (8th Cir. 1991)).

76 1951-1 C.B. 225.

77 Cf. Bates van Winkelhof v. Clyde & Co LLP, [2014] UKSC 32, [2014] 1 W.L.R. 2047 (Supreme Court, May 21, 2014) (concluding that a law partner can be a “worker” entitled to protection under the Employment Rights Act 1996 because, “[a]s the case of the controlling shareholder in a company who is also employed as chief executive shows, one can effectively be one’s own boss and still be a ‘worker’”).
rules applicable in determining the employer-employee relationship, has the status of an employee.\textsuperscript{78}

The references to a “bona fide member of a partnership” and the “conduct of the trade or business of the partnership” suggest that the drafters of the ruling had in mind traditional service partners in traditional partnerships, who share decision-making and receive the bulk of their compensation in the form of a share of profits, for whom such a conclusion might be correct in most situations.\textsuperscript{79} In practice, however, the Service’s position seems to be that granting a partnership interest to an individual who will perform any services in a partner capacity prevents the individual from being an employee with respect any compensation or other income he or she receives from the partnership, even if very little of it comprises a share of profits, and even if the individual was historically an employee and continues to receive the bulk of his or her compensation in the form of fixed payments.\textsuperscript{80}

As explained in Section C.2, the Proposed Regulations under section 707(a)(2) that were issued in 2015 suggest a greater focus on the substance of an individual’s relationship with the partnership. However, Rev. Rul. 69-184 has not been revoked.\textsuperscript{81}

C. Subchapter K

1. Section 707(a)(1)

Section 707(a)(1) provides that “[i]f a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.” Both the House and the Senate reports on

\textsuperscript{78} See GCM 34001 (Dec. 23, 1969) for a further discussion. See also GCM 34173 (July 25, 1969) (partners cannot be employees for income tax purposes); CCA 200117003 (April 27, 2001) (partners cannot be employees for employment tax purposes); cf. CCA 201916004 (April 19, 2019) (payment made by CPEO to partner in partnership must always be treated as payment to self-employed individual, citing Rev. Rul. 1969-184); T.D. 9860, 84 Fed. Reg. 24,367, 24,371 (2019) (similar statement in final CPEO regulations).

\textsuperscript{79} See Hishon v. King & Spalding, 467 U.S. 69, 79 (1984) (Powell, J., concurring) (listing the types of distinguishing management decisions made by law firm partners); EEOC v. Sidley Austin Brown & Wood, 315 F.3d 696, 706 (7th Cir. 2002) (explaining that in Hishon v. King & Spalding Justice Powell was describing a “traditional law partnership”). Clackamas, 538 U.S. at 446, also cited with approval Judge Easterbrook’s concurring opinion in Sidley, in which he asserted that “real” or “bona fide” partners, which he described as those who “share profits and bear all residual risk of loss,” cannot be employees under the common law test. See 315 F.3d at 710.

\textsuperscript{80} The position appears to be limited to services performed for the same partnership (or a disregarded entity owned by the partnership): For example, in e-mail advice dated January 11, 2008, the Service wrote that “RR 69-184 says bona fide partners cannot be employees of the partnership, but 69-183, 1969-1 C.B. 255, says they can be [employees] of another entity so that their compensation for services are wages, even if run through a partnership.”

the provision, which Congress added in 1954, explain that it represents a deliberate rejection of the “aggregate theory” of partnership in favor of the “entity theory” in cases in which a partner performs services “for” the partnership.\textsuperscript{82} *Armstrong v. Phinney*\textsuperscript{83} cites this fact in rejecting the pre-1954 case law holding that a partner cannot be an employee of his partnership under any circumstances, stating “it is now possible for a partner to stand in any one of a number of relationships with the partnership, including . . . employee-employer.”

2. **Section 707(a)(2)(A)**

Section 707(a)(2)(A) authorizes Treasury to issue Regulations to recast a purported allocation and distribution to a partner related to the partner’s performance of services for the partnership that are properly characterized as occurring between the partnership and the partner in a capacity other than as a partner as non-partner payments for services under section 707(a)(1). The legislative history of the provision, which Congress added in 1984, provides guidance on how to draw the distinction between payments made to a member of a partnership in a partner capacity versus in a capacity other than as a partner.\textsuperscript{84} The factors are:

1. Most importantly, whether the payment is subject to an appreciable risk as to amount.

2. Whether the partner status of the recipient is transitory.

3. Whether the distribution and allocation is close in time to the performance of the services.

4. Whether under the facts and circumstances it appears the recipient became a partner to obtain benefits of the partnership which would not have been available if he had rendered services to the partnership in a third party capacity.

5. Whether the value of the recipient’s interest in the continuing profits of the partnership is small relative to the allocation and distribution.

Treasury and the Service issued Proposed Regulations under section 707(a)(2) in 2015.\textsuperscript{85} The Proposed Regulations adopt the five factors from the legislative history and


\textsuperscript{83} 394 F.2d 661, 664 (5th Cir. 1968).


add a sixth factor (the arrangement provides for different allocations or distributions with respect to different services received, where the services are provided either by a single person or by persons that are related and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly). Consistent with the statement in the legislative history that whether the allocation and distribution is subject to appreciable risk as to amount is the most important factor, the Proposed Regulations provide that if the allocation and distribution lack significant entrepreneurial risk, the allocation and distribution will be treated as a non-partner payment under section 707(a)(1) (however, in the Proposed Regulations the allocation is treated as the distribution). Indeed, the preamble characterizes factors (2) through (6) as “secondary factors.”

3. Section 707(c)

Section 707(c) provides that “payments to a partner for services . . . shall be considered as made to one who is not a member of the partnership” but only for purposes of section 61(a) and, subject to section 263, for purposes of section 162(a), “[t]o the extent [that the payments are] determined without regard to the income of the partnership.” The House report on the provision, which Congress also added in 1954, explained that:

Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive share of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary. The existing approach has been to treat the fixed salary in such years as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. Such treatment is unrealistic and unnecessarily complicated. The bill provides that payment of a fixed or guaranteed amount for services shall be treated as salary income to the recipient and allowed as a business deduction to the partnership.

The Senate report added that:

In the case of guaranteed salary payments your committee followed the House bill but made it clear that such income is to be reported for tax purposes at the end of the partnership year in which it is paid and that this treatment is only provided for purposes of the reporting of the income by the partner and the deducting of the payments by the partnership.

86 Id. at 43655.


4. Distinguishing Services Provided in a Partner Capacity from Services Provided in a Non-Partner Capacity

The preamble to the Proposed Regulations under section 707(a)(2) states that Treasury and the Service have concluded that section 707(a)(2) applies when distributions to the service-provider depend on the income of the partnership (and are treated as payments to a non-partner) and that section 707(c) applies to payments unrelated to partnership income. This leaves open the question of how to determine whether the services rendered for fixed amounts are rendered in a partner capacity, in which case section 707(c) would apply, or in a capacity other than as a partner, in which case section 707(a)(1) would apply under current law. The preamble also requests comments on how Rev. Rul. 69-184 applies in the context of partners providing services to the partnership.

Rev. Rul. 81-301 found a partner’s services to be in a non-partner capacity when the partner was rendering similar services to persons other than the partnership, was supervised by the managing partners of the partnership, could be relieved of its duties and right to compensation on 60 days’ notice by the managing partners and was responsible for its own expenses. The facts of this ruling indicate that the Service believed that the partner was acting in an independent contractor capacity because his compensation and services situation looked like that of any other independent contractor providing similar services.

In contrast, if an individual has partner-type rights (such as the ability to examine books and records or the right to vote on extraordinary or all matters) or has waived those rights and retains the right to an economic return that is subject to entrepreneurial risk, the partner’s services are rendered in connection with the partnership’s trade or business, and the partner receives a fixed payment for those services, that payment is likely a guaranteed payment under the rules of section 707(c).

A subset of “guaranteed payment” is the fixed compensation for services paid to a partner or LLC member who satisfies the control-based definition of a common-law employee – with limited or no management rights and limited rights to vote, if any – with respect to that compensation. In this case, as discussed more fully below, we believe it

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90 The preamble to the Proposed Regulations, 80 Fed. Reg. at 43,654, states that:

Congress identified as its first and most important factor whether the payment is subject to significant entrepreneurial risk as to both the amount and fact of payment. In explaining why entrepreneurial risk is the most important factor, Congress provides that “[p]artners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk.” S. Prt. [98-169] at 227.


92 See, e.g., CCA 200117003. Not all partners that receive guaranteed payments satisfy the definition of a common law employee. For example, the managing partners of a partnership are clearly outside this
is more appropriate that the partner should be treated as acting in an employee capacity in exchange for a salary, rather than as an independent contractor under section 707(a)(1) who has his or her own trade or business, and as a partner with respect to the distributive share of income, gain, loss, and deduction from the partnership.

5. Previous American Bar Association Section of Taxation and New York City Bar Comments

On December 2, 2011, the American Bar Association Section of Taxation submitted “Options for Tax Reform Relating to Partnerships.”93 In that submission, the Section recommended that partners who otherwise would qualify as employees under general principles of tax law and own ten percent or less of the profits and capital of the partnership may be classified by their employer partnership as employees with respect to benefits they otherwise would receive as employees, and that the partnership may make a one-time irrevocable election to treat as wages the guaranteed payments for services provided to the partnership by such partners.

On June 18, 2014, the New York City Bar Committee on Taxation of Business Entities submitted a report entitled “New York City Bar Report Offering New Partnership Guidance on the Treatment of a Partner as an Employee for Federal Tax Purposes.” In this report, the Committee made an extensive analysis of the relevant differences between the taxation of partner “benefits” and those of an “employee,” and recommended that a partnership be allowed to elect to treat an individual partner whose share of partnership profits is ten percent or less as an employee with respect to fixed compensation paid to him or her if, but for such share of partnership profits, the relationship between the partner and the partnership would be that of an employee with an employer. The Committee believed that such changes would not require legislation but could be implemented through Regulations.94

II. RECOMMENDATIONS

A. Recognize the Possibility of Dual Status as a General Principle

1. Recommendation

We recommend that Treasury and the Service revoke Rev. Rul. 69-184 and recognize the possibility that an individual can be an employee and a bona fide partner of the same partnership or LLC with respect to different streams of income from the partnership or LLC, where the facts support such treatment. We recommend that the dual-status partner not be treated as two individuals for purposes of the employee benefit category and may receive both fixed compensation as a guaranteed payment and a distributive share of partnership profits.


94 See page 2 of the report.
and employment tax provisions of the Code, such as the social security wage base rules and the definition of “highly compensated employee,” but rather that those provisions be applied on an aggregated basis to his or her income and benefits.

For provisions that apply differently to employees and partners, such as those governing employer-provided meals and lodging, we recommend that Treasury and the Service allow the dual-status partner’s compensation and benefits to be attributed – to the extent such treatment has substance, e.g., is consistent with the applicable plan documents – to his or her services as an employee.

Where an allocation is needed, such as with respect to contributions to a qualified plan, we recommend that the partnership or LLC be allowed to make that allocation – again to the extent such treatment has substance and is appropriate based on the facts and circumstances. In the case of the few employee benefit provisions that treat an individual as exclusively an employee or exclusively a partner, such as the definition of “full-time employee” for purposes of the shared responsibility provisions, we recommend that Treasury and the Service treat the dual-status partner as an employee or partner depending on which treatment is more protective of employees as a group.

2. Explanation

a) Previous Concerns about Recognizing Dual Status as a General Principle

In Phinney, the Fifth Circuit held that it was “legally possible for a partner to be an employee of his partnership for purposes of section 119 of the Code,” the exclusion from gross income for employer-provided meals and housing that is limited to common-law employees. As noted above, it rejected the case law interpreting the 1939 Internal Revenue Code, which “held that a partner could not be an employee of his partnership under any circumstances,” because that case law was “grounded on the theory, present throughout the 1939 Code, that a partnership and its partners are one inseparable legal unit.” The Fifth Circuit stated that by adopting section 707(a) in 1954, “Congress rejected this ‘aggregate theory’ in favor of the ‘entity theory’ in cases where ‘a partner sells property to, or performs services for the partnership’.”

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95 See Treas. Reg. § 54.4980H-1(a)(15) (“The term employee means an individual who is an employee under the common-law standard. . . . [A] partner in a partnership . . . is not an employee.”).

96 For example, the shared responsibility provisions impose penalties on large employers that do not provide health coverage that meets certain standards to substantially all of their full-time employees; this effectively confers rights on full-time employees that they would not have if they were non-employees.

97 394 F.2d at 662.

One year later, the Service issued Rev. Rul. 69-184, which rejected the rationale in *Phinney*. It did so for administrative as much as for legal reasons.

The Service explained the administrative rationale in GCM 34001:99

To introduce the possibility of dual “status” into the application of the statutes in question so that the determination of “wages” under I.R.C. § 3121(a) would virtually have to be on a transaction by transaction basis (rather than one based on a single continuing relationship) would render it almost impossible to administer the employment taxes of subtitle C. It is hardly rational to assert that Congress intended or would approve such a result merely because the statute which it wrote did not link up an individual’s “status of an employee” with the person for whom the individual performs services . . . .

The Service explained the legal rationale in GCM 34173,100 in which it took the position that Congress intended section 707(c), which was enacted at the same time as section 707(a), to apply in situations in which a partner receives a salary in addition to a share of partnership income, and that section 707(c) allows the salary to be treated as regular employment income only for very limited purposes – not including the employee benefit provisions of the Code.101

In addition to the concerns noted above, Treasury and the Service have suggested more recently that recognizing dual status, as the Fifth Circuit did in *Phinney*, might (1) place a significant burden on Treasury and the Service by requiring it to issue additional guidance under various provisions, and (2) increase the potential for tax abuse by encouraging dual-status partners to take the position that they are subject to employment taxes (under FICA) only on their wage-type payments and not on their partnership allocations, similar to the treatment of owner-employees in an S corporation,102 and giving dual-status partners the “best of both worlds” by allowing them

100 July 25, 1969
101 The GCM explained that:

The House initially viewed a partner receiving such payments “like any other employee who is not a partner.” [citation omitted] This characterization was abandoned, however, by the Senate which, in summarizing the import of section 707(c), made it clear that guaranteed payments were to be treated, not as amounts paid to a partner acting as an employee of the firm, but as amounts paid to a partner acting “as one who is not a partner.” [citation omitted]

Treas. Reg. § 1.707-1(c) states that:

[A] partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc.”

to continue to receive the full range of employee benefits in their roles as employees while still benefiting from the favorable treatment of profits interests in their roles as partners or LLC members. Respectfully, as explained below, we think these concerns are not material enough to justify continued adherence to Rev. Rul. 69-184.

b) Reasons for Recognizing Dual Status as a General Principle

(1) Consistency with Current Law

(a) Common law

We believe that revoking Rev. Rul. 69-184 and recognizing the possibility that an individual can be an employee and a bona fide partner of the same partnership or LLC would be consistent with the common-law standard that is used to determine employment status under the Code. As noted above, a bona fide partner generally cannot qualify as an employee with respect to services he or she performs as a partner under the common law test because the level of entrepreneurial risk and relationship of the parties that distinguish a partner from an employee also are some of the most important factors taken into account under that test. But Congress clearly endorsed the “entity” theory of partnerships when it enacted section 707(a)(1), and the common law does not preclude an owner of an entity from being an employee of the same entity, or from serving simultaneously as an independent contractor and an employee of the same entity.

Even if the Service’s position in Rev. Rul. 69-184 produces the right result in some situations, we believe the “all or nothing” rule it applies is inconsistent with the facts-and-circumstances approach of the common-law test and not reflective of the myriad ways many contemporary partnerships operate and compensate their employees. For example, it immediately treats an employee who receives a partnership interest as a non-employee even if his or her distributive share is a small fraction of the individual’s historical compensation received as an employee and the individual’s historical compensation and services rendered will continue.

We believe it is more appropriate in such a situation to (1) treat such an individual’s compensation pursuant to the partnership agreement as income received by a self-employed person, focusing on the entrepreneurial risk inherent in that compensation – which is a factor taken into account both under section 707(a) and the common-law test – but (2) treat the compensation received by the individual pursuant to whatever schedule of salary and benefits applies to employees as income received by an employee, focusing not only on the lack of entrepreneurial risk inherent in that compensation but also on the other elements of control taken into account under the

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103 See the discussion supra at note 82.
common-law test, which in all likelihood will continue to exist with respect to that compensation.

(b) Subchapter K

We believe that revoking 69-184 and recognizing the possibility that an individual can be an employee and a bona fide partner of the same partnership or LLC would be consistent with Subchapter K. Section 707(a) expressly acknowledges the possibility that a partner can perform services other than as a partner. Congress did not provide that a partner acting other than in his or her capacity as a partner would have to be treated as an independent contractor. Indeed, the preamble to the Proposed Regulations under section 707(a)(2) makes it clear this means the partner can have the status of an employee.\textsuperscript{104} Although the preamble cites Rev. Rul. 69-184 for this principle, it seems contrary to the way Rev. Rul. 69-184 has been applied, namely to require the individual to be a partner for all purposes.

Similarly, we believe that section 707(c) does not require a different result. It deals with amounts determined without regard to partnership income but nonetheless received for services performed in a partner capacity. Neither it nor its legislative history addresses how amounts received for services performed in another capacity should be treated. That issue is addressed in section 707(a)(1). Furthermore, the factors in the Proposed Regulations under section 707(a)(2) appear to make section 707(c) nearly obsolete. Under them, any distribution and allocation for services for which there is no entrepreneurial risk is treated as a payment to the partner for services performed in a non-partner capacity. A payment that is not dependent on the income of the partnership lacks significant entrepreneurial risk under the Proposed Regulations. Accordingly, if that is the universal test for determining whether services are rendered in a partner capacity, section 707(c) can no longer apply to any payments to partners for services in the capacity of a partner. For similar reasons, the Joint Committee on Taxation has stated that “[t]he statutory distinction between guaranteed payments and nonpartner payments has little continuing purpose,”\textsuperscript{105} and the Tax Section of the American Bar Association adopted a policy in 1999 recommending repeal of section 707(c). Nevertheless, it is unnecessary to determine whether section 707(c) is (or should be) obsolete for purposes of treating partners who are also common-law employees as being outside the purview of section 707(c) because section 707(c) relates to services performed in a partner capacity, not as a common-law employee.

\textsuperscript{104} 80 Fed. Reg. at 43,654 (“if an arrangement is subject to section 707(a), taxpayers should look to relevant authorities to determine the status of the service-provider as an independent contractor or employee”).

\textsuperscript{105} Options to Improve Tax Compliance, at 172.
(2) Lack of Additional Burden on Service

(a) Determination of Employment Status and Employee Compensation

We believe that revoking Rev. Rul. 69-184 and recognizing the possibility that an individual can be an employee and a bona fide partner of the same partnership will not require Treasury or the Service to make more, or more complex, determinations of employment status or the amount of compensation earned from it. Most importantly, we believe that the common-law standard and the evolving rules under section 707(a) regarding when a partner acting is in his capacity as a member of the partnership or LLC already requires those determinations to be made with respect to each type of service and compensation performed and received by a service-provider, just as it does in the corporate context. Treating a dual-status partner as only a partner or an employee effectively avoids, rather than complies with, those standards and rules.

In any event, we believe that revoking Rev. Rul. 69-184 will not impose additional administrative burdens on Treasury or the Service. Most dual-status partners will perform services in their employee capacity that are typical of the services performed by other employees and will receive partnership interests that are similar to those received by other partners or LLC member, so the status of those employees as bona fide employees under the common law as well as the compensation they receive, and the status of the other interests as bona fide partnership interests as well as the income allocated under those other interests, can be used as the benchmark to determine whether the partnership’s characterizations are correct. That benchmark may be helpful when new employees are hired and also offered a profits interest as an incentive to help the business venture generate more profits.

The Code already treats taxpayers differently with respect to different streams of income in other contexts,¹⁰⁶ and Treasury and the Service have been able to administer those rules.

(b) Determination of Limited Partner Status

We believe that revoking Rev. Rul. 69-184 will not require Treasury or the Service to make more, or more complex, “limited partner” status determinations. Notwithstanding the dicta in Renkemeyer, we believe that a state-law limited partner clearly qualifies under the terms of section 1402(a)(13). Nevertheless, for other types of partners or LLC members, even under current law, the Service must determine whether an individual classified as a partner under Rev. Rul. 69-184 is appropriately being treated as a limited partner rather than a general partner. Distinguishing the individual’s services as an employee could have several effects, depending on how limited partner status is

¹⁰⁶ E.g., I.R.C. §§ 951-951A (imposing the 10.5% effective GILTI rate or the standard 21% rate for Subpart F income depending on the “bucket” into which a particular income stream falls); I.R.C. § 199A (allowing a non-corporate taxpayer to deduct 20% of his or her “qualified business income” “qualified REIT dividends,” “qualified cooperative dividends” and “qualified publicly traded partnership income”).
determined, but none of these effects should impose additional administrative burdens on Treasury or the Service.

If “limited partner” status (for members of entities that are not state-law limited partnerships) is determined based on the partner’s or LLC member’s involvement in management, as discussed in Renkemeyer and Castigliola, that should not involve additional burdens because the services as an employee would not involve him or her in management. If the individual’s status is determined based on the partner’s or LLC member’s level of services as a self-employed person, which was more the focus of ILM 201436049, that should not involve additional burdens because the services as an employee also would be irrelevant. If it is determined based on the partner’s or LLC member’s hours of service, which was the focus of the 1997 Proposed Regulations and President Obama’s budget proposals and to some extent is the focus of the passive activity rules under section 469, that should not involve additional burdens because the individual’s services as an employee are currently taken into account under section 469.

In other words, determination of a person’s status as a “limited partner” (when that person is not a limited partner in a state-law limited partnership) for purposes of section 1402(a)(13) is currently uncertain and depends on a weighing of the facts and circumstances. That uncertainty is not affected by allowing partners to have dual status; rather, the tax impact of that uncertainty is likely to be reduced by the efficient tax-collection associated with employee status.

(c) Employee Benefits and Executive Compensation Guidance

We believe that revoking Rev. Rul. 69-184 will not require Treasury or the Service to issue significant additional guidance under the employee benefit and employment tax provisions of the Code. The need for additional guidance is described in Column (C) of Appendix I. By and large, the only guidance that is needed is confirmation that compensation and benefits of a dual-status partner will be aggregated regardless of whether they are attributable to services as a partner or services as an employee. As noted in Column (C), many of the same complications exist under current law (without regard to dual status) when an individual switches from employee to partner status in the middle of the year.

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107 See the discussion supra at notes 23 and 27.

108 See the discussion supra at note 26.


110 See Temp. Treas. Reg. § 1.469-5T(a)(1), (e)(2). The LB&I Concept Unit cautions, however, that “[t]he material participation rules under IRC 469 have no bearing on whether an individual partner may be subject to self-employment tax under IRC 1402(a).”

111 Treas. Reg. §§ 1.469-5(f), -5T(k), Ex. (1), (2).
(3) Benefits to Rank-and-File Workers

The Service’s position in Rev. Rul. 69-184 can have a harsh impact on workers historically treated as employees who receive (often small) partnership or LLC interests as compensation for services.

Being transformed into partners and losing employee status can cause such workers to be subject to different employment tax rules with respect to all of their compensation. These include (1) the need to pay estimated taxes on amounts previously received as wages rather than rely on income tax withholding, and the possible noncompliance and consequent underpayment of taxes that can result from that; (2) the need to fill out additional schedules on Form 1040 reporting items of partnership income and loss; (3) the possible need to request extensions of Form 1040 filing deadlines as K-1 forms often are provided later than W-2 forms; and (4) the possible need to file returns in multiple states and/or foreign countries.

Being transformed into partners and losing employee status also can cause such workers to lose some employee benefits. These include (1) the loss of the ability to participate in cafeteria plans, HRAs and FSAs, and to receive employer-provided meals and housing, transportation fringe benefits, and a handful of other nontaxable benefits described in Appendix I, (2) the need to deduct pension contributions and health insurance on Schedule B to the Form 1040, and the loss of the ability to exclude or deduct them for employment tax purposes, and (3) the loss of any employer obligation to provide health insurance under section 4980H.

If the Service’s position in Rev. Rul. 69-184 is taken as a statement of the worker’s status as an independent contractor rather than a common-law employee for all purposes, there may be a risk that being transformed into partners may also cause such workers to lose the protection of a large number of laws that also use the common-law standard, including (1) Title I of the Americans with Disabilities Act (ADA), 112 (2) the Age Discrimination in Employment Act (ADEA), 113, (3) Title VII of the Civil Rights Act of 1964, 114 (4) the National Labor Relations Act (NLRA), 115 (5) the Occupational Safety and Health Act (OSHA), 116 (6) the Uniformed Services Employment and Reemployment

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114 42 U.S.C. § 2000e(b), (f); see *Burke v. Friedman*, 556 F.2d 867, 869 (7th Cir. 1977); *Hishon*, 467 U.S. at 79.
Rights Act of 1994 (USERRA),\textsuperscript{117} and (7) the Worker Adjustment and Retraining Notification (WARN) Act.\textsuperscript{118}

\section*{(4) No Encouragement of Abuse}

\subsection{(a) Employment Taxes}

We believe that revoking Rev. Rul. 69-184 and recognizing the possibility that an individual can be an employee and a bona fide partner of the same partnership or LLC will not encourage abuse of the employment tax provisions of the Code. In fact, we believe that it will enhance compliance by ensuring that at least their income attributable to services as an employee will be subject to withholding, while the treatment of their income attributable to services as a partner or LLC member will remain the same.

The principal concern seems to be that dual-status partners will take the position that they are subject to employment taxes (under FICA) only on their income from employment, and not on any of their other income, similar to the treatment of owner-employees in an S corporation. However, that seems to assume that dual-status partners will ignore their tax obligations, which seems no likelier to occur if Rev. Rul. 69-184 is revoked or retained. We believe that \textit{Riether}\textsuperscript{119} supports this view. The plaintiffs in that case treated a small amount of their earnings as FICA wages and none of their distributive share as SECA income. The court noted that “[t]he income at issue is not the income they treated as ‘wages,’ but the income they treated as their distributive share of partnership income. Plaintiffs’ characterization of some of the income as wages does not change the character of the remaining income.” The court explained that the plaintiffs cited \textit{no authority} for excluding the rest of their income from SECA, and made \textit{no attempt} to fit within section 1402(a)(13). It easily concluded that section 1402(a)(13) did not apply to them because they were not limited partners, in that they “lack[ed] management powers but enjoy[ed] immunity from liability for debts of the partnership.”

Another concern seems to be that revoking Rev. Rul. 69-184 might make it easier for a dual-status partner to argue that he or she is a limited partner for purposes of section 1402(a)(13) despite not being a state law limited partner, because service as an employee is disregarded in determining whether the individual qualifies under standards such as those established in the 1997 Proposed Regulations discussed above. However, that too seems to assume that dual-status partners will ignore their tax obligations. As noted above, services as an employee should matter for this purpose only if the applicable test uses hours of service to make this determination and allows services as an employee to be disregarded. If so, the only way the individual could manipulate that result is by mischaracterizing himself or herself as an employee with respect to those services. If

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119 See 919 F. Supp. 2d at 1158-59.
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Treasury and the Service believe that excessive numbers of hours of service will be characterized as employment-related, other options are available besides simply retaining Rev. Rul. 69-184. They could, for example, issue guidance providing that services performed for wage income can be ignored only if the service-provider receives the same wage income for those services as similarly situated non-partner employees.\(^{120}\)

**(b) Employee Benefits and Executive Compensation**

We believe that revoking Rev. Rul. 69-184 will not result in abuse of the employee benefit provisions of the Code. Most importantly, there are not significant advantages under those provisions to being treated as an employee. The tax-free benefits that can be provided solely to employees – employer-provided meals and housing, transportation fringe benefits, group-term life insurance, retirement planning services, USERRA benefits, VEBAs, and possibly a few others that are restricted to “employees” (but do not define that term) – have limited value to the recipients and, in many cases, are subject to deduction limits under the Act.\(^{121}\) We agree that there will be situations in which individuals characterize themselves as employees without actually providing meaningful services as employees or without receiving meaningful compensation beyond the benefits themselves or enough compensation to justify providing those benefits, but we believe that can be addressed by making it clear that such a characterization must have some substance in order to be respected.\(^{122}\) We do not believe it is necessary to adopt a blanket rule like Rev. Rul. 69-184 just to make sure no such abuses occur.

**(c) Profits Interests**

We believe that revoking/modifying Rev. Rul. 69-184 and recognizing the possibility that an individual can be an employee and a bona fide partner of the same partnership or LLC is correct as a matter of law given modern partnership arrangements and does not permit abuse of the Service’s guidance on the tax treatment of profits interests.\(^{123}\) Most importantly, we note that the use of a profits interest consistent with that guidance allows businesses to incentivize service-providers in a manner that is consistent with subchapter K and is not an abuse. The guidance is a safe harbor that was intended to resolve, as a practical matter, disputes about the nature of profits interests, in particular profits interests received for services, including whether they had anything

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\(^{120}\) *Cf. Prop. Treas. Reg. § 1.1402(a)-2(h)(4) (analogous but more limited approach).*

\(^{121}\) For example, although a partner or LLC member may not exclude from gross income under section 106 the health insurance premiums he or she elects to pay through a cafeteria plan, because partners and LLC member may not participate in cafeteria plans, the partner or LLC member may deduct the same premiums under section 162(l).

\(^{122}\) In *Phinney*, for example, the court was careful to note that the taxpayer also received “a fixed salary for his services as manager of the ranch.” 394 F.2d at 662.

more than “speculative” value at the time of receipt. The Act substantially reduced the tax benefits to recipients of certain interests in investment-type funds but did not eliminate the profits interest as a useful tool for businesses.

Therefore, like previous comments by the American Bar Association Section of Taxation, these Comments do not suggest any change to the treatment of profits interests under that guidance, at least until a more comprehensive review of the guidance is undertaken, similar to the review that was undertaken in 2005. However, we recognize that Treasury and the Service have an ongoing concern and obligation to be sure the guidance is used by taxpayers only in situations to which it applies. We also agree that there will be situations in which service-providers may attempt to take advantage of the guidance without actually providing meaningful services in a partner capacity or anticipating ever becoming bona fide partners, but we believe that can be addressed by making it clear that the individual must be a bona fide partner. Treasury and the Service already have taken steps in that direction. We do not believe it is necessary to retain a blanket rule like Rev. Rul. 69-184 just to make sure no such misuses occur. The requirement in Rev. Rul. 69-184 that the service-provider be treated as a partner for all purposes seems to us to be out of proportion to the requirement in the guidance that there be some nexus between the profits interest and the partnership or LLC.

(d) Section 199A

For similar reasons, we also believe that revoking Rev. Rul. 69-184 will not facilitate the abuse of section 199A and in fact could discourage abuse. If Rev. Rul. 69-184 is retained, an employee who receives a partnership interest in his or her partnership/employer is automatically converted to non-employee status. Regulation section 1.199A-5(d)(3) provides that, solely for purposes of section 199A(d)(1)(B) and the related Regulations, an individual who was treated as an employee for employment tax purposes by the service-recipient and who subsequently is treated as a non-employee

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124 See Rev. Proc. 93-27, Section 3 (Background).
125 See the discussion supra at note 56.
126 See, e.g., American Bar Association Section of Taxation, Comments in Response to REG-103580-02, 2003 TNT 213-21 (Oct. 9, 2003).
128 The preamble to the Proposed Regulations under I.R.C. § 707(a)(2) states that Treasury and the Service “have determined that Rev. Proc. 93-27 does not apply” to “transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain,” such as where “a management company that provides services to a fund in exchange for a fee [waives] that fee, while a party related to the management company receives an interest in future partnership profits the value of which approximates the amount of the waived fee.” 80 Fed. Reg. at 43,656. The Service also has questioned whether interests that are “received in an employee capacity,” see CCA 2013071210312415 (July 12, 2013), or are a substitute for other compensation or are issued in conjunction with a partner forgoing payment of a substantially fixed amount, see 80 Fed. Reg. at 43,656, should be able to rely on this guidance.
by the service-recipient with regard to the same services, is presumed for three years after ceasing to be treated as an employee to be in the trade or business of performing services as an employee. However, this presumption can be rebutted by citing other “Federal tax law, regulations, and principles (including common-law employee classification rules).”

Rev. Rul. 69-184 is a statement of the government’s view of the common-law principles as of 1969. Under those principles, if an individual is properly classified as a partner under Federal tax law (because of having partner rights and entrepreneurial risk, for example), the individual cannot be an employee. Thus, the individual may be able to rebut the presumption in the section 199A regulations that he or she is properly treated as an employee.

By contrast, if Rev. Rul. 69-184 is revoked or modified, the worker would have to demonstrate that he or she was not a common law employee with respect to those services provided to the partnership as a partner, based on the substance of the arrangement and current law. And, if our recommendation to allow dual status is accepted, the services provided by a partner as a common law employee could be segregated and treated separately for purposes of section 199A. In any case, retaining Rev. Rul. 69-184 in its unmodified state creates ambiguity with respect to the application of section 199A in these situations.

Finally, taxpayers can enter into arrangements\textsuperscript{129} where Rev. Rul. 69-184 is not applicable because the partner is employed in a separate tax entity and each entity has a business purpose and is respected for Federal tax purposes. In this way, they can allow certain employees to become indirect partners in order to incentivize them by allowing the individual a share in the profits of the enterprise. This structure formally segregates the individuals’ Form W-2 wages from their shares of partnership profits. In our view, this is unnecessarily expensive for both taxpayers and the government, and the cost could be avoided by reasonable dual status rules for purposes of section 199A as well as for other purposes of the Code.

B. Alternative Recommendation: Recognize the Possibility of Dual Status for Holders of Small Interests

1. Recommendation

As an alternative, we recommend that Treasury and the Service modify Rev. Rul. 69-184 to recognize the possibility that an individual can be an employee and a bona fide partner of the same partnership only if the individual holds a small interest in the partnership or LLC, and treat a capital or profits interests of less than ten percent as small for this purpose. Because the ten-percent cutoff would be chosen in the interest of administrability but without any direct authority in the Code, we recommend that

\textsuperscript{129} The arrangements could involve multiple partnerships or a partnership and a corporation, either a C corporation or an S corporation.
approach be adopted in the form of the Revenue Procedure attached as Appendix II, which would modify and supersede Rev. Rul. 69-184.

2. Explanation

As a practical matter, individuals who hold small interests in a partnership or LLC are less likely to participate in its management and, by definition, do not receive large profits interests. Comparable employees who hold no interests at all also are more likely to exist. Thus, many of the concerns that Treasury and the Service otherwise might have about recognizing dual status should be diminished. At the same time, these service-providers have less capacity to adapt to the complexities of being treated like partners with respect to all of their income. Thus, the arguments for offering them some relief seem stronger.

This recommendation would be consistent with the comments submitted by the Tax Section on December 2, 2011.130

C. Permit Voluntary Withholding on Guaranteed Payments

1. Recommendation

As preliminary step – but not an alternative to the recommendations made in Sections A.1 and B.1 above – we recommend that Treasury and the Service extend voluntary withholding under section 3402(p) to guaranteed payments for services under section 707(c).

2. Explanation

As noted in Section I.A.1.c) above, many partnerships and LLCs already use a variety of “synthetic withholding” arrangements to help their partners and members, but the status of these arrangements is not entirely clear. Extending voluntary withholding under section 3402(p) to guaranteed payments would help address these issues by making the withholding official. It also would be well within the spirit of section 3402(p). The preamble to the Temporary Regulation that preceded the current Regulation131 stated that:

Expanding the use of voluntary withholding agreements to payments designated by the Secretary as eligible for voluntary withholding will permit taxpayers to use the withholding regime (rather than the estimated tax payment process) to meet their tax payment obligations on a timely

130 See Section I.C.5. The drafters of these Comments also considered a suggestion to revoke Rev. Rul. 69-184 with respect to all profits interests, or with respect to all profits interests with service-based vesting, on the basis that former employees are more likely to receive these interests and that, correspondingly, recipients of them are less likely to participate in management. However, we ultimately concluded that there was too much variety in these interests and the situations in which they were granted to suggest this as a bright line rule.

basis, minimize the risk of underpayment of taxes, and achieve administrative simplification for taxpayers and the IRS.

Helping partners and members of partnerships and LLCs meet their tax payment obligations is exactly what these arrangements are designed to achieve.

We do not recommend that Treasury and the Service take this step in lieu of revoking or modifying Rev. Rul. 69-184. That is because, as explained the other sections above, doing so would not address the breadth of other issues, such as employee benefits, that turn on various facets of the individual’s relationship with the partnership or LLC.
## Appendix I

Employee Benefit and Executive Compensation Provisions Affected by Recognition of Dual Status

<table>
<thead>
<tr>
<th>(A) Employee Benefit</th>
<th>(B) Coverage of Partners, Including Dual-Status Partners</th>
<th>(C) Comments and Special Rules</th>
<th>(D) Need for Guidance if Dual Status Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium tax credit (I.R.C. §§ 36B, 162(l), 280C(g))</td>
<td>Partners are covered because the rules apply to all “applicable taxpayers.” I.R.C. § 36B(a).</td>
<td>The amount of the premium tax credit (“PTC”) and the section 36B(f)(2) limit depend on household income, which depends on its members’ adjusted gross incomes. I.R.C. § 36B(d)(2). The section 162(l) deduction affects an individual’s adjusted gross income, which affects the PTC and the section 36B(f)(2) limit, and the PTC and section 36B(f)(2) limit in turn affect the taxpayer’s section 162(l) deduction, creating a circular relationship. The Service has issued guidance, including safe harbor calculation methods, to use in resolving this circularity. Treas. Reg. §§ 1.36B-4T(a)(3)(iii) &amp; 1.162(l)–1T; Rev. Proc. 2014-41, 2014-33 I.R.B. 364.</td>
<td>There is no need for additional guidance. Household income and associated section 162(l) deductions already are determined on an aggregate basis when they are received by different individuals in the same household or by the same individual from different payors, meaning there should be no difficulty aggregating different forms of income and associated section 162(l) deductions when they are received by the same individual from the same payor. The same thing happens when an individual switches from employee to partner status in the middle of the year. Recognizing dual status also requires section 162(l) deductions to be taken into account only if the dual-status partner participates in the employer’s group health plan based on his or her status as a partner in addition to his or her status as an employee. This question is discussed in more detail below.</td>
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<tr>
<td>Early distributions from qualified plans (I.R.C. § 72(t))</td>
<td>Partners are covered because the rules apply to all “taxpayers.” I.R.C. § 72(t)(1).</td>
<td>A special rule treats a self-employed individual as satisfying the exception for distributions to unemployed individuals “if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self-employed.” I.R.C. § 72(t)(2)(D)(iii).</td>
<td>There is no need for additional guidance. The special rule results in employees and partners being treated the same way.</td>
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<tr>
<td>Employee achievement awards (I.R.C. §§ 74, 274)</td>
<td>Partners probably are not covered because the rules refer solely to “employees.” I.R.C. §§ 74(c), 274(j)(3)(B).</td>
<td>Section 274(j)(3) was amended to codify the exclusion, currently found in Proposed Regulation section 1.274-8(c)(2), for certain non-tangible property from the definition of employee achievement awards. Public Law Number 115-97 § 13310.</td>
<td>There is no need for additional guidance. Dual-status partners will be covered – if at all – as employees.</td>
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<td>Group-term life insurance (I.R.C. § 79)</td>
<td>Partners are not covered because the rules refer solely to section 3401 “employees.” I.R.C. § 79(a); Treas. Reg. § 1.79-0(b).</td>
<td>Prop. Treas. Reg. § 1.707-2, 80 Fed. Reg. 43652 (July 23, 2015), suggests factors to use in determining when an individual is acting in a partner capacity, which could limit the situations where the Rev. Proc. apply. The preamble to the regulations also proposes various restrictions on the scope of the Rev. Procs. themselves. See also CCA 2013071201312415 (July 12, 2013) (e-mailed guidance) (Rev. Procs. might not apply to interests “received in an employee capacity”). These changes are beyond the scope of this comment.</td>
<td>There is no need for additional guidance. Dual-status partners will be covered – if at all – as employees.</td>
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<tr>
<td>Transfers of property for services (I.R.C. § 83)</td>
<td>Partners are covered because the rules apply to all service-providers. I.R.C. § 83(a). However, there is a special rule that is available only to partners. Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, state that if an individual receives a profits interest in a partnership in exchange for services to a partnership in a partner capacity or in anticipation of becoming a partner, the Service will not treat the receipt of the interest as a taxable event for the individual or the partnership, unless certain exceptions apply. C.B. 191, state that if an individual receives a profits interest in a partnership in exchange for services to a partnership in a partner capacity or in anticipation of becoming a partner, the Service will not treat the receipt of the interest as a taxable event for the individual or the partnership, unless certain exceptions apply. Rev. Proc. 2001-43, 2001-2 C.B. 191, states that if an individual receives a profits interest in a partnership in exchange for services to a partnership in a partner capacity or in anticipation of becoming a partner, the Service will not treat the receipt of the interest as a taxable event for the individual or the partnership, unless certain exceptions apply.</td>
<td>There is no need for additional guidance. Profits interests received by dual-status partners will be subject to the same rules as profits interests received by other service-providers. Whether the Rev. Procs. apply will be determined based on the reasons the profits interests are granted and the nature of the interests. The fact that dual-status partners will, by definition, continue to perform some services as employees is not directly relevant to that analysis, and therefore they will not be subject to any special rules beyond any new rules the Service chooses to apply to other recipients.</td>
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<tr>
<td>Certain employee death benefits (I.R.C. § 101(ij))</td>
<td>Partners are covered because the rules define “employees” to include section 401(c)(1) employees. I.R.C. § 101(i)(3).</td>
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<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
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<tr>
<td>Certain employer-owned life insurance (I.R.C. § 101(j))</td>
<td>Partners might be covered because the rules refer to “highly compensated employees,” which includes section 401(c)(1) employees. I.R.C. § 101(j)(5)(A). Specifically, there is an exception for an insured who was “a highly compensated employee within the meaning of section 414(q) (without regard to paragraph (1)(B)(ii) thereof).” I.R.C. § 101(j)(2)(A)(ii)(II).</td>
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<td>There is no need for additional guidance. The Service could consider clarifying whether partners are covered by this provision. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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<tr>
<td>Compensation for injuries or sickness (I.R.C. § 104)</td>
<td>Partners are covered because the rules apply to all amounts received through accident or health insurance.</td>
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<td>Accident and health insurance – employees (I.R.C. §§ 105, 106)</td>
<td>Partners are not covered by the rules for employees because they define “employees” to exclude section 401(c)(1) employees. I.R.C. § 105(g); Treas. Reg. §§ 1.12-15(g), 1.105-1(a). However, partners generally may deduct 100% of the premiums they pay to participate in the partnership’s group health plan. I.R.C. § 162(l)(1)(A), (l)(2)(A); see also Notice 2008-1, 2008-1 C.B. 251; CCA 200524001 (May 17, 2005); and may receive benefits from the plan tax-free, I.R.C. § 104(a)(3); Treas. Reg. § 1.104-1(d). The combination of sections 162(l) and 104(a)(3) has the same economic effect for partners as the combination of sections 105 and 106 exclusion has for employees, except that the section 162(l) deduction is not allowed in calculating SECA income whereas accident and health insurance benefits are excluded in calculating FICA wages. However, they are accounted for differently. In the case of an employee, the partnership as a whole absorbs the cost of the coverage and is entitled to deduct that cost under section 162(a)(1). That cost is then treated as a</td>
<td>There is no need for additional guidance. The partnership will have to determine, for its own tax and reporting purposes, the extent to which the cost of coverage is subject to the rules applicable to employees or the rules applicable to partners. The partnership can be allowed to make that determination on its own. The Subchapter K rules will prevent the determinations from having substance. To have substance, the cost of any coverage (e.g., supplemental coverage) that is limited to partners will have to be subject to the rules applicable to partners; and</td>
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<tr>
<td>Accident and health insurance – partners (I.R.C. §§ 162(l), 104)</td>
<td>Partners are not covered by the rules for employees because they define “employees” to exclude section 401(c)(1) employees. I.R.C. § 105(g); Treas. Reg. §§ 1.12-15(g), 1.105-1(a).</td>
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<td>benefit to the employee, but excluded from the employee’s income under sections 105 and 106. In the case of a partner, who absorbs the cost of the coverage is determined by the partnership agreement and the terms of the plan. To the extent it is the partnership, the cost probably is a guaranteed payment and the partnership is entitled to deduct that cost under sections 162(a)(1) and 707(c). To the extent it is the partner, the cost probably might be a guaranteed payment, in which case the partner is entitled to deduct that cost under sections 162(a)(1) and 707(c); or more likely it simply is a distribution of the partner’s share of partnership income, which is not deductible but also is not taxed to the partner. In either case, the partner must include the total cost in income (either as a guaranteed payment or a share of partnership income) and is entitled to deduct the total cost under section 162(l).</td>
<td>the cost of any coverage that is limited to employees will have to be subject to the rules applicable to employees. The cost of any coverage that is open to both partners and employees will have to be allocated by the partnership in a way that reflects which parties bear the costs. In most cases partners, including dual-status partners, will, if anything, pay more for such coverage because they have higher incomes. Therefore the cost of such coverage provided to dual-status partners will, if anything, be less than it would be for employees and can appropriately continue to be allocated entirely to employee compensation costs. If that allows a dual-status partner to continue to exclude the cost from his or her FICA wages, that will be the result of a bona fide allocation of cost not to any tax abuse.</td>
<td>Qualified tuition reduction (I.R.C. § 117(d))</td>
<td>Partners might be covered because the rules refer to “highly compensated employees,” which includes section 401(c)(1) employees. I.R.C. § 117(d)(3). Specifically, tuition reduction plans may not discriminate in favor of “highly compensated employees within the meaning of section 414(q).” I.R.C. § 117(d)(3). There is no need for additional guidance. The Service could consider clarifying whether partners are covered by this provision. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
</tr>
<tr>
<td>Employer-provided meals and lodging (I.R.C. § 119)</td>
<td>Partners are not covered because the rules refer solely to “employees.” I.R.C. § 119(a), (d)(1); Treas. Reg. § 1.119-1(e). This was the provision at issue in Phinney. The deductibility of meals provided for the employer’s convenience that are described in section 119 has been significantly curtailed beginning in 2026. Public Law Number 115-97 § 13304 (amending section 274).</td>
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<tr>
<td>Cafeteria plans (I.R.C. § 125)</td>
<td>Partners are not covered because the rules define “employees” to exclude partners. I.R.C. § 125(d)(1)(A); Prop. Treas. Reg. § 1.125-1(g)(2)(i). “Dual-status individuals” (employees who also provide services as independent contractors) are allowed to participate in an employer’s cafeteria plan, but this rule The ability of partners to decide whether and when to participate in the partnership’s group health plan, and to deduct 100% of any premiums they pay as a result, has essentially the same economic effect for them as a cafeteria plan has for employees, at least with respect to health insurance. In fact, they have even more flexibility because they can change their elections without regard to the “family status” change rules. There is no need for additional guidance. The Service could consider issuing guidance clarifying that a cafeteria plan’s failure to exclude an individual who becomes a partner (including a dual-status partner) from the covered group will not disqualify the plan as long as the individual participates – if at all – solely with respect to compensation and benefits he or she receives.</td>
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<td>Qualified tuition reduction (I.R.C. § 117(d))</td>
<td>Partners might be covered because the rules refer to “highly compensated employees,” which includes section 401(c)(1) employees. I.R.C. § 117(d)(3). Specifically, tuition reduction plans may not discriminate in favor of “highly compensated employees within the meaning of section 414(q).” I.R.C. § 117(d)(3). There is no need for additional guidance. The Service could consider clarifying whether partners are covered by this provision. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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<tr>
<td>Employer-provided meals and lodging (I.R.C. § 119)</td>
<td>Partners are not covered because the rules refer solely to “employees.” I.R.C. § 119(a), (d)(1); Treas. Reg. § 1.119-1(e). This was the provision at issue in Phinney. The deductibility of meals provided for the employer’s convenience that are described in section 119 has been significantly curtailed beginning in 2026. Public Law Number 115-97 § 13304 (amending section 274).</td>
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<td>Cafeteria plans (I.R.C. § 125)</td>
<td>Partners are not covered because the rules define “employees” to exclude partners. I.R.C. § 125(d)(1)(A); Prop. Treas. Reg. § 1.125-1(g)(2)(i). “Dual-status individuals” (employees who also provide services as independent contractors) are allowed to participate in an employer’s cafeteria plan, but this rule The ability of partners to decide whether and when to participate in the partnership’s group health plan, and to deduct 100% of any premiums they pay as a result, has essentially the same economic effect for them as a cafeteria plan has for employees, at least with respect to health insurance. In fact, they have even more flexibility because they can change their elections without regard to the “family status” change rules. There is no need for additional guidance. The Service could consider issuing guidance clarifying that a cafeteria plan’s failure to exclude an individual who becomes a partner (including a dual-status partner) from the covered group will not disqualify the plan as long as the individual participates – if at all – solely with respect to compensation and benefits he or she receives.</td>
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<tr>
<td>Educational assistance plans (I.R.C. § 127)</td>
<td>Partners are covered because the rules define “employees” to include section 401(c)(1) employees. I.R.C. § 127(c)(2), (3); Treas. Reg. § 1.127-2(c), (b).</td>
<td>The exclusion is limited to an individual’s “earned income,” which is defined by cross-reference to section 32(c)(2) generally as wages “plus” net earnings from self-employment within the meaning of section 1402(a).</td>
<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
</tr>
<tr>
<td>Dependent care (I.R.C. § 129)</td>
<td>Partners are covered because the rules define “employees” to include section 401(c)(1) employees. I.R.C. § 129(c)(3).</td>
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<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
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<tr>
<td>No-additional-cost services (I.R.C. § 132(a)(1), (b))</td>
<td>Partners are covered because the rules define “employees” to include partners. Treas. Reg. § 1.132-1(b)(1) (flush language).</td>
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<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
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<td>Qualified employee discounts (I.R.C. § 132(a)(2), (c))</td>
<td>Partners are covered because the rules define “employees” to include partners. Treas. Reg. § 1.132-1(b)(1) (flush language).</td>
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<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
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<tr>
<td>Working condition fringes (I.R.C. § 132(a)(3), (d))</td>
<td>Partners are covered because the rules define “employees” to include partners. Treas. Reg. § 1.132-1(b)(2).</td>
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<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
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<tr>
<td>De minimis fringes (I.R.C. § 132(a)(4), (c))</td>
<td>Partners are covered because the rules apply to all “recipients.” Treas. Reg. § 1.132-1(b)(3).</td>
<td>The deductibility of food and beverages that are de minimis fringes has been significantly curtailed beginning in 2018, and related eating facilities beginning in 2026. Public Law Number 115-97 § 13304 (amending section 274).</td>
<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
</tr>
<tr>
<td>Qualified transportation fringes (I.R.C. § 132(a)(5), (f))</td>
<td>Partners are not covered because the rules define “employees” to exclude partners. I.R.C. § 132(f)(5)(E); Treas. Reg. § 1.132-9, Q&amp;A-24.</td>
<td>Partners may exclude transportation fringes from income only to the extent they qualify under one of the other exclusions, most likely the one for de minimis fringes.</td>
<td>There is no need for additional guidance. Dual-status partners will be covered – if at all – as employees.</td>
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<td>Qualified moving expense reimbursements (I.R.C. §§ 82, 132(a)(6), (g))</td>
<td>Partners probably are not covered because the rules refer solely to amounts received “from an employer.” I.R.C. § 132(g); cf. Treas. Reg. § 1.82-1(a)(1) (moving expense reimbursements attributable to self-employment are includible in gross income).</td>
<td>This might not be economically significant for partners because they (like employees) can deduct any reimbursements they receive that are included in income under section 217 (moving expenses). The exclusion for qualified moving expense reimbursements for employees, and the deduction for unreimbursed moving expenses for both employees and partners, are temporarily suspended for the period 2018-2025. Public Law Number 115-97 §§ 11048-49 (amending section 132 and 217).</td>
<td>There is no need for additional guidance. The Service could consider clarifying whether partners are covered by this provision. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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<tr>
<td>Qualified retirement planning services (I.R.C. § 132(a)(7), (m))</td>
<td>Partners probably are not covered because the rules refer solely to advice provided to an “employee” by an “employer.” I.R.C. § 132(m)(1).</td>
<td>This might not be economically significant for partners because they can deduct any reimbursements they receive that are included in income against their partnership income on Schedule E. Before 2018, employees could take deductions subject to the 2% floor. See Treas. Reg. § 1.67-1T(a)(1)(ii). However, the deduction for miscellaneous itemized expenses has been suspended for the period 2018-2025. Public Law Number 115-97 § 11045.</td>
<td>There is no need for additional guidance. The Service could consider clarifying whether partners are covered by this provision. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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<tr>
<td>Qualified military base closure fringes (I.R.C. § 132(a)(8), (n))</td>
<td>Partners are unlikely to be covered because the rules apply only to payments by the Department of Defense that are authorized by the Demonstration Cities and</td>
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<td>There is no need for additional guidance under the Code. This is a determination that must be made under a different law. If the Department of Defense makes</td>
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<td>Metropolitan Development Act of 1966, as in effect on the date of enactment of the American Recovery and Reinvestment Act of 2009, which applies only to members of the military and civilian employees of the Department of Defense. I.R.C. § 132(n).</td>
<td>Payments to dual-status partners, the rules will treat them the same as employees.</td>
<td>Metropolitan Development Act of 1966, as in effect on the date of enactment of the American Recovery and Reinvestment Act of 2009, which applies only to members of the military and civilian employees of the Department of Defense. I.R.C. § 132(n).</td>
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<td>Adoption assistance (I.R.C. § 137)</td>
<td>Partners probably are not covered because the rules refer solely to assistance provided to an “employee” by an “employer.” I.R.C. § 137(c).</td>
<td>There is no need for additional guidance. The Service could consider clarifying whether partners are covered by this provision. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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<td>$1 million limit on deductible compensation (I.R.C. § 162(m)(1)-(4))</td>
<td>Neither partners nor employees of a partnership are covered because the limit does not apply to payments by a partnership. I.R.C. § 162(m)(1).</td>
<td>The exception for a partnership applies even if the partnership is publicly traded. See PLR 199915036 (April 16, 1999). Significant changes to the $1 million limit have been made, but not in ways the affect partnerships. Public Law Number 115-97 § 13601 (amending section 162(m)).</td>
<td>There is no need for additional guidance. Neither employees of partnerships nor their partners will be covered by section 162(m).</td>
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<tr>
<td>$500,000 limit on deductible compensation for certain health insurance providers (I.R.C. § 162(m)(6))</td>
<td>The limit applies equally to payments to employees and partners. Treas. Reg. § 1.162-31(b)(7)(i) (definition of “applicable individual”).</td>
<td>Although a partnership is unlikely to be a “health insurance issuer” itself, it can be a “covered health insurance provider” by being part of its “aggregated group.” Treas. Reg. § 1.162-31(b)(4)(i)(D) (definition of “covered health insurance provider”).</td>
<td>There is no need for additional guidance. The rules treat employees and partners the same way.</td>
</tr>
<tr>
<td>IRAs (I.R.C. § 219)</td>
<td>Partners are covered because the rules apply to all “individuals.” I.R.C. § 219(a).</td>
<td>Contributions may not exceed includible “compensation,” I.R.C. § 219(b)(1)(B), which is defined to include “earned income (as defined in section 401(c)(2),” I.R.C. § 219(f)(1).</td>
<td>There is no need for additional guidance. The rules treat employees and partners the same way. In the case of a dual-status partner, compensation received in an employee capacity will be aggregated with compensation received in a partner capacity in applying the deduction limit.</td>
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<tr>
<td>Archer MSAs (I.R.C. § 220)</td>
<td>Partners are covered because the rules define “eligible individuals” to include section 401(c)(1) employees. I.R.C. § 220(c)(1)(A)(iii).</td>
<td>The deduction in the case of an employee may not exceed the individual’s earned income derived from the trade or business with respect to which the high deductible health plan is established.</td>
<td>There is no need for additional guidance. The rules treat employees and partners the same way. In the case of a dual-status partner, compensation received in an employee capacity will be aggregated with compensation received in a partner capacity in applying the deduction limit.</td>
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<td>HSAs (I.R.C. § 223)</td>
<td>Partners are covered because the rules apply to all “individuals.” I.R.C. § 223(a).</td>
<td>Exactly how the rules apply to partners, including dual-status partners, if the partnership is publicly traded is unclear because independent contractors are not treated as employees for all purposes. See I.R.C. § 280G(c); Treas. Reg. § 1.280G-1, Q&amp;A-18 (limit on number of officers), Q&amp;A-19 (definition of highly compensated employee). In addition, section 280G imposes as a penalty only the loss of a deduction, which would not be relevant to compensation paid to a partner unless it was subject to section 707(a) or (c).</td>
<td>There is no need for additional guidance, the rules treat employees and partners the same way. As in the case of accident and health plans, the partnership will have to determine, for its own tax and reporting purposes, the extent to which HSA contributions made by the partnership are subject to the rules applicable to employees or the rules applicable to partners. As in the case of accident and health plans, the partnership can be allowed to make that determination on its own.</td>
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<tr>
<td>Golden parachute payments (I.R.C. §§ 280G, 4999)</td>
<td>Although the rules are limited to “corporations,” partnerships are covered if they are publicly traded because a “corporation” includes a publicly traded partnership. I.R.C. § 280G(b)(2)(A), (c); Treas. Reg. § 1.280G-1, Q&amp;A-45. If a partnership is covered, the rules appear to apply to partners. Id.</td>
<td>There is no need for additional guidance, other than confirmation that compensation and benefits of a dual-status partner will be aggregated regardless of whether they are attributable to service as a partner or service as an employee. The same complications exist when an individual switches from employee to partner status in the same tax year. The Service could consider clarifying how partners are covered by this provision. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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<td>Qualified retirement plans – deductions and inclusions in income (I.R.C. §§ 402, 404)</td>
<td>Partners are covered because the rules apply to section 401(c)(1) employees. I.R.C. §§ 402(i), 404(a)(8)(A); Treas. Reg. § 1.404(a)-1(a)(1). A partner does not really need the exclusion from income in section 402 when the partnership contributes to a qualified plan on his or her behalf, because the partner must include the total contribution in income anyway (either as a guaranteed payment or a share of partnership income) but then is entitled to deduct the contribution under section 404. But the effect is the same. See, e.g., Treas. Reg. § 1.401(k)-1(a)(6). Contributions to a qualified plan on a partner’s behalf are not deductible to the extent that they exceed the earned income derived from the partnership that established the plan. I.R.C. § 404(a)(8)(C); Treas. Reg. § 1.404(a)(8)-1T. In addition, contributions that are used to purchase life, accident, health or other insurance for a partner, and</td>
<td>There is no need for additional guidance, other than confirmation that compensation, contributions and benefits of a dual-status partner will be aggregated regardless of whether they are attributable to service as a partner or service as an employee. The same complications exist when an individual switches from employee to partner status in the same tax year, or works as an employee and a partner for two different members of the same controlled group that participate in the same plan. The partnership will have to determine, for its own tax and reporting purposes, the extent to which the cost of contributions to a qualified plan is subject to the rules applicable to employees or the rules applicable to partners.</td>
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related income, are not treated as employer-provided and therefore are neither deductible nor taxed to the individual. I.R.C. §§ 72(m)(3), 404(a)(8)(C), (e); Treas. Reg. §§ 1.72-17, 1.404(e)-1A(b)(1), (g).

"Compensation" for purposes of the usual section 404(a) limitations is defined to mean "earned income," I.R.C. § 404(a)(8)(D), and "earned income" is defined to mean the individual’s net earnings from self-employment for SECA purposes from the partnership, plus gains (other than capital gains) on sales of property created by the individual’s personal efforts, minus the contributions themselves. I.R.C. §§ 401(c)(2), 404(a)(8)(B). Because the plan contributions themselves reduce earned income for this purpose, even though they don’t for regular SECA purposes, an algebraic formula is necessary to ensure that the contribution amount for a self-employed individual is not in excess of earned income.

The special net unrealized appreciation ("NUA") rules in section 402(e)(4) do not apply to a section 401(c) employee who receives his or her entire account balance on account of separation from service, or to an employee who receives his or her entire account balance after he or she becomes disabled. I.R.C. § 402(e)(4)(D). Cf. PLR 8001073 (Oct. 15, 1979) and Ridenour v. United States, 3 Cl. Ct. 128 (1983) (explaining why the "separation from service" rule does not apply to self-employed).
Partners are covered because the qualification rules apply to section 401(c)(1) employees, and the nondiscrimination rules are qualification requirements. I.R.C. § 401(a)(3)-(5), 401(c)(1); Treas. Reg. §§ 1.401-10(b)(1), 1.414(q)-1T, Q&A-7(a); see also Treas. Reg. §§ 1.401(a)(4)-12, 1.401(k)-6, 1.401(l)-1(c)(11), 1.401(m)-5, 1.410(b)-9 (all definitions of “employee”), 1.401(a)(17)-1(c)(1).

The only express additional requirement is that a plan that covers 10% partners (“owner-employees”) must provide that contributions for those partners may be made only with respect to earned income they derive from the partnership that established the plan. I.R.C. § 401(a)(10)(A), (d); Treas. Reg. §§ 1.401-1(a)(3)(ix), 1.401-10(d), (e).


The section 414(s) definition differs depending on whether the individual is a partner or an employee. Specifically, employee compensation may be defined in many different ways, but partner compensation must be defined as earned income within the meaning of section 401(c)(2) (plus elective deferrals in most cases) or earned income (plus elective deferrals) multiplied by the ratio of included compensation to total compensation for the employer’s nonhighly compensated employees. Treas. Reg. §§ 1.414(s)-1(b)(3), (g)(1), 1.415(c)-2(b).

Some special rules apply to partners under section 401(k) and (m). I.R.C. § 402(g)(8); Treas. Reg. § 1.401(k)-1(a)(6). They are necessary to reflect the different timing of partner versus employee compensation and the fact that partners generally are allocated the entire cost of their matching and elective contributions.

There is no need for additional guidance, other than confirmation that compensation, contributions and benefits of a dual-status partner will be aggregated regardless of whether they are attributable to service as a partner or service as an employee. The same result presumably already occurs when an individual switches from employee to partner status in the middle of the year, or works as an employee and a partner for two different members of the same controlled group that participate in the same plan.

The special rules for partners can be applied separately to compensation attributable to partner services and contributions attributable to that compensation.

The only exception is the rule requiring self-employed individuals to be disregarded when applying the nondiscrimination requirement in Treas. Reg. § 1.414(s)-1(d)(3). It would be helpful if the Service clarified whether dual-status partners either will or will not be disregarded under that rule.

The Service also could consider issuing guidance – perhaps in the Rev. Proc. governing the Service’s Employee Plans Compliance Resolution System (EPCRS) – clarifying that a qualified plan’s failure to provide expressly for coverage of section 401(c) employees and owner-employees and to require contributions to be made only with respect to earned income from the partnership that established the plan will not disqualify the plan as long as the plan is amended voluntarily to correct that. However, this is an issue under current law, not one that is raised only if dual status is recognized.
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<td>Qualified retirement plans – limits on contributions (I.R.C. § 415)</td>
<td>Treas. Reg. § 1.414(s)-1(d)(3)(iii)(B) disregards “self-employed individuals” when applying the nondiscrimination requirement for alternative definitions of compensation in that section.</td>
<td>There is no need for additional guidance, other than confirmation that compensation, contributions and benefits of a dual-status partner will be aggregated regardless of whether they are attributable to service as a partner or service as an employee. The same result presumably already occurs when an individual switches from employee to partner status in the same tax year, or works as an employee and a partner for two different members of the same controlled group that participate in the same plan.</td>
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<td>Qualified retirement plans – top-heavy rules (I.R.C. § 416)</td>
<td>The definition of “compensation” that is used for this purpose differs depending on whether the individual is a partner or an employee. Specifically, employee compensation may be defined in many different ways, but partner compensation must be defined as earned income within the meaning of section 401(c)(2). I.R.C. § 415(b)(3), (c)(3)(B); Treas. Reg. § 1.415(c)-2(b), (d).</td>
<td>There is no need for additional guidance, other than confirmation that compensation, contributions and benefits of a dual-status partner will be aggregated regardless of whether they are attributable to service as a partner or service as an employee. The same result presumably already occurs when an individual switches from employee to partner status in the same tax year, or works as an employee and a partner for two different members of the same controlled group that participate in the same plan.</td>
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<td>Military benefits (I.R.C. § 414(u))</td>
<td>The rules clarify that a partner of a partnership is not treated as an officer merely because he or she owns a capital or profits interest in the partnership, exercises voting rights as a partner, or acts as an agent of the partnership. Treas. Reg. § 1.416-1, T-13.</td>
<td>There is no need for additional guidance under the Code. This is a determination that must be made under a different law. If dual-status partners are entitled to benefits under USERRA, the rules will treat them the same as employees. The Service could consider issuing guidance stating that tax-qualified plans must treat dual-status partners as employees for this purpose, but only to the extent of their employee compensation, until guidance to the contrary is provided under USERRA.</td>
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Qualified retirement plans – limits on contributions (I.R.C. § 415)

Partners are covered because the qualification rules apply to section 401(c)(1) employees, and the section 415 rules are qualification requirements. I.R.C. § 401(a)(16), 401(c)(1).

Qualified retirement plans – top-heavy rules (I.R.C. § 416)

Partners are covered because the qualification rules apply to section 401(c)(1) employees, and the top-heavy rules are qualification requirements. I.R.C. §§ 401(a)(10)(B), 401(c)(1), 416(i)(3).

Military benefits (I.R.C. § 414(u))

Partners are not covered because the rules implement USERRA, which applies only to employees. I.R.C. § 414(u); 38 U.S.C. §§ 4303, 4312.
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<td>Qualified annuities (I.R.C. § 403(a))</td>
<td>Partners are covered because the rules apply to section 401(c)(1) employees. I.R.C. § 403(a)(3); Treas. Reg. § 1.403(a)-1(f).</td>
<td>The Service generally takes the position that an LLC or partnership cannot be tax-exempt (and therefore cannot sponsor a section 403(b) plan) unless all of its members are tax-exempt.</td>
<td>There is no need for additional guidance. The same rules should apply as apply to tax-qualified plans.</td>
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<tr>
<td>Tax-sheltered annuities (I.R.C. § 403(b))</td>
<td>Partners are not covered because the rules generally apply only to common-law employees. Treas. Reg. § 1.403(b)-2(b)(9).</td>
<td>Coverage of partners could result in a loss of deductions for the entire plan. See I.R.C. § 404A(e) (plan must be “for the exclusive benefit of the employer’s employees”).</td>
<td>There is no need for additional guidance. Dual-status partners should not be covered.</td>
</tr>
<tr>
<td>Foreign deferred compensation plans (I.R.C. § 404A)</td>
<td>Partners probably are not covered because the rules refer solely to “employees.” I.R.C. § 404A(a).</td>
<td>Coverage of partners could result in a loss of deductions for the entire plan. See I.R.C. § 404A(e) (plan must be “for the exclusive benefit of the employer’s employees”).</td>
<td>There is no need for additional guidance. The Service could consider clarifying how the rules apply when an employer has partners, which neither section 404A nor the proposed regulations explains in detail. But this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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<tr>
<td>Deferred compensation (I.R.C. § 409A)</td>
<td>Partners are covered. Section 409A applies to nonqualified deferred compensation plans for all kinds of “service providers.” Treas. Reg. § 1.409A-1(b)(1) (definition of “deferral of compensation”).</td>
<td>The regulations reserve on the application of section 409A to arrangements between partnerships and partners. Treas. Reg. § 1.409A-1(b)(7). Notice 2005-1, 2005-1 C.B. 274, Q&amp;A-7, says that the same rules generally apply to equity-based compensation issued by partnerships to partners as apply to equity-based compensation issued by corporations to employees. The preamble to the final regulations says that taxpayers may continue to rely on that guidance until additional guidance is issued. 72 Fed. Reg. 19233, 19243 (April 17, 2007)</td>
<td>There is no need for additional guidance. The regulations already explain how dual-status situations will be treated. See Treas. Reg. § 1.409A-1(c)(2)(ii). The Service could consider clarifying how the rules apply to partners, but this is an issue under current law, not one that is raised only if dual status is recognized.</td>
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Id. at 19243-44.
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<tr>
<th>(A) Employee Benefit</th>
<th>(B) Coverage of Partners, Including Dual-Status Partners</th>
<th>(C) Comments and Special Rules</th>
<th>(D) Need for Guidance if Dual Status Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare benefit funds (I.R.C. §§ 419-419A)</td>
<td>Partners are covered because the qualification rules apply to section 401(c)(1) employees. I.R.C. § 419(g).</td>
<td>Exactly how the rules apply to partners, including dual-status partners, is unclear. Section 419 imposes as a penalty only the loss of a deduction, which would not be relevant to compensation paid to a partner unless it is subject to section 707(a) or (c). Perhaps as in Neonatology Associates v. Commissioner, 115 T.C. 43 (2000), aff’d, 299 F.3d 221 (3d Cir. 2002), if the rules are not satisfied the contributions are treated as a dividend or distribution.</td>
<td>There is no need for additional guidance. However, as in the case of deductions for health plans generally, the partnership will have to determine, for its own tax and reporting purposes, the extent to which the cost of coverage is subject to the rules applicable to employees or the rules applicable to partners. The Service could consider clarifying how the rules apply to partners, but this is an issue under current law, not one that is raised only if dual status is recognized.</td>
</tr>
<tr>
<td>Incentive stock options and ESPPs (I.R.C. §§ 421-424)</td>
<td>Partners are not covered because the rules limit eligibility to “employees” of the issuing “corporation” or a related corporation. I.R.C. §§ 422(b), 423(a); Treas. Reg. § 1.421-1(b).</td>
<td>Although the rules are limited to “corporations,” partnerships are covered if they are taxed as corporations. Treas. Reg. § 1.421-1(i)(1).</td>
<td>There is no need for additional guidance. Dual-status partners will be covered – if at all – as employees of a related corporation.</td>
</tr>
<tr>
<td>Section 457 plans (I.R.C. § 457)</td>
<td>Partners are covered. Section 457 applies to nonqualified deferred compensation plans for all kinds of “service providers,” including independent contractors. I.R.C. § 457(e)(2).</td>
<td>Some special rules apply to independent contractors. Most importantly, section 457 does not apply to nonelective deferred compensation for services performed by independent contractors. I.R.C. § 457(e)(12); Treas. Reg. § 1.457-2(k)(1). However, partners are unlikely to be covered as a practical matter because “eligible employers” are unlikely to be partnerships. The Service generally takes the position that an LLC or partnership cannot be tax-exempt (and therefore cannot sponsor a section 403(b) plan) unless all of its members are tax-exempt.</td>
<td>There is no need for additional guidance.</td>
</tr>
<tr>
<td>A) Employee Benefit</td>
<td>B) Coverage of Partners, Including Dual-Status Partners</td>
<td>C) Comments and Special Rules</td>
<td>D) Need for Guidance if Dual Status Recognized</td>
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<tr>
<td>---------------------</td>
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<tr>
<td>Section 457A plans (I.R.C. § 457A)</td>
<td>Partners are covered. Section 457A applies to all amounts deferred under a nonqualified deferred compensation plan of a “nonqualified entity.” I.R.C. § 457A(a).</td>
<td>Different rules apply to determine whether a corporation or a partnership is a “nonqualified entity.” I.R.C. § 457A(b). However, once that is determined the rules apply the same way to employees and partners of the entity.</td>
<td>There is no need for additional guidance.</td>
</tr>
<tr>
<td>VEBAs (I.R.C. § 501(c)(9))</td>
<td>Partners are not covered because the rules limit benefits to employees for employment tax or LMRA purposes and their dependents. Treas. Reg. § 1.501(c)(9)-2(b).</td>
<td>Benefits provided to partners and other non-employees and their dependents therefore must be no more than de minimis. Treas. Reg. § 1.501(c)(9)-3(a).</td>
<td>The Service could consider clarifying whether dual-status partners may not receive any benefits (or receive only de minimis benefits) from a Veba, or may receive only those benefits that are attributable to their service as employees.</td>
</tr>
<tr>
<td>Excise tax on excess tax-exempt organization executive compensation (I.R.C. § 4960)</td>
<td>Partners are not covered because the rules apply only to common-law employees. Notice 2019-9, 2019-4 I.R.B. 403, Q&amp;A-3.</td>
<td></td>
<td>There is no need for additional guidance.</td>
</tr>
<tr>
<td>Shared responsibility payments (I.R.C. § 4980H)</td>
<td>Partners are not covered because the rules are limited to common-law employees. Treas. Reg. § 54.4980H-1(a)(15).</td>
<td></td>
<td>The Service could consider clarifying whether dual-status partners are covered by this requirement or not, and, if they are, whether compensation attributable to services as a partner are taken into account in determining the affordability of the employer’s group health plan.</td>
</tr>
<tr>
<td>Tax on High-Cost Coverage (I.R.C. § 4980I) (not yet effective)</td>
<td>Coverage for partners under a group health plan is included if a deduction is allowed under section 162(l) for the cost of the coverage. I.R.C. § 4980I(d)(1)(D).</td>
<td></td>
<td>There is no need for additional guidance, other than confirmation that the cost of coverage provided to a dual-status partner will be aggregated regardless of whether it is attributable to service as a partner or service as an employee. The same result presumably already occurs when an individual switches from employee to partner status in the middle of the year, or works as an employee and a partner for two different members of the same controlled group.</td>
</tr>
</tbody>
</table>
Part III
Administrative, Procedural, and Miscellaneous

Notice [20XX-XX]

Proposed Revenue Procedure Regarding Dual-Status Partners

This notice contains a proposed revenue procedure that provides that certain partnerships may elect to treat certain individuals as both partners and employees of the partnership.

SECTION 1. Purpose.

In order to provide greater compliance and administrative ease in satisfying both the employer’s and the employee’s employment and self-employment tax responsibility, to facilitate and enhance the collection of income tax through withholding, and to reduce the cost of administration of the tax law, the Treasury Department and the Internal Revenue Service (“IRS”) propose to issue a revenue procedure substantially in the form included in section 5 of this notice. The proposed revenue procedure would modify and supersede Rev. Rul. 69-184, 1969-1 C.B. 256. The proposed revenue procedure would allow electing partnerships with certain electing individuals who do not direct the activities of the partnership to be classified as employees with respect to the receipt of compensatory periodic amounts over the course of the year that are not dependent on entity profits and to receive allocations that are dependent on entity profits as partners in the entity that employs them. The proposed revenue procedure would provide certain specific eligibility criteria that must be satisfied to qualify for this “dual status” treatment as both a partner and an employee of the same partnership. The Treasury Department and the IRS are issuing this guidance in proposed form to afford an opportunity for public comment and to limit any potential impact on current arrangements.

SECTION 2. BACKGROUND

Section 3121(d), in addition to a list of certain statutory employees, defines “employee” as “any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee . . . .” An employer-employee relationship exists under the common law “when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.” The IRS has traditionally applied a 20-factor test in determining whether a service provider is properly classified as an independent contractor or an employee.2

Prior to the enactment of the 1954 Internal Revenue Code, no concept of a partnership as an entity separate from its partners existed for federal income tax purposes. Accordingly, under pre-1954 federal income tax law, the courts generally held that it was an impossibility for a partner to be an employee of the partnership in which such partner was a member. The reasoning was that because a partnership had no legal existence independent from the individual partners, the partnership and the partners were one and the same legal entity for tax purposes. As a result, “[i]n the eyes of the taxing statute . . . a partner [could not] be an employee of the partnership.”3

1 Section 31.3121(d)-1(c).
3 Commissioner v. Doak, 234 F.2d 704, 708 (4th Cir. 1956).
The 1954 Internal Revenue Code removed the impossibility of a dual status partner and employee by recognizing the partnership as an entity separate from its partners for some purposes. Specifically, § 707(a) was added, which provided: "If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall . . . be considered as occurring between the partnership and one who is not a partner." Transactions between a partner and the partnership in a capacity other than as a member of the partnership could include the rendering of services by the partner to the partnership.\(^4\) Section 707(c) was enacted at the same time, providing: "To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership" for limited purposes.\(^5\)

Following the enactment of § 707(a) and § 707(c), services provided to a partnership by a partner of that partnership can be characterized in one of three ways: (1) as a transaction in which the partner has rendered services to the partnership in a capacity as other than a partner under § 707(a), (2) as a guaranteed payment for services under § 707(c), or (3) as a distributive share of partnership income under § 704(b). If the partner is performing the services in his capacity as a partner, § 707(a) cannot apply, and the transaction must be treated as a guaranteed payment under § 707(c) if the payment is determined without regard to the income of the partnership or as a distributive share under § 704(b) if the payment is determined with regard to the income of the partnership.

In determining the appropriate treatment of a payment to a partner in exchange for the performance of services to the partnership, the threshold question is whether the services were performed by the partner in his capacity as a partner, in which case § 704(b) or § 704(c) must apply, or whether such services were performed in a capacity other than that as a partner. In Pratt v. Commissioner, the Tax Court held and the Fifth Circuit Court of Appeals affirmed that a general partner of a partnership that purchased, developed, and operated two shopping centers and received a management fee for managerial services related to the shopping centers based on a percentage of gross receipts of the partnership were performed by the general partner in his capacity as a partner because the services were basic duties of the partnership business performed pursuant to the partnership agreement.\(^6\) The Tax Court further held that, because the fee was based on a percentage of gross income, § 707(c) was inapplicable.\(^7\) In response to Pratt, the IRS issued Rev. Rul. 81-300\(^8\) and Rev. Rul. 81-301.\(^9\) Rev. Rul. 81-300 generally followed the facts of Pratt and ruled, (1) consistent with Pratt, that the services performed by the general partner were performed in the capacity of a partner and, therefore, that § 707(a) was inapplicable and (2) contrary to Pratt, that although the payments were determined by reference to gross income of the partnership, they were nevertheless properly treated as guaranteed payments under § 707(c) rather than as distributive share under § 704(b). Rev. Rul. 81-301 also involved a general partner performing services in exchange for a percentage of gross income of the partnership, but the general partner in Rev. Rul. 81-301 also performed similar services to other parties, was subject to removal by another general partner, was not liable to the other partners for any losses, and was supervised by another general partner. Under these facts,

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\(^4\) Section 1.707-1(a).

\(^5\) Non-partner treatment is proper only for purposes of § 61(a) (relating to gross income) and § 162(a) (relating to trade or business expenses). Section 1.707-1(c).

\(^6\) Pratt v. Commissioner, 64 T.C. 203 (1975), aff’d in part, 550 F.2d 1023 (5th Cir. 1977).

\(^7\) Id. at 1024.


the IRS concluded that the partner was performing services in a capacity other than as a partner such that § 707(a) applied.

In Armstrong v. Phinney, a case involving whether a partner was an employee of a partnership under § 119, the Fifth Circuit Court of Appeals stated that following the enactment of § 707(a), "it is now possible for a partner to stand in any one of a number of relationships with his partnership, including . . . employee-employer." The decision in Armstrong precipitated an IRS study that led the IRS to publish Rev. Rul. 69-184 which provides:

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 . . . . Such a partner who devotes his time and energies 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 individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

The facts of Rev. Rul. 69-184 involve an individual who is either "devoting his time and energies in conducting the trade or business of the partnership, ['first partner'] or . . . providing services to the partnership as an independent contractor ['second partner']. . . ." The revenue ruling concludes that such a person cannot be an employee of the partnership, providing little analysis in reaching this conclusion. Presumably, the individual who is "devoting his time and energies in conducting the trade or business of the partnership" is providing services in his capacity as a member of the partnership, in which case § 707(a) would be inapplicable and the partner could not be an employee of the partnership under the case law existing prior to the enactment of § 707(a). The second individual is simply presumed to be an independent contractor under the facts of Rev. Rul. 69-184, which leaves open the possibility that an individual who is performing services other than in his capacity as a member of the partnership may be providing those services either in the capacity of an independent contractor or an employee, "under the usual common law rules applicable in determining the employer-employee relationship . . . ." Despite the ambiguity in Rev. Rul. 69-184, the IRS has historically interpreted it to mean that a partner cannot be an employee of a partnership in which he is a partner under any circumstances.

In 1984, Congress expressly provided for a partner providing services in a capacity other than as a partner. Section 707(a)(2)(A) was added to the Internal Revenue Code, granting the Treasury authority to issue anti-abuse regulations providing that if a partner performs services for a partnership and receives a related direct or indirect allocation and distribution and the performance of services and allocation and distribution, when viewed together are properly characterized as a transaction occurring between the partnership and a partner acting other than in its capacity as a partner, the transaction will be treated as occurring between the partnership and a person who is not a partner under § 707(a)(1). Congress did not provide that a partner acting other than in its capacity as partner necessarily would be treated as an independent contractor. Congress enacted § 707(a)(2)(A) in response to concerns that partners were providing services for partnerships in exchange for allocations of gross income, which Pratt had held was not a guaranteed payment under § 707(c), and such partners were avoiding capitalization and non-deductibility rules in treating such allocations as distributive share under § 704(b). The legislative history listed a number of factors that Congress expected would be in the regulations for determining whether a transaction between a partner and the partnership is properly characterized as a transaction occurring between

10 394 F.2d at 664.
11 Rev. Rul. 69-184, 1969-1 C.B. 256 (citing §§ 1402(a) and 3121(d)(2)).
the partnership and a partner acting other than in its capacity as a partner. The primary factor provided in the legislative history is whether the payment is subject to an appreciable risk as to amount and fact of payment. Additionally, the Senate Report indicated Congress’s approval of the conclusions in Rev. Rul. 81-301 but that the general partner described in Rev. Rul. 81-300 should be treated as performing services in a capacity other than as a partner under § 707(a).  

On July 23, 2015, the Treasury Department and the IRS issued proposed regulations under § 707(a)(2)(A). Specifically, the proposed regulations adopt, as the primary standard for such a determination, whether the payment is subject to entrepreneurial risk both as to amount and fact of payment. The preamble to the proposed regulations indicates that the Treasury and IRS have concluded that § 707(a)(2) applies to arrangements in which distributions to the service provider depend on an allocation of income subject to entrepreneurial risk, while § 707(c) applies to amounts whose payments to partners providing services in the capacity of a partner are unrelated to partnership income. Additionally, Rev. Rul. 81-300 was obsoleted at the same time with comments requested on whether it should be reissued with modified facts. Finally, the preamble states that if an arrangement is subject to § 707(a), “taxpayers should look to relevant authorities to determine the status of the service provider as an independent contractor or employee,” citing Rev. Rul. 69-184.

In May of 2016, Proposed and Temporary Regulations were issued that clarified and confirmed that the partners of a partnership who are employed by a disregarded entity wholly owned by the partnership are subject to the same self-employment tax rules as applicable to the partners of the partnership. In the preamble to such Proposed and Temporary Regulations, the IRS again requested comments concerning circumstances in which it may be appropriate to permit partners to also be employees of the partnership, and the impact on employee benefit plans and employment taxes and received comments as a result.

SECTION 3. Request for Comments.

The Treasury Department and the IRS has sought and received comments on the circumstances in which it may be appropriate to permit partners to also be employees of the same partnership and seeks public comments on all aspects of the proposed revenue procedure, including comments on ways to facilitate innovative arrangements consistent with promoting administrative certainty and sound tax policy. The Treasury Department and the IRS also seek specific comments on the criteria to be satisfied for eligibility for dual status, whether and under what circumstances such eligibility shall be terminated, how an election or other notice of dual status should be made known to the IRS,

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15 The preamble to the proposed regulations under § 707(a)(2)(A) may indicate that some in the Treasury and the IRS may have been considering that a § 707(a) payment could be wages under the applicable law because the individual is functioning, not as a partner, but as an employee of the partnership.
16 TD 9766, supra.
17 TD 9766, 81 FR 26693-26695 (May 4, 2016).
and any changes under current regulations that would be required for implementation of a rule that would allow dual status for partner/employees.

SECTION 3. Effective Date.

SECTION 4. Drafting Information.

SECTION 5. Form of Proposed Revenue Procedure.

Set forth below is the form of the proposed revenue procedure that is proposed in this notice:
Form of Proposed Revenue Procedure

Part III

Administrative, Procedural, and Miscellaneous
Section 3121(d).—Employee
Section 7701(a)(2).—Partnership and Partner
26 CFR 31.3121(d)-1: Who are Employees.

Rev. Proc. [20XX-XX]

SECTION 1. Purpose

In order to provide greater compliance and administrative efficiency in satisfying employment and self-employment tax responsibilities, to facilitate and enhance the collection of income tax through withholding, and to reduce the cost of administration of the tax law, the Treasury Department and the Internal Revenue Service ("IRS") propose to issue a revenue procedure that would modify and supersede Rev. Rul. 69-184, 1969-1 C.B. 256, and allow electing partnerships and certain electing individuals who do not direct the activities of the partnership to be classified as employees with respect to the receipt of compensatory periodic amounts over the course of the year that are not dependent on entity profits and to receive allocations that are dependent on entity profits as partners, as defined in § 7701(a)(2), in the same partnership. The revenue procedure would provide specific eligibility criteria that must be satisfied to qualify for this "dual status" treatment as both a partner and an employee of a partnership. This revenue procedure provides rules for partnerships, partners, and employees for purposes of income tax and employment tax reporting.

SECTION 2. Background

Rev. Rul. 69-184 was issued at a time before the existence of limited liability companies and other contemporary types of partnerships were unknown and the check-the-box regulations had not been promulgated. Today, it is not unusual for an entity with many corporate characteristics (limited liability, centralized management, and interests denominated in units) to be treated as a partnership for federal tax purposes. Like many corporate enterprises, these entities are interested in incentivizing their employees by giving their employees a share in business successes and the pride of being an owner by issuing them an interest in the partnership. As a member of a partnership, a service provider who is receiving standard wage-type compensation can also share in income and gains realized by the partnership if certain thresholds are satisfied. Nevertheless, the implication of Rev. Rul. 69-184 is that individuals who are issued a partnership interest can no longer receive W-2 wage income. The transition from employee to self-employed and the attendant responsibility for both the "employer" and the "employee" share of the tax on income from self-employment (SECA), the quarterly estimated tax responsibility, and multi-state tax filing complexity is unwelcome and inhibits businesses from creating arrangements that could lead to greater productivity, profitability, and labor stability. As a result, partnerships engage in restructuring that increases the number of tiered entity arrangements to which the tax laws must be applied, increasing both the cost of doing business and the cost of administering the tax laws.

Moreover, the prohibition against partners being employees can be confusing to taxpayers who are unaware of the rule and familiar with guidance that defines an employee in a manner that describes many partners. In addition, employment taxes are more readily collected than SECA taxes and the collection of withheld income tax occurs more quickly and with more certainty than estimated income tax payments. As a result, it is in the interest of sound tax administration to establish a procedure under which certain individuals providing services and not in a position of control who are issued profits interests or are otherwise permitted to acquire an interest in a partnership can remain subject to the FICA tax regime and withholding on periodic compensation.
SECTION 3. Scope

This revenue procedure applies only to eligible partners in eligible partnerships with respect to eligible compensation.

3.01 Eligible Partner. An eligible partner is an individual (i) who is a member in an entity properly classified as a partnership for federal income tax purposes; (ii) who is not in a position of exercising control over the operations of the partnership such as a manager, president, chief executive, a director (or position of equivalent authority however designated, herein “a manager or in an equivalent capacity”); and (iii) whose equity interest has a right to a [10%] or less share in net profits of a business or financial undertaking of such entity. 18

3.02 Eligible Partnership. An eligible partnership is a business entity, other than a general partnership, properly classified as a partnership for federal tax purposes and that (i) complies with its income and employment tax responsibilities by timely filings and payments of its withholdings and employment taxes while the election is outstanding and (ii) files required statements under this revenue procedure.

3.03 Eligible Compensation. Eligible compensation is an individual partner’s periodic receipts, including a bonus paid no later than [30] days following the end of the partnership’s tax year of not more than ___%19 of the individual partner’s otherwise W-2 compensation for the year, for services to or for the benefit of the partnership in a capacity other than as a manager or in an equivalent capacity that are not dependent on the profits of the entity properly classified as a partnership for federal income tax purposes.

3.04 Effect. An election under this revenue procedure has the limited effect of allowing the dual status partner/employee to be treated as a partner only with respect to his or her distributive share of income from the partnership other than eligible compensation: If an election is made, the individual’s distributive share of income, gain, loss, and deduction other than eligible compensation will continue to be treated as income received in a capacity as a partner for § 704 and other purposes. Thus, for example, it will not be treated as “wages” for purposes of employment taxes or the withholding of income taxes. Moreover, if the dual status partner/employee is properly subject to the SECA tax on the distributive share other than eligible compensation, that liability will exist unaffected by the election made under this revenue procedure. In addition, the election made under this revenue procedure will not affect the applicability of Rev. Proc. 93-27 or Rev. Proc. 2001-43 to

18 Note to Draft: The Section did not believe an income limit is necessary. However, if an income limit may be a criteria desired by the Treasury and/or IRS. If so a potential limit may be:

“and (iv) whose aggregate average (a) § 704(b) distributions (other than capital gains), (b) § 704(c) guaranteed payments; (c) § 707(a)(2)(A) distributions for services; and/or (d) W-2 amounts from the partnership for the three calendar years, or such shorter period therein such person was an employee or partner, ending immediately before the prior tax year did not exceed $200,000 multiplied by the cost-of-living adjustment under § 1(f)(3) substituting 2015 for 1992.”

Since withholding and employment taxes are on a calendar year basis, the current year’s income or, particularly in the case of calendar year partnerships, the immediate prior year’s income is not practical as the information will not be known in a timely manner for proper withholding and reporting. The three year average or shorter period the person has been an employee or partner of the partnership is to prevent an unusual year from disqualifying the individual.

19 It is anticipated that the vast majority of compensation of a dual status partner’s compensation will be periodic payments which are included in the W-2 income and bonuses will be equal to or less than a reasonable percentage (perhaps less than 25% or 30%) of the periodic annual compensation and promptly paid following the end of the year.
any profits interest the dual status partner/employee holds in the partnership with respect to other than eligible compensation. The effect of the election made under this revenue procedure is limited to allowing certain eligible partners to share in profits of their partnerships and does not affect any rights of the dual status partner/employee as an employee or any employer provided benefits. Income from the partnership that would, but for the dual status election, be treated as compensation for purposes of § 415 and other retirement plan purposes, will continue to be so treated.

SECTION 4. Rules of Application

4.01 Election.20 An existing eligible partnership makes an election to treat eligible electing partners as dual status partner/employees by filing a statement with its timely filed tax return (including extensions) for the tax year immediately preceding the tax year for which the election is to be effective and agreeing to be bound by the provisions of this revenue procedure. The election is effective only for those eligible partners who are identified in the election statement who have each affirmatively executed an election to be treated as such and provides such election to the eligible partnership. If an eligible partner is added or removed from the initial election statement, the partnership’s amended election statement must be filed with the partnership’s tax return for the tax year for which the change is effective and any additional eligible electing partner must sign an election to be so treated and provide such election to the eligible partnership. Notwithstanding the preceding, a new partnership must make the election by filing such statement with its timely filed partnership tax return (with extensions) for its first tax year and such election will be effective as of the first day of such tax year. The IRS may rely on the representation that an eligible partner listed on such statement has made such an election and the partner has the burden of proof by clear and convincing evidence that such partner did not make such an election.

4.02 Election Statement. The initial partnership election statement must be made under penalties of perjury and must include:

(1) The name and federal identification number of the partnership.

(2) The names and social security numbers of the eligible electing partners.

(3) A statement that these partners each has a [10%] or less interest in partnership profits and each such partner is not a manager or a director (or holds a position of equivalent authority however designated) and therefore does not control the activities of the partnership.

(4) [If an income limitation is a requirement, a statement concerning such would be required.21]

(5) A statement that the employment tax responsibilities of the partnership/employer and the withholding tax responsibilities of the partnership will be and will continue to be satisfied with respect to each of these eligible electing partners.

(6) A statement that each of the eligible electing partners has provided the partnership a signed election to be treated as an employee with respect to eligible compensation, each agrees that

20 Note to Draft: Consider allowing a partnership to qualify to treat certain partners as employees – as having dual status -- by meeting the criteria and by maintaining records that establish that the partners and partnership are eligible and have consented under the revenue procedure, rather than by filing the elections specified in this proposed revenue procedure.

21 Note to Draft: For example, “A statement that for each of these eligible electing partners, the aggregate average (i) § 704(b) distributions (other than capital gains), (ii) § 704(c) guaranteed payments; (iii) § 707(a)(2)(A) distributions for services; and/or (iv) W-2 amounts from the partnership for the three calendar years or such shorter period therein such person was an employee or partner, ending immediately before the prior tax year did not exceed [$200,000] multiplied by the cost-of-living adjustment under § 1(f)(3) substituting 2015 for 1992.”
all qualified retirement plans, health and welfare plans associated with the partnership will be based on the partner being classified as an employee and, to extent applicable, will be computed only on such person’s W-2 earnings and the partnership shall make such signed election available to the IRS upon request.22

(7) A statement that the partnership will compute all qualified retirement plan and health and benefit plan contributions and benefits for eligible electing partners only on such person’s W-2 compensation.

(8) If a requirement that unreimbursed business expenses associated with the partnership be treated as an employee business expense, a statement concerning such would be required.23

4.03 Amended Election Statement for Newly Eligible Partners. An amended election statement with respect to newly eligible partners of an existing electing partnership that elect to be treated as employees with respect to their eligible compensation must be made under penalties of perjury and included with the timely filed (including extensions) partnership return for the tax year for which such election is applicable and must include:

(1) The name and federal identification number of the partnership.

(2) The names and social security numbers of the newly eligible partners that made the election.

(3) A statement that each of these eligible electing partners has a [10%] or less interest in partnership profits and each such partner is not a manager or a director (or holds a position of equivalent authority however designated) and therefore does not control the activities of the partnership.

(4) [If an income limitation is a requirement, a statement concerning such would be required.24]

(5) A statement that the employment tax responsibilities of the partnership/employer and the withholding tax responsibilities of the partnership has been and will be satisfied with respect to each eligible electing partner.

(6) A statement that each of the eligible electing partners has provided the partnership a signed election to be treated as an employee with respect to eligible compensation, each agrees that all qualified retirement plans, health and welfare plans associated with the partnership will be based on the partner being classified as an employee and, to extent applicable, will be computed only on such person’s W-2 earnings and the partnership shall make such signed election available to the IRS upon request.

(7) A statement that the partnership has and will compute all qualified retirement plan and health and benefit plan contributions and benefits for eligible electing partners based only on such person’s W-2 compensation.

22 The IRS may choose to require a copy of the signed statement attached to the partnership’s return in lieu of such a statement.

23 For example, “A statement that the partner agrees to treat all non-reimbursed business expenses associated with the partnership will be treated as an employee business expense for federal income tax purposes.”

24 Note to Draft: See footnote 36.
(8) If a requirement that non-reimbursed business expenses associated with the partnership be treated as an employee business expense, a statement concerning such would be required.

4.04 Amended Election Statement for Previously Eligible Partners Electing Employee Treatment. An amended election statement with respect to previously eligible partners that elect to be treated as employees with respect to their eligible compensation for tax years after the year the partnership’s election was effective must be made under penalties of perjury and included with the timely filed (including extensions) partnership return for the tax year immediately prior to the tax year for which such election is applicable and must include:

(1) The name and federal identification number of the partnership.

(2) The names and social security numbers of the previously and currently eligible electing partners that are now electing and had not previously elected to be so treated or, if previously elected, had subsequently ceased to be eligible partners for one or more tax years.

(3) A statement that each of these eligible electing partners has a [10%] or less interest in partnership profits and each such partner is not a manager or a director (or holds a position of equivalent authority however designated) and therefore does not control the activities of the partnership.

(4) If an income limitation is a requirement, a statement concerning such would be required.

(5) A statement that the employment tax responsibilities of the partnership/employer and the withholding tax responsibilities of the partnership will be satisfied with respect to each of these eligible partners.

(6) A statement that each of the eligible electing partners has provided the partnership a signed election to be treated as an employee with respect to eligible compensation, each agrees that all qualified retirement plans, health and welfare plans associated with the partnership will be based on the partner being classified as an employee and, to extent applicable, will be computed only on such person’s W-2 earnings and the partnership shall make such signed election available to the IRS upon request.

(7) A statement that the partnership has and will compute all qualified retirement plan and health and benefit plan contributions and benefits for eligible electing partners based only on such person’s W-2 compensation.

4.05 Amended Election Statement for Previously Eligible Partners Ceasing to be Eligible Partners. An amended election statement with respect to previously eligible electing partners who ceased to be eligible partners during the tax year must be made under penalties of perjury and must include the names and social security numbers of those individuals who were previously eligible electing partners who during the tax year have ceased being eligible electing partners. Such amended statement shall be included with the timely filed (including extensions) partnership return for the tax year such previously eligible electing partners ceased being eligible.

4.06 Amended Election Statement for Previously Eligible Partners Who Revoked Election. An amended election statement with respect to previously eligible electing partners who revoked their election effective for the next following tax year of the partnership must be made under penalties of perjury and must include the names and social security numbers of those individual eligible partners who previously elected and affirmed such revocation was received by the

25 Note to Draft: see footnote 36.
partnership prior to the first day of the effective tax year. Such amended statement shall be included with the timely filed (including extensions) partnership return for the tax year immediately prior to the tax year for which such election was revoked. A partner that voluntarily revokes its election may not re-elect within the next following five years without the Commissioner’s consent.

4.07 Partnership Ineligibility. If an eligible partnership becomes ineligible, the election under this revenue procedure terminates as of the first day of the next tax year following (i) the election or (ii) the year during which the partnership becomes ineligible. The partnership must file a statement regarding the termination of the election with its tax return for that year. In the next tax year, the partnership must comply with all rules and regulations applicable to employees and partners.

SECTION 5. Effect on Other Documents and Effective Date

Rev. Rul. 69-184 is modified and superseded. This revenue procedure applies to partners and partnerships for taxable years beginning after the date [the revenue procedure is published in final form].


SECTION 7. No inferences on Law.

This revenue procedure provides administrative relief to address a special need in a category of partners and partnerships in the furtherance of public policy. No implication is intended, and no inference should be drawn, from this revenue procedure regarding any general principle of substantive law with respect to partner status or employee status or partnership status.