Consider the tax consequences before making an employee a partner

In today's competitive environment, offering employees an equity interest in your business can be a powerful tool for attracting, retaining and motivating quality talent. If your business is organized as a partnership, however, there are some tax traps you should watch out for. Once an employee becomes a partner, you generally can no longer treat him or her as an employee for tax and benefits purposes, which has significant tax implications.

Employment taxes

Employees pay half of the Social Security and Medicare taxes on their wages, through withholdings from their paychecks. The employer pays the other half. Partners, on the other hand, are treated as being self-employed — they pay the full amount of "self-employment" taxes through quarterly estimates.

Often, when employees receive partnership interests, the partnership continues to treat them as employees for tax purposes, withholding employment taxes from their wages and paying the employer's share. The problem with this practice is that, because a partner is responsible for the full amount of employment taxes, the partnership's payment of a portion of those taxes will likely be treated as a guaranteed payment to the partner.

That payment would then be included in income and trigger *additional* employment taxes. Any employment taxes *not* paid by the partnership on a partner's behalf are the partner's responsibility.

Treating a partner as an employee can also result in *overpayment* of employment taxes. Suppose your partnership pays half of a partner's employment taxes and the partner also has other self-employment activities — for example, interests in other partnerships or sole proprietorships. If those activities generate losses, the losses will offset the partner's earnings from your partnership, reducing or even eliminating self-employment taxes.

Employee benefits

Partners and employees are treated differently for purposes of many benefit plans. For example, employees are entitled to exclude the value of certain employer-provided health, welfare and fringe benefits from income, while partners must include the value in their income (although they may be entitled to a self-employed health insurance deduction). And partners are prohibited from participating in a cafeteria plan.

Continuing to treat a partner as an employee for benefits purposes may trigger unwanted tax consequences. And it could disqualify a cafeteria plan.

Partnership alternatives

There are techniques that allow you to continue treating newly minted partners as employees for tax and benefits purposes. For example, you might create a tiered partnership structure and offer employees of a lower-tier partnership interests in an upper-tier partnership. Because these employees aren't partners in the partnership that employs them, many of the problems discussed above will be avoided.

Please contact Ceschini, CPAs at (631) 474-9400 for more information about this topic and other tax and business developments – such as new IRS regulations and court decisions.