



[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[TD 9766]

RIN 1545-BM87

Self-employment Tax Treatment of Partners in a Partnership that Owns a Disregarded Entity

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that clarify the employment tax treatment of partners in a partnership that owns a disregarded entity.

These regulations affect partners in a partnership that owns a disregarded entity. The text of these temporary regulations serves as the text of proposed regulations (REG-114307-15) published in the Proposed Rules section in this issue of the **Federal**

**Register**.

DATES: Effective date: These regulations are effective on May 4, 2016.

Applicability date: For date of applicability, see §301-7701-2T(e)(8).

FOR FUTURE INFORMATION CONTACT: Andrew K. Holubeck at (202) 317-4774 (not a toll-free number).

## SUPPLEMENTARY INFORMATION

### Background

Section 301.7701-2(c)(2)(i) states that, except as otherwise provided, a business entity that has a single owner and is not a corporation under §301.7701-2(b) is

disregarded as an entity separate from its owner (a disregarded entity). However, §301.7701-2(c)(2)(iv)(B) provides that an entity that is a disregarded entity is treated as a corporation for purposes of employment taxes imposed under subtitle C of the Internal Revenue Code (Code). Therefore, the disregarded entity, rather than the owner, is considered to be the employer of the entity's employees for purposes of employment taxes imposed by subtitle C.

While §301.7701-2(c)(2)(iv)(B) treats a disregarded entity as a corporation for employment tax purposes, this rule does not apply for self-employment tax purposes. Specifically, §301.7701-2(c)(2)(iv)(C)(2) provides that the general rule of §301.7701-2(c)(2)(i) applies for self-employment tax purposes. After setting forth this general rule, the regulation applies this rule in the context of a single individual owner by stating that the owner of an entity that is treated in the same manner as a sole proprietorship is subject to tax on self-employment income. The regulation, at §301.7701-2(c)(2)(iv)(D), also includes an example that specifically illustrates the mechanics of the rule. In the example, the disregarded entity is subject to employment tax with respect to employees of the disregarded entity. The individual owner, however, is subject to self-employment tax on the net earnings from self-employment resulting from the disregarded entity's activities. The regulations do not include a separate example in which the disregarded entity is owned by a partnership.

It has come to the attention of the Treasury Department and the IRS that even though the regulations set forth a general rule that an entity is disregarded as a separate entity from the owner for self-employment tax purposes, some taxpayers may have read the current regulations to permit the treatment of individual partners in a

partnership that owns a disregarded entity as employees of the disregarded entity because the regulations did not include a specific example applying the general rule in the partnership context. Under this reading, which was not intended, some taxpayers have permitted partners to participate in certain tax-favored employee benefit plans. The Treasury Department and the IRS note that the regulations did not create a distinction between a disregarded entity owned by an individual (that is, a sole proprietorship) and a disregarded entity owned by a partnership in the application of the self-employment tax rule. Rather, §301.7701-2(c)(2)(iv)(C)(2) provides that the general rule of §301.7701-2(c)(2)(i) applies for self-employment tax purposes for any owner of a disregarded entity without carving out an exception regarding a partnership that owns such a disregarded entity. In addition, the Treasury Department and the IRS do not believe that the regulations alter the holding of Rev. Rul. 69-184, 1969-1 CB 256, which provides that: (1) Bona fide members of a partnership are not employees of the partnership within the meaning of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954), and (2) such a partner who devotes time and energy in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

To address this issue, the Treasury Department and the IRS clarify in these temporary regulations that the rule that a disregarded entity is treated as a corporation

for employment tax purposes does not apply to the self-employment tax treatment of any individuals who are partners in a partnership that owns a disregarded entity. The rule that the entity is disregarded for self-employment tax purposes applies to partners in the same way that it applies to a sole proprietor owner. Accordingly, the partners are subject to the same self-employment tax rules as partners in a partnership that does not own a disregarded entity.

### **Explanation of Provisions**

This document contains amendments to the Procedure and Administration Regulations (26 CFR part 301) under section 7701 of the Code to clarify that a disregarded entity that is treated as a corporation for purposes of employment taxes imposed under subtitle C of the Code is not treated as a corporation for purposes of employing its individual owner, who is treated as a sole proprietor, or employing an individual that is a partner in a partnership that owns the disregarded entity. Rather, the entity is disregarded as an entity separate from its owner for this purpose. Existing regulations already provide that the entity is disregarded for self-employment tax purposes and specifically note that the owner of an entity treated in the same manner as a sole proprietorship under §301.7701-2(a) is subject to tax on self-employment income. These temporary regulations apply this existing general rule to illustrate that, if a partnership is the owner of a disregarded entity, the partners in the partnership are subject to the same self-employment tax rules as partners in a partnership that does not own a disregarded entity.

While these temporary regulations provide that a disregarded entity owned by a partnership is not treated as a corporation for purposes of employing any partner of the

partnership, these regulations do not address the application of Rev. Rul. 69-184 in tiered partnership situations. Several commenters have requested that the IRS provide additional guidance on the application of Rev. Rul. 69-184 to tiered partnership situations, and have also suggested modifying the holding of Rev. Rul. 69-184 to allow partnerships to treat partners as employees in certain circumstances, such as, for example, employees in a partnership who obtain a small ownership interest in the partnership as an employee compensatory award or incentive. However, these commenters have not provided detailed analyses and suggestions as to how the employee benefit and employment tax rules would apply in such situations. The Treasury Department and the IRS request comments on the appropriate application of the principles of Rev. Rul. 69-184 to tiered partnership situations, the circumstances in which it may be appropriate to permit partners to also be employees of the partnership, and the impact on employee benefit plans (including, but not limited to, qualified retirement plans, health and welfare plans, and fringe benefit plans) and on employment taxes if Rev. Rul. 69-184 were to be modified to permit partners to also be employees in certain circumstances.

In order to allow adequate time for partnerships to make necessary payroll and benefit plan adjustments, these temporary regulations will apply on the later of: (1) August 1, 2016, or (2) the first day of the latest-starting plan year following May 4, 2016, of an affected plan (based on the plans adopted before, and the plan years in effect as of, May 4, 2016) sponsored by an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2. For these purposes, an affected plan includes any qualified plan, health plan, or section 125 cafeteria plan if the plan benefits

participants whose employment status is affected by these regulations. For rules that apply before the applicability date of these regulations, see 26 CFR part 301 revised as of April 1, 2016.

### **Special Analysis**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), please refer to the Special Analysis section in the preamble to the cross-referenced notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal author of these regulations is Andrew Holubeck of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 301**

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

### **Amendments to the Regulations**

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 301.7701-2 is amended by:

1. Revising paragraph (c)(2)(iv)(C)(2).
2. Adding paragraph (e)(8).

The revision and addition reads as follows:

§301.7701-2 Business entities; definitions.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iv) \* \* \*

(C) \* \* \*

(2) [Reserved]. For further guidance, see §301.7701-2T(c)(2)(iv)(C)(2).

\* \* \* \* \*

(e)(8) [Reserved]. For further guidance, see §301.7701-2T(e)(8).

Par. 3. Section 301.7701-2T is added to read as follows:

§301.7701-2T Business entities; definitions (temporary).

(a) through (c)(2)(iv)(C)(1) [Reserved]. For further guidance, see §301.7701-2(a) through (c)(2)(iv)(C)(1).

(2) Section 301.7701-2(c)(2)(i) applies to taxes imposed under subtitle A, including Chapter 2—Tax on Self-Employment Income. Thus, an entity that is treated in the same manner as a sole proprietorship under §301.7701-2(a) is not treated as a corporation for purposes of employing its owner; instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of its owner. The owner will be subject to self-employment tax on self-employment income with respect to the entity's activities. Also, if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2 is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2.

(c)(2)(iv)(D) through (e)(7) [Reserved]. For further guidance, see §301.7701-2(c)(2)(iv)(D) through (e)(7).

(8)(i) Effective/applicability date. Paragraph (c)(2)(iv)(C)(2) of this section applies on the later of—

(A) August 1, 2016, or

(B) The first day of the latest-starting plan year following May 4, 2016, of an affected plan (based on the plans adopted before, and the plan years in effect as of,



May 4, 2016) sponsored by an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2. For rules that apply before the applicability date of these regulations, see 26 CFR part 301 revised as of April 1, 2016. For these purposes--

(1) An affected plan includes any qualified plan, health plan, or section 125 cafeteria plan if the plan benefits participants whose employment status is affected by paragraph (c)(2)(iv)(C)(2),

(2) A qualified plan means a plan, contract, pension, or trust described in paragraph (A) or (B) of section 219(g)(5) (other than paragraph (A)(iii)), and

(3) A health plan means an arrangement described under §1.105-5 of this chapter.

(ii) Expiration date. The applicability of paragraph (c)(2)(iv)(C)(2) of this section expires on or before May 3, 2019, or such earlier date as may be determined under amendments to the regulations issued after May 3, 2019,.

John M. Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: April 20, 2016.

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

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