

**Abstract:** In today's competitive employment market, a business organized as a partnership may want to promote an employee to a full partner. This brief article advises caution before acting, explaining some of the potential tax traps of doing so.

## **Beware of tax traps when making an employee a partner**

In today's competitive employment market, offering an employee an equity interest in your business can be a powerful tool for attracting and retaining top talent. If your company is organized as a partnership, however, beware of the tax traps of doing so.

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 incorrectly 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 could 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.

As you can see, there's much to consider. Please contact our firm before making this move.

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