Ralph Levy, Jr.

So You Want to "Make Partner"? A Word of Warning to Junior Professionals: Watch What You Wish For

Make Sure You Understand the Tax Implications

Ralph Levy, Jr. is of counsel in the Nashville, Tenn. office of Dickinson Wright PLLC. He can be reached at 615/620-1733 or by email at rlevy@dickinsonwright.com. Dickinson Wright PLLC is a full-service law firm with over 400 attorneys with offices in Michigan, Tennessee, Arizona, Nevada, Ohio, Kentucky, Washington, D.C., and Toronto, Ontario.

Group medical and dental practices often look to expand their practices by hiring additional professionals, typically those with less experience than the equity owners of the practice group. Invariably, both the group practice and the potential new hire will insist on an employment agreement that will provide the practice group with protection that the junior professional will continue to provide services to the group during a specified time period and that will assure the professional of payment for providing services. In addition, the potential new hire will request that the employment agreement provide for the opportunity to "make partner" within a specified time period after the date of hire.

This initial time period before the newly employed professional is considered for equity participation is typically viewed as a probationary period during which the parties will see if the relationship is a "good fit." The group practice will accede to the junior professional's request for equity participation after a limited time period of employment in order to "align the incentives" of the professional with that of the practice and also to facilitate in business succession of the practice group such that the group (or the junior professional) can pay the more senior equity owners for their equity interests in the practice as they retire. So far, so good?

By focusing on the business aspects of the employment relationship and possible equity participation, the tax aspects of the arrangement may be overlooked by the practice group and are generally ignored by the professional who is being hired. For example, the practice group owners and the junior professional are generally aware of the various "payroll taxes" (Medicare, Social

Security, and state and federal unemployment taxes) that apply during the initial phase of the employment agreement during which the professional is an employee but not an equity owner.

During this time period, regardless of the structure of the practice for federal tax purposes (*i.e.*, PC versus PLLC), the group practice as employer pays the "employer side" of payroll taxes, and the employee pays the "employee side" of payroll taxes via tax withholdings. For example, the group practice and the employed professional will each pay old age, survivors and disability insurance (OASDI, or Social Security) taxes of 6.2 percent of compensation paid to the junior professional up to an annually specified cap ($127,200 for 2017). In addition, the group practice and the employed professional will each pay hospital insurance (Medicare) taxes of 1.45 percent of compensation paid to the junior professional (not capped).

However, depending on how the group practice is organized for federal tax purposes, the parties may overlook the federal tax consequences when the employed professional "makes partner" of the group practice, particularly as to payroll taxes for practices organized as a professional limited liability company (PLLC) or a professional limited liability partnership (PLLP). Specifically, subject to an exception for certain income of limited partners that will be discussed below, for professionals who perform services for PLLCs or PLLPs in which they are also equity owners, all compensation received by the professionals from the group practice will be subject to self-employment tax.

For a junior professional being paid $100,000 in annual compensation before becoming an equity owner, the junior professional will pay through federal income tax withholdings Social Security taxes of $6,200.00 and Medicare taxes of $1,450.00, for a total of $7,650.00 (7.65 percent of compensation). The group practice will pay the same amount for the "employer side" of these taxes. Once the junior professional "makes partner" of an unincorporated group practice (*i.e.*, one taxed as a partnership for federal tax purposes), the professional will pay 15.3 percent in Social Security and Medicare taxes on income up to the annual Social Security income cap and 2.9 percent in Medicare taxes only on income above that annual limit. For the junior professional being paid $100,000, the Social Security and Medicare taxes for which the professional is responsible will increase from $7,650 to $15,300, double what the employed professional paid before becoming an equity owner.

This often overlooked tax consequence to "making partner" was addressed in recent guidance issued by the Office of Chief Counsel (OCC) of the Internal Revenue Service. In Chief Counsel Advice (CCA 201640014, issued 9/30/2016), the OCC found that all of a franchisee's share of earnings from a partnership operating several restaurants is subject to self-employment taxes when the franchisee, an individual, served as the manager, president, and chief executive officer (CEO) of the partnership. In reaching this conclusion, the OCC overruled the argument of the franchisee that the income derived from the partnership should be divided into two components, one that represented an investment return on contributed capital (exempt from self-employment tax) and another as compensation for services rendered by the individual to the partnership (subject to self-employment tax).

By asserting the argument that the franchisee's income from the partnership should be "split" into two streams (one subject to self-employment tax and another not subject to self-employment tax), the individual tried to distinguish the activities of the restaurant partnership from *Renkemeyer, Campbell & Weaver, LLP*, a 2011 Tax Court case in which the Tax Court determined that even though the attorneys who provided legal services for a law firm that was operated as a partnership were

limited partners of the law firm partnership, their income from the partnership was subject to self-employment tax.

The CCA found that for the same reasons adopted in the *Renkemeyer* case, all of the individual franchisee's income from the restaurant partnership was subject to self-employment income and not just the guaranteed payments made by the partnership to the individual who was the principal owner of the partnership.

Despite the franchisee's delegation of a portion of the services required by the partnership to operate the franchised restaurants to an executive management team, the individual's entire distributive share of the partnership income should be treated as compensation for services rendered by the individual as president, CEO, and manager of the partnership. As a result, the income paid to the individual was not exempt from self-employment income tax under IRC §1402(a)(13) (exemption of limited partner's distributive share of income).

The main lesson to be learned from the CCA and from the *Renkemeyer* case is that before finalizing an employment agreement with a professional group practice that is organized as a PLLC or a PLLP, the professional should insist on an increase in compensation upon being admitted as an equity owner of the practice to compensate for the increase of self-employment and other payroll taxes. Otherwise, the professional's take home compensation may actually decrease as a result of "making partner." Hence, the title of this article… "Watch what you wish for…"

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