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[Debbie Reiss Hardesty](#)

Partnership and LLC Alert: Some Workers Treated as Employees for Tax Purposes May Need to be Reclassified as Partners as Early as August 1, 2016

Though described by the IRS as merely clarifying existing federal tax law, the new regulations will likely require many businesses to alter their employment tax treatment of workers of their subsidiaries. In addition to changing how and who must remit taxes for that worker's earnings, the altered tax treatment may preclude or otherwise impact a worker's participation in certain employee benefit arrangements.

Example:

Joe owns 1% of Parent LLC, which is a tax partnership. Parent LLC owns 100% of Operating LLC, which is a disregarded entity of Parent LLC. Joe receives a salary from Operating LLC, which has been reported as wages on a Form W-2 for federal tax purposes, and with respect to which Operating LLC withholds taxes as required for employee wages. Operating LLC's profits (after expenses, which include Joe's wages) are reported as partnership income of Parent LLC. Joe receives a Schedule K-1 each year from Parent LLC reflecting his share of those profits, which is reported on his personal tax return. He does not treat those profits as self-employment income (*i.e.*, he is only reporting his salary from Operating LLC as subject to federal employment taxes).

Under the new regulations, Joe should no longer receive a Form W-2 or have taxes withheld as an employee for tax purposes; rather, any salary or compensation Operating LLC pays him should be included as part of his share of Parent LLC income on his Schedule K-1. Benefit plan differences will also result from this reporting change.

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