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MEMORANDUM FOR ELIZABETH S. HENN
DEPUTY AREA COUNSEL
(NORTHEAST & MIDATLANTIC AREA)
TAX EXEMPT AND GOVERNMENT ENTITIES
CC:TEGE:NEMA

FROM: Mary Oppenheimer
Assistant Chief Counsel
(Exempt Organizations/Employment Tax/Government Entities)
Office of Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

SUBJECT: Worker Classification - Of Counsel Attorneys

This responds to your request for our review of the issues raised by a proposed employment tax audit of a law firm. The proposed employment tax audit would focus on whether certain attorneys, referred to as “Of Counsel” attorneys, were classified correctly by the firm as partners or were actually employees. Because the firm classified the attorneys as partners, the firm did not treat the attorneys as employees and did not withhold or pay any employment taxes on payments made to those attorneys. In accordance with I.R.C. § 6110(k)(3), this memorandum should not be cited as precedent.

1. Facts

An audit has yet to be conducted so we do not yet know the specific facts regarding the relationship between the firm and each Of Counsel attorney. One of the Of Counsel attorneys filed a Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, that provided the following facts. The Of Counsel attorney provided legal services to the firm, a partnership. The Of Counsel attorney entered into a written agreement with the firm. The agreement provided that the firm could terminate the Of Counsel attorney, in writing, for cause, and that the Of Counsel attorney could terminate the agreement at any time with reasonable notice. The agreement further provided that the Of Counsel attorney would be paid a fixed amount per year, payable monthly. The Of Counsel attorney was not a partner in the firm for state law purposes. The Of Counsel attorney had no interest in the firm’s profits, losses or capital; no managerial rights or control over partnership decisions; and no ability to bind the partnership.

The firm did not withhold or pay employment taxes with respect to the payments that the firm made to the Of Counsel attorney. The firm treated the payments as "guaranteed payments" on Schedules K and K-1 of Form 1065, U.S. Partnership Return of Income.

2. Section 530 of the Revenue Relief Act of 1978

An employment tax audit of the firm would require an initial determination of whether the firm is entitled to relief under section 530 of the Revenue Act of 1978, Pub. L. No. 95-600 (1978), as amended (Section 530 relief). Only if Section 530 relief is unavailable will an analysis of the attorney's status as an employee be required.

To qualify for Section 530 relief, the firm must satisfy both the consistency test and the reasonable basis test.

A. The Consistency Test

To satisfy the consistency test, the firm must have filed all federal tax returns (including information returns) on a basis consistent with the firm's treatment of the worker as other than an employee. Although providing Forms 1099 typically is the manner of meeting this requirement, Forms 1099 are not always required to satisfy the consistency test. Rather, the returns filed must be consistent with the treatment of the worker. In the case of a purported partner, the proper return would be a Form K-1 and, only if the purported partner also performed services for the firm as an independent contractor, a Form 1099.

To satisfy the consistency test, the firm must also have treated all workers in substantially similar positions the same. A substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities are substantially similar. In addition, section 530(e)(6) of the Revenue Act of 1978, amended by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (1996), states that the determination of whether workers hold substantially similar positions requires consideration of the relationship between the firm and the workers. This includes, but is not limited to, the degree of supervision and control. This statutory change appears to be designed to enable differences in managerial responsibilities and differences in reporting requirements to be taken into account, along with differences in job duties. Presumably, the contractual relationship and the provision of employee benefits are also entitled to some weight.

In the case of a typical law firm, some attorneys are treated as partners, some attorneys are treated as employees (often, but not in all cases, labeled associates), and some attorneys are treated as independent contractors (often, but not in all cases, labeled Of Counsel attorneys). These labels are not determinative, however, of (1) whether the attorneys have been correctly classified as employees or non-employees or (2) which attorneys are in substantially similar positions. Therefore, in determining whether the consistency requirement has been satisfied as part of the proposed employment tax audit, the Service would have to determine (1) which attorneys, if any, have substantially similar positions to the particular Of Counsel attorney, and (2) whether all of those attorneys have been treated consistently regarding their employment status.

B. The Reasonable Basis Test

To satisfy the reasonable basis test, the firm must reasonably rely on one of the following: (1) the judicial precedent safe haven; (2) the past audit safe haven; (3) the industry practice safe haven; or (4) any other reasonable basis. It is not enough that the firm establish the existence of a safe haven, the firm must also demonstrate that it reasonably relied upon the safe haven in classifying the worker. For more information regarding the application of the reasonable basis test, see the IRS training material on determining worker status - “Independent Contractor or Employee?” Training 3320-102 (Rev. 10-96), TPDS 842381.

3. Worker Classification

If the proposed audit is undertaken and the Service determines that Section 530 relief is not available, then an analysis must be made as to the proper classification of each Of Counsel attorney as an employee or non-employee. The firm may have treated some or all of the Of Counsel attorneys as partners. Revenue Ruling 69-184, 1969-1 C.B. 256, provides that for employment tax purposes, a bona fide partner cannot be considered an employee. Therefore, before determining whether any Of Counsel attorney is an employee, the Service must first determine whether the attorney is a bona fide partner. If the attorney is not a bona fide partner for employment tax purposes, that does not necessarily indicate that the attorney is an employee. Rather, an additional determination must be made whether that attorney provided his or her services as either an employee or an independent contractor.

The Of Counsel attorney will be a bona fide partner if a bona fide partnership exists between the Of Counsel attorney and the partners of the firm. Therefore, it is necessary to apply the relevant cases addressing the requirements for a bona fide partnership.

As provided by the Supreme Court, a partnership is created “when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is a community of interest in the profit and losses." *Commissioner v. Tower*, 327 U.S. 280 (1946), at 286. Thus, the determination of the existence of such a bona fide partnership will depend on the facts and circumstances surrounding the relationship between the firm and the attorney, and whether that relationship rises to the level of a partnership.

The intent of the parties is the key factor in determining whether a particular arrangement constitutes a partnership. One must determine whether "the parties acting in good faith and with a business purpose intended to join together in the present conduct of the enterprise." *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). Although the Court in *Culbertson* held that intent was the key factor in determining whether or not a partnership exists, courts will take into account a number of other factors including: (1) the joint contribution of capital and services, (2) the sharing of profits and losses, and (3) the joint participation in management.

The commingling of property is generally considered to be a strong indicator that a valid partnership has been formed. However, it is not uncommon for a person who only provides services to the partnership to be a partner of that partnership provided that there are other indicia of a partnership, such as joint control of the venture and the sharing of profits and losses. In *Culbertson*, the Court said that where a partner "has not participated in the 'management and control of the business' or contributed 'original capital' [it] has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to joint together as partners." *Id.* at 744. The Court concluded that a person could become a partner by contributing just services where the services were of such value to the partnership that they entitled the contributor to participate in the sharing of profits. *Id.* at 745.

The question of whether or not a person is a bona fide partner in a partnership is one of federal law. While state law can provide indicia of partnership status (*e.g.*, whether a person has the ability to bind the partnership), a person who is not a partner for state law purposes may be a partner for federal tax purposes where other indicia are present. Similarly, the issuance of a Schedule K-1 by a partnership evidences an intent to treat the recipient as a partner but is not, by itself, determinative of partner status.

In light of these considerations, an attorney who has no interest in the profits, losses, or capital of the firm, has no managerial rights and cannot bind the firm, is not a partner for federal tax purposes, and the partnership's payments to the attorney are not guaranteed payments.

4. Hazard of Litigation: Potential Necessity of a Prior TEFRA Proceeding

One hazard of litigation may arise if the Service conducts an employment tax audit of the firm without conducting a prior audit under the Uniform Audit and Litigation procedures set forth in sections 6221 through 6233 of the Code ("a TEFRA proceeding"). If that occurs, the firm may raise an objection that any resulting employment tax assessment is prohibited by application of section 6225 of the Code. Section 6225 restricts assessments of deficiencies attributable to partnership items unless the TEFRA procedures are followed. Current guidance does not provide a definitive answer as to the application of TEFRA under the circumstances of an employment tax audit of a partnership involving purported partners being reclassified as employees.

A. Background: TEFRA Proceedings, Employment Taxes and the Self-Employment Tax

The employment tax liabilities in question are not subject to direct determination under the TEFRA procedures. Under sections 6221 and 6231(a)(3) of the Code, the TEFRA partnership procedures are limited to "partnership items," which are items under Subtitle A of the Code. Employment taxes are imposed under Subtitle C. Furthermore, the Tax Court in *Chef's Choice v. Commissioner*, 95 T.C. 388 (1990), explained that the intent of the TEFRA provisions was merely to aggregate the partners' income tax deficiency proceedings into a single proceeding insofar as their income tax liability derived from a partnership. Since the partnership does not pay income tax, it is not even a party to the TEFRA proceeding relating to income tax determinations. *Id*. at 394-395. Finally, under Code sections 6211(a) and (c) and 6225, the TEFRA restriction on assessment under section 6225 applies only to certain deficiencies, which do not include employment taxes.[1] Thus, TEFRA does not explicitly apply to assessments of employment taxes under Subtitle C.

In contrast to the treatment of employment taxes, the identification of income subject to self-employment tax under section 1401 of Subtitle A is subject to the TEFRA procedures. This would include classification of payments as guaranteed payments, because under section 1402 of the Code, guaranteed payments to partners generally are included as self-employment income subject to self-employment tax. Section 6221 of the Code mandates that "partnership items" be determined under the TEFRA procedures. Section 6231(a)(3) generally provides that the term "partnership item" includes any item required to be taken into account for the partnership's taxable year under Subtitle A to the extent provided by the regulations. Section 301.6231(a)(3)-1(a)(4)(ii) of the Procedure and Administration Regulations provides that the amount

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[1]Section 6211(a) of the Code defines a "deficiency" in terms of subtitles and chapters other than Subtitle C. Section 6211(c) of the Code refers to subchapters C and D for determinations of such deficiencies attributable to partnership items. Section 6225 restricts assessments of deficiencies attributable to partnership items unless the TEFRA procedures are followed.

and character of an amount distributed to a partner is a partnership item. *See also* Treas. Reg. § 301.6231(a)(3)-1(c)(3)(i). Section 301.6231(a)(3)-1(a)(2) specifically lists as a partnership item the character of an amount as a guaranteed payment. Finally, § 301.6231(a)(3)-1(b) provides that the term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing and characterization of items of income.

Treatment of the payments to the Of Counsel attorney as wages for employment tax purposes would be inconsistent with a treatment of the payments as self-employment income for self-employment tax purposes. Self-employment income is not subject to employment taxes. Thus, a determination in a TEFRA proceeding that the Of Counsel attorney is a partner and that the payments to the attorney constitute self-employment income would be inconsistent with a determination in an employment tax audit that the Of Counsel attorney is an employee and the collection against the partnership of employment taxes on these same amounts.

B. Application of TEFRA Procedures to the Proposed Employment Tax Audit

The following discussion outlines the arguments as to whether a prior TEFRA proceeding recharacterizing the guaranteed payments on the partnership income tax return must be conducted before employment taxes may be assessed based on the recharacterization of those guaranteed payments as wages for employment tax purposes. First it is noted that the Of Counsel attorney will be treated as a partner for TEFRA purposes because the attorney is listed as a partner on the partnership return, even if the attorney is not a bona fide partner of the partnership for employment tax purposes. Second it is noted that the recharacterization of the guaranteed payment to the Of Counsel attorney on the partnership income tax return as some other type of payment, because the Of Counsel attorney is not a bona fide partner, would require a TEFRA proceeding. Finally, the opposing arguments are discussed as to whether the Service may reclassify the guaranteed payments to the Of Counsel attorney in an employment tax audit in a manner inconsistent with the partnership return (because no TEFRA proceeding as to the partnership income tax return has been conducted).

i. The Of Counsel Attorney Will be Treated as a Partner for TEFRA Purposes, Regardless of the Attorney's Status as a Bona Fide Partner

TEFRA procedures may apply to issues involving a purported partner listed on the partnership return, even if the purported partner is not a bona fide partner. For TEFRA purposes, persons listed on the partnership return are treated as partners subject to the TEFRA procedures even though such persons may not be bona fide partners. Section 6223(c) of the Code provides that "for purposes of [the TEFRA] subchapter . . . the

Secretary shall use the names, addresses, and profits interests shown on the partnership return."

Alternatively, section 6231(a)(2)(B) defines the term "partner" for TEFRA purposes as including "any other person whose income tax liability under Subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." Section 6222 of the Code requires that a partner report items consistently with the partnership return. If an individual is listed as a partner on the partnership return and reports partnership items consistently with the Forms K-1 issued by the partnership, that person has in fact determined his or her income tax liability by taking the listed partnership items into account. Thus, the individual's liability is determined by taking partnership items into account within the meaning of section 6231(a)(2)(B), and the individual is a partner for TEFRA purposes.

ii A TEFRA Proceeding is Required to Recharacterize a Guaranteed Payment on the Partnership Income Tax Return Based on a Finding that the Recipient is not a Partner of the Partnership Making the Payment

The recharacterization on the partnership income tax return of guaranteed payments to a purported partner as some other type of payment because the individual is not actually a partner, and any related finding that the payments are not subject to self-employment tax, may only be done through a TEFRA proceeding. Section 6231(g)(1) provides that if, on the basis of the partnership return for a taxable year, the Secretary reasonably determines that the TEFRA provisions apply, and such determination is erroneous, the TEFRA provisions "are hereby extended to such partnership (and its items) . . . or to partners of such partnership." Thus, based on the face of the partnership return, if the Service reasonably determines that the TEFRA procedures apply to the reported guaranteed payments, the TEFRA provisions are thereby extended to the determination of "guaranteed payments" reported on the partnership return, and whether in fact those payments qualify as such because the listed individual is or is not a partner.

Section 6233 of the Code also can be read to mandate the application of the TEFRA provisions to recharacterize guaranteed payments on the partnership return as some other type of payments because the recipient is not a partner. Section 6233(b) of the Code and section 301.6233-1T(c) of the Procedure and Administration Regulations provide that if a partnership return is filed for a year but no entity exists, then the TEFRA provisions apply and may include the determination that no entity exists. Section 301.6233-1T(a) provides that the final partner administrative adjustment (FPAA - the TEFRA equivalent of a notice of deficiency) or decision of the court may include determinations with respect to all items of the entity which would be partnership items if such entity had been a partnership in such taxable year. Thus, the Service may determine as part of the TEFRA procedures that there is no partnership between the employees listed as partners and the legitimate partners of the partnership and that, consequently, the distributed amounts do not qualify as self-employment income under section 1402 of the Code. *But cf. Hang v. Commissioner*, 95 T.C. 74 (1990) (deficiency procedures apply to determine that an alleged beneficial shareholder not listed as a shareholder in a TEFRA S corporation return is in fact the true shareholder).[2]

iii May the Service Take a Position in an Employment Tax Audit Regarding the Treatment of an Item Inconsistent with the Treatment of the Item on the Partnership Income Tax Return Absent a TEFRA Proceeding?

In the absence of a TEFRA proceeding, it is not clear whether the Service may take a position in an employment tax audit regarding the treatment of an item inconsistent with the treatment of the item on the partnership income tax return. In the absence of a TEFRA proceeding to recharacterize partnership items as reported on the partnership return, at least three courts have held that the partnership return controls the treatment of any partnership item for purposes of later proceedings. *Roberts v. Commissioner*, 94 T.C. 853, 857 (1990) (in the context a an “affected item” deficiency proceeding, and in the absence of a partnership proceeding, partnership items will be considered final in accordance with the partnership return); *Estate of Quick v. Commissioner*, 110 T.C. 172 (1998); *Doe v. Commissioner*, 97-1 U.S.T.C. ¶ 50,460 (10th Cir. 1997). In all three cases, the courts reasoned that since partnership items can only be adjusted through TEFRA partnership proceedings, the government is bound by the partnership reporting of such items on a partnership return if it does not conduct a TEFRA partnership proceeding.

It is unclear whether this rationale would extend to the assessment of employment taxes under Subtitle C. In an employment tax audit, the Service adjusts items under Subtitle C, which are not partnership items. In addition, the Service is assessing the partnership, and the partnership generally is not considered to be a party to the TEFRA proceeding in its capacity as a separate entity. *See Chef’s Choice*, 95 T.C. 388 (1990). But the firm may argue that an employment tax audit of a partnership involving the reclassification of a partner recharacterizes self-employment income of a listed partner as wages and, therefore, a TEFRA proceeding is required because, as explained above, the recharacterization of self-employment income would be a partnership item adjustment. The firm may also argue that because the partnership is an aggregation of the partners who would be parties to a TEFRA proceeding, the partnership actually

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[2]We believe that this opinion is clearly wrong and limited to its facts with respect to S corporations. In a later opinion with respect to partnerships, *Brookes v. Commissioner*, 108 T.C. 1 (1997), the Tax Court held that deficiency procedures do not apply to the allocation of partnership among partners.

would be a party to a TEFRA proceeding in which this recharacterization would be determined.

Alternatively, the firm might argue that the employment tax liability is at least an "affected item" whose partnership item components must be respected as reported on the partnership return unless adjusted under the TEFRA procedures. Section 6231(a)(5) of the Code and section 301.6231(a)(5)-1T of the Procedure and Administration Regulations define an item as an "affected item" to the extent such item is affected by a partnership item. *See N.C.F. Energy Partners v. Commissioner*, 89 T.C. 741 (1987). Affected items generally may not be determined until a TEFRA partnership proceeding is complete, and any affected item proceeding is bound by the partnership item determinations. *See G.A.F. v. Commissioner*, 114 T.C. 519 (2000).

C. Conclusion

As demonstrated above, there are both arguments that a prior TEFRA proceeding must be conducted before the proposed employment tax audit, and arguments that a prior TEFRA proceeding is not necessary. Although TEFRA was enacted in 1982, and generally became effective in 1986, the Service has not faced this issue to date.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any further questions about the issue of status as a bona fide partner, please contact Horace Howells at (202) 622-3050 or about the application of TEFRA proceedings, please contact Bill Heard at (202) 622-7860. If you have any other further questions, please contact Stephen Tackney at (202) 622-6040.