

I Didn't Mean for That to Happen! Potential Unintended Consequences of Equity Awards to Employees of a Partnership

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PRACTICES Employee Benefits and Executive Compensation

When granting equity awards to employees of a partnership (or an LLC taxed as a partnership), the granting employers need to use caution to avoid unintended, negative consequences to those employees.

For example, an individual cannot be both a partner in a partnership and an employee. Once an individual receives an equity interest in a partnership (*i.e.*, an actual partnership interest or a profits interest), they will become a partner in the partnership. Consequently, the individual would no longer be considered an employee and would then be responsible for both the employer and employee side of applicable employment taxes. Their income would also no longer be subject to income tax withholdings. Rather, the individual would need to begin making estimated quarterly tax payments to the relevant tax authorities for their income and employment taxes. In addition, income would no longer be reported on Form W-2, but rather on Form K-1. Perhaps most importantly, such individuals would no longer be able to participate in the employer's health and welfare benefit plans on a pre-tax basis.

There are ways to avoid these potential consequences based on the organizational structure of the partnership, such as through a tiered partnership structure, a non-disregarded C-Corp subsidiary that employs the individual or if the partnership interests are held in the parent. Your benefits and tax counsel can advise on the pros and cons of granting equity awards to employees in a partnership as well as strategies to mitigate any negative consequences.