Leimberg Information Services, Inc.

Steve Leimberg's Business Entities
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Subject: Steve Gorin on *Fleischer v. Commissioner*: Using an S Corporation to Limit Self-Employment Tax Imposed on Financial Industry Services Compensation

"To avoid self-employment tax on income from financial industry services provided by the owner of an S corporation, the S corporation itself must enter into a written contract to provide management services and receive compensation directly. In Fleischer v. Commissioner, a financial consultant learned that lesson the hard way."

In Business Entities Newsletter #158 (March 28, 2017), **Steve Gorin** explained how self-employment (SE) tax applies to entities taxed as partnerships. Steve now explains how a taxpayer unsuccessfully tried to use an S corporation to deflect SE income and discusses whether using an S corporation to avoid SE tax is a wise decision in the first place.

Steve Gorin is a partner in **Thompson Coburn LLP**, a law firm headquartered in St. Louis, with offices in Chicago, Los Angeles, and Washington, D.C. Steve is a nationally recognized practitioner in the areas of estate planning and the structuring of privately held businesses. Lawyers, accountants and business owners regularly look to Steve for fresh, highly knowledgeable insights into the best possible tax and estate planning approaches to their transactions. Steve crafts estate plans for individuals, keeping in mind their financial security and desire to save income and estate tax. His quarterly newsletter, "Business Succession Solutions" is considered essential reading for hundreds of CPAs, attorneys, and technically-oriented financial advisers and trust officers. **LISI** members may email Steve at sgorin@thompsoncobutn.com to obtain a free copy of over 1,200 pages of technical materials and to subscribe to his free quarterly newsletter that provides the most recent version. For information not necessarily technically oriented, visit Steve's blog at http://www.thompsoncoburn.com/insights/blogs/business-succession-

solutions/about. For more information about Steve, see http://www.thompsoncoburn.com/people/steve-gorin.

Steve thanks his partner, **Dee Anne Sjogren**, for her input on how registered investment advisors do business. For more information on Dee Anne, see http://www.thompsoncoburn.com/people/deeanne-sjögren.

Here is Steve's commentary:

EXECUTIVE SUMMARY:

Code Section 1401 imposes self-employment (SE) tax, which starts at 15.3% and dips to 2.9% before increasing to 3.8%, on the business earnings of a sole proprietor or partner. SE tax represents the combined employer's and employee's shares of FICA, which consists of Social Security (OASDI) and Medicare taxes.

Many owners elect S corporation status in order to avoid paying SE tax or FICA on their business earnings. The IRS frequently attacks whether payments an owner receives from an S corporation are subject to FICA or are merely distributions as an owner.

These disputes assume that the S corporation was the proper taxpayer to report the income. First, however, the S corporation must be the entity that receives the income. *Fleischer v. Commissioner* held that a financial consultant himself, not his S corporation, earned the income and therefore the individual financial consultant was subject to SE tax on the income.

Below is a discussion of what happened in the case, what the financial consultant needed to do, and other ways to approach the situation if the ideal result cannot be attained.

COMMENT:

Using an S Corporation to Save SE Tax

Any income that an S corporation earns is not subject to SE tax, which is imposed only upon individuals (including partners of partnerships).[i]

The IRS often asserts that distributions to shareholder-employees are really compensation for services rendered, frequently imposing not only FICA but also interest and penalties.[ii] One CPA's license was suspended for being too aggressive in determining only a small amount to be treated as compensation.[iii]

However, before even figuring out how much should be treated as reasonable compensation and how much should be treated as a distribution, the business owner must prove that the S corporation, not the individual who provided the services, is the taxpayer that earned the income. And that brings us to Mr. Fleischer.

Fleischer v. Commissioner – Who Earned the Income?

In *Fleischer v. Commissioner*,[iv] Fleischer was a financial consultant, developing investment portfolios for clients. Here are the facts, according to the Tax Court:

"On February 2, 2006, petitioner entered into a representative agreement with Linsco/Private Ledger Financial Services (LPL). The agreement expressly states that petitioner's relationship with LPL is that of an independent contractor. Petitioner signed the agreement in his personal capacity.

After consulting both his business attorney and his CPA, petitioner incorporated Fleischer Wealth Plan (FWP) and caused it to elect S corporation status. The Court takes judicial notice of the fact that FWP was incorporated in the State of Nebraska on February 7, 2006. See Fed. R. Evid. 201. Petitioner was the sole shareholder and the president, secretary, and treasurer of FWP. On February 28, 2006, petitioner entered into an employment agreement with FWP. The agreement expressly states that petitioner's term of employment with FWP began on February 28, 2006.

Petitioner was paid an annual salary to 'perform duties in the capacity of Financial Advisor.' Those duties consisted of: (1) acting in the clients' best interests in managing client investment portfolios; (2) expanding

FWP's client base and the ‘overall presence’ of FWP; (3) drafting and reviewing financial documents; and (4) representing FWP ‘diligently and responsibly at all times.’ The agreement gives FWP the right to reasonably modify petitioner's duties at its discretion. The agreement includes other common provisions found in employment agreements, such as provisions for the reimbursement of expenses and how to terminate the agreement, an arbitration clause, and a noncompete clause. The agreement does not include a provision requiring petitioner to remit any commissions or fees from LPL or any other third party to FWP. Petitioner signed the agreement twice—once as FWP's president and once in his personal capacity. Outside of the employment agreement, FWP entered into no other contracts during the years in issue.

On March 13, 2008, petitioner entered into a broker contract with MassMutual Financial Group (Mass Mutual). The contract is between petitioner and MassMutual—there is no mention of FWP in the contract. The contract explicitly states that there is no employer-employee relationship between petitioner and MassMutual. Petitioner signed the contract in his personal capacity. At the time petitioner entered into the contract, he was selling only fixed insurance products.

There are no addendums or amendments to either the LPL agreement or the MassMutual contract requiring those entities to begin paying FWP instead of petitioner or to recognize FWP in any capacity.”

Fleischer reported all of his gross receipts on FWP’s Form 1120S, reporting just under $35,000 per year wage income and 2009, 2010 and 2011 S corporation taxable income of (rounded) $12,000, $148,000, and $115,000, respectively.

The court applied the following test (citations omitted): “For a corporation, not its service-provider employee, to be the controller of the income, two elements must be found: (1)the individual providing the services must be an employee of the corporation whom the corporation can direct and control in a meaningful sense; and (2) there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position.”[v] (Further below the court referred to the second test as “the second element of the control test outlined in *Johnson*.”)

The court held that Fleischer, not his S corporation, had earned all of the income, reasoning: "There was no indicium for LPL to believe that FWP had any meaningful control over petitioner as FWP had not been incorporated and no purported employer-employee relationship between FWP and petitioner existed at the time petitioner signed the representative agreement with LPL. Moreover, there is no evidence of any amendments or addendums to the LPL agreement after FWP was incorporated. Although FWP had been incorporated before petitioner entered into the broker contract with MassMutual, FWP is not mentioned in the contract, and petitioner offered no evidence that MassMutual had any other indicium that FWP had any meaningful control over him. See *Roubik v. Commissioner*, 53 T.C. 365 (1969) (holding income earned by individual taxpayers where corporation did not enter into any agreements with third parties and agreements between physicians in their independent capacities and third parties continued after corporation was formed). For the reasons stated above, the Court finds that petitioner has failed to meet the second element of the control test outlined in Johnson. Because petitioner does not meet the second element of the test enumerated in *Johnson*, there is no need for the Court to analyze, and the Court makes no decision as to, whether petitioner was an employee of FWP. Therefore, petitioner individually, not FWP, should have reported the income earned under the representative agreement with LPL and the broker contract with MassMutual for the years in issue.

What Should Fleischer Have Done?

Fleischer argued that it was impossible for LPL and MassMutual to contract directly with FWP, because only an individual, and not a corporation, can be personally licensed as a "registered representative" or "agent" as required in order to sell investment and insurance products under applicable FINRA rules and state blue sky securities and insurance licensing laws and regulations. The court was not sympathetic, holding, "The fact that FWP was not registered, thus preventing it from engaging in the sale of securities, does not allow petitioner to assign the income he earned in his personal capacity to FWP."[vi]

So, Fleischer did not take the steps required to deflect income to his S corporation. As an aside, reporting salary that is only a fraction of the taxable wage base, combined with reporting S corporation income

several times as large as wages, might very well have put Fleischer in the hot seat from the get go and might have drawn an attack even if FWP could have made the necessary contractual arrangements.

What Can A Financial Consultant Do to Avoid SE Tax If Unable to Cause an S Corporation to Contract Directly to Receive Commissions or Fees?

A financial consultant typically employs staff, which may include an assistant, secretary and/or junior salespeople, who assist the consultant in providing advice on investment and insurance products. The S corporation could employ these staffers, and the financial consultant could pay the S corporate a management fee to obtain the staff's assistance. The management fee could be calculated based on the employees' compensation, benefits, and related costs along with a reasonable profit for the S corporation. A "reasonable profit" on these management services should not be viewed as a deflection of the financial consultant's earned income by the IRS based on theories that have been suggested over the years; although there are no guarantees when dealing with the IRS.

If the S corporation distributes its earnings to the financial consultant, those distributions may appear to the IRS and the tax courts to be a circular flow of cash – meant to "recycle" money. In theory, nothing is wrong with distributions, but appearances can sway examiners and judges. Ideally, the S corporation would reinvest its profits and not distribute them until the financial consultant's death or, if earlier, a reasonable period after the financial consultant retires.

Is an S Corporation the Best Choice For A Financial Consultant Looking to Retire/Sell the Business?

Using an entity to avoid SE tax makes sense only if the savings are large enough. If they really are that large, should the financial consultant consider issues other than SE tax?

Consider when the financial consultant wants to sell the financial consultant's business. The seller would pay capital gain tax, and the buyer would pay tax on the earnings that the buyer uses to pay the seller. So, even though an S corporation is viewed as incurring a single

level of tax, two layers of tax are involved in this sale. Is there any way around that?

If the entity were taxed as a partnership, the buyer could deduct the payments made to the seller.[vii] The seller would pay ordinary income tax but not capital gain tax; the sale price would need to be grossed up. Here is an example for the sale of an interest in a business worth $100; add as many zeroes as you wish:

Example:

1. Assume an individual's combined federal and state income tax rates are 40% for ordinary income and 30% for capital gain.

2. An S corporation would need to earn $167 to generate $100 net income after tax after subtracting $67 income tax ($167 times 40%) paid by the buyer on the buyer's K-1 income. The seller nets $70, which is the $100 sale price minus $30 (30% of $100) income tax.

3. A partnership would need to earn only $117 to get the same $70 to the seller. The partnership pays the seller the full $117, and the seller nets $70 after subtracting $47 tax ($117 times 40%).

4. How does one account for the $50 difference between the $167 earnings used for the buyout in the S corporation scenario and the $117 earnings used for the buyout in the partnership scenario? First, whoever gets the $50 pays $20 tax (40% of $50) on it, leaving $30. The parties can negotiate who receives how much of this $30. This $30 in after-tax money is the savings generated by using a partnership in an S corporation and matches the $30 capital gain tax avoided by using a partnership.

Based on the figures above, a partnership would be much better than an S corporation to use when selling a financial consulting business. Is there any way the financial consultant can have the financial consultant's cake and eat it too by using a partnership and avoiding SE tax on the earnings?

Yes! First, for the sake of simplicity, the financial consultant needs to accept paying modest SE tax when the financial consultant has modest earnings. Start with an LLC taxed as a sole proprietorship or partnership (depending on whether one or more owners are involved).

When SE tax gets sufficiently painful, the financial consultant transfers the LLC interests to a limited partnership, taking back a 99% interest as a limited partner and a 1% interest as a general partner owned by the S corporation which, in turn, is owned by the financial consultant. The LLC continues to do business as before, with the LLC owner providing advice on investments and insurance products to the public in the owner's capacity as a registered representative/agent of an independent securities business (such as LPL). The LLC pays a management fee to the S corporation, which pays the financial consultant reasonable compensation; for the sake of simplicity, the LLC's other payroll would probably be transitioned to the S corporation as well, but that element is not essential to this plan. The 99% profits as a limited partner would not be subject to SE tax,[viii] nor would the 1% profits that the S corporation receives. When it is time to buy out the financial consultant, 99% of the buyout can be done using the scenario described above.

For more details on this structure and its technical underpinnings, email Steve Gorin.[ix] Before moving on, let's explore an opportunity to save SE tax if the LLC interests are not transferred to a limited partnership structure and the financial consultant retires.

Self-employment tax does not apply to amounts received by a partner pursuant to a written plan with the partnership, which plan satisfies certain IRS requirements and provides for payments on account of retirement, on a periodic basis,[x] to partners generally or to a class or classes of partners, which payments will continue at least until such partner's death,[xi] if:[xii]

(A) such partner rendered no services with respect to any trade or business carried on by such partnership during the taxable year of such partnership, ending within or with such partner's taxable year, in which such amounts were received,[xiii]

(B) no obligation exists (as of the close of the partnership's taxable year described above) from the other partners to such partner except with respect to retirement payments under such plan, and

(C) such partner's share, if any, of the capital of the partnership has been paid to such partner in full before the close of the partnership's taxable year referred to above.

Note that such payments would likely be characterized as deductible payments that are ordinary income to a partner who is being redeemed in full.[xiv] And, although such payments are generally excluded from the draconian Code § 409A nonqualified deferred compensation rules,[xv] payments under this provision are not excluded from Code § 409A.[xvi]

Avoiding SE Tax on Retirement Income of Insurance Agents

Code § 1402(k) excludes from SE income any amount received during the taxable year from an insurance company on account of services performed by an individual as an insurance salesman for such company if:

(1) such amount is received after termination of such individual's agreement to perform such services for such company,

(2) such individual performs no services for such company after such termination and before the close of such taxable year,

(3) such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

(4) the amount of such payment-

  (A) depends primarily on policies sold by or credited to the account of such individual during the last year of such agreement or the extent to which such policies remain in force for some period after such termination, or both, and

  (B) does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service).

Conclusion

Financial consultants may use a variety of structures to save self-employment taxes, the feasibility of which varies according to the situation.

However, be sure not to sacrifice a more lucrative exit strategy when looking for ways to avoid SE tax.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Gorin

CITE AS:

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CITES:

Code §§ 1402(a), 736(a)(1), 1402(a)(13), 1402(a)(10), 736, 409A, 707(a)(1) and 1221(a)(2); Reg. §§ 31.3121(d)-1(c)(2) and 1.1402(a)-17; *Fleischer v. Commissioner*, T.C. Memo. 2016-238; *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Joly v. Commissioner*, T.C. Memo 1998-361; *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); *Dunn & Clark, P.A. v. Commissioner*, 853 F.Supp. 365 (D. Idaho 1994); *Wiley L. Barron, CPA, Ltd. v. Commissioner*, T.C. Summary Opinion 2001-10; *Yeagle Drywall Co. v. Commissioner*, T.C. Memo. 2001-284; *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001); *Joseph M. Grey, P.C. v. Commissioner*, 119 T.C. 121 (2002); *Nu-Look Design Inc. v. Commissioner*, 356 F.3d 290 (3rd Cir. 2004); *Herbert v. Commissioner*, T.C. Summary Opinion 2012-124; *Sean McAlary Ltd, Inc. v. Commissioner*, T.C. Summary Opinion 2013-62; *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180; *Watson, P.C, v. U.S.,* 105 AFTR.2d 2010-2624; *In the matter of Biyu Wong*, Case No. AC-2009-26; *Johnson v. Commissioner*, 78 T.C. 882, 891 (1982); *Vercio v. Commissioner*, 73 T.C. 1246, 1254-1255 (1980); *Vnuk v. Commissioner*, 621 F.2d 1318, 1320-1321 (8th Cir. 1980); *Pacella v. Commissioner*, 78 T.C. 604 (1982); *Keller v. Commissioner*, 77 T.C. 1014 (1981); *Sargent v. Commissioner*, 929 F.2d 1252, 1256

(8th Cir. 1991); *Jones v. Commissioner*, 64 T.C. 1066 (1975) and *Brandschain v. Commissioner*, 80 T.C. 746 (1983); Rev Ruls. 74-44 and 79-34; Letter Rulings 8052117 and 7905032; IRS Fact Sheet 2008-25; [add references to articles – other than mine - here]; and various parts of Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (ver. 157 printed 2/22/2017), a more recent version available for free by emailing the author at sgorin@thompsoncoburn.com (fully searchable PDF in excess of 1,200 pages and 11MB file size).

CITATIONS:

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[i] Code § 1402(a). All references to the Code are to the Internal Revenue Code of 1986, as amended.

[ii] For a summary of cases, see Looney and Levitt, "Compensation Reclassification Risks for C and S corporations," *Journal of Taxation* (May 2015). Note the tips provided by Kirkland, "Helping S corporations avoid unreasonable compensation audits: Find out what entries on Forms 1120S may trigger these audits," *Journal of Accountancy* (6/1/2015). See IRS Fact Sheet 2008-25, "Wage Compensation for S corporation Officers," http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers and "S Corporation Compensation and Medical Insurance Issues," http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues, as well as http://www.irs.gov/Businesses/Valuation-of-Assets (which includes reasonable compensation issues); Rev. Rul. 74-44; *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990) (law firm); *Joly v. Commissioner*, T.C. Memo 1998-361 (20% penalty assessed when S corporation treated compensation as loans); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990) (accounting firm); *Dunn & Clark, P.A. v. Commissioner*, 853 F.Supp. 365 (D. Idaho 1994) (law firm); *Wiley L. Barron, CPA, Ltd. v. Commissioner*, T.C. Summary Opinion 2001-10 (CPA firm); *Yeagle Drywall Co. v. Commissioner*, T.C. Memo. 2001-284 (drywall construction business); *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001) (consulting and surgical services provided to veterinarians); *Joseph M. Grey, P.C. v. Commissioner*, 119 T.C. 121 (2002) (accounting firm); *Nu-Look Design Inc. v. Commissioner*, 356 F.3d 290 (3rd Cir. 2004) (residential home improvement company); see *Herbert v.*

Commissioner, T.C. Summary Opinion 2012-124 (taxpayer claimed only $2,400 of compensation; IRS alleged $55,000 in compensation; court used taxpayer's approximately $30,000 average annual compensation; penalties do not appear to have been imposed on wages but were imposed on other items); *Sean McAlary Ltd, Inc. v. Commissioner*, T.C. Summary Opinion 2013-62 (taxpayer penalized for failing to report any compensation; court reject IRS' expert's reliance on merely a percentage of gross receipts, instead computing an hourly wage based on its view of the cases: "the employee's qualifications, the nature, extent, and scope of the employee's work, the size and complexity of the business, prevailing general economic conditions, the employee's compensation as a percentage of gross and net income, the employee/shareholder's compensation compared with distributions to shareholders, the employee/shareholder's compensation compared with that paid to non-shareholder/employees, prevailing rates of compensation for comparable positions in comparable concerns, and comparable compensation paid to a particular shareholder/employee in previous years where the corporation has a limited number of officers"). The IRS might even recharacterize purported repayments of open account indebtedness as compensation, even when the amounts significantly exceed the K-1 income; see *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180. For more detailed summaries and additional cases, see Christian & Grant, "¶34.06. Reasons for Payment of Salaries," *Subchapter S Taxation* (WG&L). However, it appears that, in a professional services firm, the IRS might concede that a significant portion of distributions are not subject to FICA. See *Watson, P.C, v. U.S.,* 105 AFTR.2d 2010-2624 (denying the taxpayer's motion for summary judgment) and 107 AFTR.2d 2011-311 (S.D. Iowa) (finding in favor of the IRS), ***aff'd*** 109 AFTR.2d 2012-1059 (8th Cir.), cert. den. 10/1/2012.

[iii] *In the matter of Biyu Wong*, Case No. AC-2009-26, found at http://www.dca.ca.gov/cba/discipline/accusations/ac-2009-26.pdf, the California Board of Accountancy, Department of Consumer Affairs, suspended a CPA for preparing an S corporation's return that reported "minimal or no officer compensation," resulting in the corporation being "assessed significant payroll taxes and penalties." Wong's license was revoked, but the revocation was stayed and Wong was suspended from practice for 60 days and placed on probation for 3 years.

[iv] T.C. Memo. 2016-238.

[v] The court identified Reg. § 31.3121(d)-1(c)(2) as the controlling regulation and directly or indirectly cited *Johnson v. Commissioner*, 78 T.C. 882, 891 (1982); *Vercio v. Commissioner*, 73 T.C. 1246, 1254-1255 (1980)), *aff'd* without published opinion, 734 F.2d 20 (9th Cir. 1984); *Vnuk v. Commissioner*, 621 F.2d 1318, 1320-1321 (8th Cir. 1980), *aff'g* T.C. Memo. 1979-164); *Pacella v. Commissioner*, 78 T.C. 604 (1982), *Keller v. Commissioner*, 77 T.C. 1014 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983); and *Sargent v. Commissioner*, 929 F.2d 1252, 1256 (8th Cir. 1991). All references to "Reg." mean U.S. Treasury Regulations.

[vi] As support, the court said, "See *Jones v. Commissioner*, 64 T.C. 1066 (1975) (holding that a court reporter improperly assigned income to his personal service corporation because a court reporter was legally required to be an individual, and although the corporation was a valid entity, by law it could not perform such services)."

[vii] Code § 736(a)(1) would apply in most cases, but other ways are available. Gorin, II.Q.8.b.ii.(b). Flexibility in Choosing between Code § 736(a) and (b) Payments, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (version 157, printed 2/22/2017), available for free by emailing the author at sgorin@thompsoncoburn.com (this paper is referred to simply as "Gorin" in the endnotes that follow).

[viii] Code § 1402(a)(13).

[ix] Gorin (endnote vii), II.E Recommended Structure for Entities.

[x] Payments made by a partnership retirement plan to a retired partner from current partnership earnings excepted from the term net earnings from self-employment for purposes of Code § 1402(a) even if receipt of part of the payments is deferred until shortly after the beginning of the following year. Rev. Rul. 79-34.

[xi] Terminating payments before the partner's death disqualifies the payments from this exclusion. Letter Ruling 8052117.

[xii] Code § 1402(a)(10); Reg. § 1.1402(a)-17.

[xiii] A lawyer who retired from practicing law but continued to perform arbitration services through the same law firm did not fall within this exclusion from self-employment tax. *Brandschain v. Commissioner*, 80 T.C. 746 (1983).

[xiv] Letter Ruling 7905032. For a general discussion of Code § 736, see Gorin (endnote vii), part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[xv] For a general discussion of Code § 409A, see Gorin (endnote vii), part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules. For general application (or lack thereof) of Code § 409A to partnerships, see Gorin (endnote vii), text accompanying footnote 2089.

[xvi] Notice 2005-1, A-7 provides:

> The application of § 409A is not limited to arrangements between an employer and employee. Accordingly, § 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan…. [U]ntil further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A. Finally, § 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

This rule continues to apply under the final regulations issued under Code § 409A. Section 4 of Notice 2007-86.

In (G.) Arrangements Between Partnerships and Partners, T.D. 9321, which promulgated final regulations under Code § 409A, provides:

> Commentators raised issues concerning the application of the provision in Notice 2005-1, Q&A-7 stating that until further guidance is issued, taxpayers may treat arrangements providing for payments subject to section 736 (payments to a retiring partner or a deceased

partner's successor in interest) as not being subject to section 409A, except that an arrangement providing for payments that qualify as payments to a partner under section 1402(a)(10) is subject to section 409A. Section 1402(a)(10) provides for an exception from the Self-Employment Contributions Act (SECA) tax for payments to a retired partner, provided that certain conditions are met…

Commentators questioned the appropriateness of the inclusion of such arrangements under section 409A, because neither the statute nor the legislative history refers to section 1402(a)(10). However, the Treasury Department and the IRS believe it is appropriate for such arrangements to be subject to section 409A because such arrangements are purposefully created to provide deferred compensation, and do not raise issues regarding the coordination of the provisions of section 409A with the provisions of section 736, specifically the rules governing the classification of payments to a retired partner under section 736(a) (payments considered as distributive share or guaranteed payments) and section 736(b) (payments for interest in partnership).

However, further clarification and relief is provided concerning the application of the deferral election timing rules to these payments. Until further guidance is issued, for purposes of section 409A, taxpayers may treat the legally binding right to the payments excludible from SECA tax under section 1402(a)(10) as arising on the last day of the partner's taxable year before the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10), and the services for which the payments are compensation as performed in the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). Accordingly, for purposes of section 409A, the time and form of payment of such amounts generally may be established, including through an election to defer by the partner, on or before the final day of the partner's taxable year immediately preceding the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). However, this interim relief does not apply a second time where an amount paid under an arrangement in one year has been excluded from SECA tax under section 1402(a)(10), and an amount paid in a subsequent year

has not been excluded from SECA tax under section 1402(a)(10) because, for example, the partner performed services in that subsequent year.