

# PARTNERS AS COMMON LAW EMPLOYEES

RANDALL J. GINGISS\*

## INTRODUCTION

In 1991, approximately sixty-one percent of law school graduates entered private practice as associates in law firms.<sup>1</sup> As associates, they are employees of their respective firms. As employees, these associates have certain rights. These rights include the right to workers' compensation if they are injured on the job, the right to participate in qualified pension or profit sharing plans or welfare benefit plans, and the right to be free of discrimination based on sex, religion, national origin, or age. Upon becoming partners, they lose some of these rights because they are no longer considered employees. In the context of discrimination cases under Title VII of the Civil Rights Act of 1964,<sup>2</sup> the Equal Employment Opportunity Commission (EEOC) has argued, for the most part unsuccessfully,<sup>3</sup> that some partners should be accorded the same protection as senior employees of corporations and that other partners, who do not need such protection, can be identified.<sup>4</sup> Partners already receive equal treatment compared to common law employees in qualified pension plans<sup>5</sup> under the Employee Retirement Income Security Act of 1974 (ERISA),<sup>6</sup> but not in welfare benefit plans.

This Article examines the long-standing debate over whether a partnership should be considered an aggregate or entity and then each of the aforementioned subjects in turn. The issue of classification of partners arises among the following contexts: workers' compensation, employment discrimination, qualified deferred compensation plans and welfare benefit plans, and federal income tax of partners and partnerships. This Article suggests that: (a) current court decisions under the Uniform Partnership Act (UPA)<sup>7</sup> on issues of workers' compensation and under Title VII which hold that partners are not employees are probably correct, and (b) this result should be reversed upon enactment of the Revised Uniform Partnership Act (RUPA).<sup>8</sup> The adoption of the entity theory in the RUPA—that a partnership is an entity separate and distinct from its partners—should

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\* Partner, Katten, Muchin & Zavis, Chicago, Illinois; Chair, American Bar Association, Committee on Post Mortem Tax Planning, Section of Real Property, Probate and Trust Law; Past Chair, Estate and Gift Tax Division of the Committee of Federal Taxation, Chicago Bar Association; Adjunct Faculty, DePaul University College of Law and Loyola University of Chicago School of Law. The author wishes to thank two friends and colleagues for their helpful comments, James Colliton, Professor of Law, DePaul University and Rochelle C. Miller, Attorney and Adjunct Professor, IIT Chicago - Kent College of Law. B.A., *cum laude*, 1966, Amherst College; J.D., 1969, University of Michigan; LL.M. in Taxation, 1980, DePaul University; M.B.A., 1991, University of Chicago. The author wishes to thank Katten, Muchin & Zavis research librarian Pamela LaMarca, whose limitless patience for and prompt response to the author's outrageous requests allowed this Article to become finished.

1. BARRON'S GUIDE TO LAW SCHOOLS 71 (10th ed. 1992).

2. 42 U.S.C. § 2000e (1974 & Supp. 1994).

3. See *infra* notes 102-111 and accompanying text.

4. The EEOC has argued this as the "economic realities test," which is presented in terms of a partner's ability to control his employment. See *infra* notes 102-111 and accompanying text.

5. See 26 U.S.C. § 401(d) (1988). There is one minor exception; owner-employees are not eligible to receive loans from qualified plans, as such loans are prohibited transactions under ERISA.

6. Pub. L. No. 93-406, 88 Stat. 832.

7. UNIF. PARTNERSHIP ACT §§ 1-45, 6 U.L.A. 1-45 (1969 & Supp. 1994) [hereinafter UPA].

8. UNIF. PARTNERSHIP ACT (1993) §§ 101-1007, 6 U.L.A. 101-1007 (Supp. 1994) [hereinafter RUPA].

provide needed protection for partners. This protection may include treating partners as common law employees for purposes of workers' compensation and Title VII, and probably for welfare benefit plans as well.

## I. ENTITY V. AGGREGATE: THE DEBATE

### A. *An Overview*

When analyzing the issue of whether a partner should be accorded the status of an employee, it is helpful to determine whether a partnership is considered (i) an aggregate of its individual partners (the "aggregate theory") or (ii) is an entity capable of having a separate existence from its partners (the "entity theory"). The latter theory conceptually allows a partner to be an employee of an entity totally distinct from the individual partners. The United Kingdom provides one example of this theory: The statutes that prohibit sex discrimination and racial discrimination avoid the issue by giving partners the same protection as non-partners, regardless of whether partners are considered employees.<sup>9</sup> The RUPA, which explicitly endorses the entity theory, upsets the conclusions that are based on the aggregate theory of the UPA.

A pivotal issue in drafting the UPA was whether to adopt the entity theory or the aggregate theory. Two of the early drafters, Dean James Barr Ames of Harvard Law School and Dean William Draper Lewis of the University of Pennsylvania Law School had differing positions on the issue.<sup>10</sup>

### B. *The Initial Debate*

According to its primary drafter, Dean Lewis, the UPA ostensibly endorses the aggregate theory.<sup>11</sup> Others expressed the view that, at least by implication, the UPA endorses neither approach but looks at the purpose of a particular section and determines whether the aggregate or entity theory is appropriate.<sup>12</sup> One contemporary supporter of the aggregate theory and the UPA's creation of the concept of tenancy in partnership stated that the UPA is a "live working formula, by which our courts may decide cases in accordance with the circumstances and the reasonable expectations of the parties litigant."<sup>13</sup> However, the courts seem to base their decisions on an all or nothing approach.<sup>14</sup> It is curious, then, that so few

9. Sex Discrimination Act, 1975, ch. 65, §11 (Eng.); Race Relations Act, 1976, ch. 74, §10 (Eng).

10. See generally A. Ladru Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377 (1963). Dean Ames died during the drafting of the UPA, and Dean Lewis assumed the work of the drafting committee. For responses to the final product, compare Judson A. Crane, *The Uniform Partnership Act—A Criticism*, 28 HARV. L. REV. 762 (1915) [hereinafter *Crane I*] and William Draper Lewis, *The Uniform Partnership Act—A Reply to Mr. Crane's Criticism*, 29 HARV. L. REV. 158 (1915) [hereinafter *Lewis I*].

11. William Draper Lewis, *The Uniform Partnership Act*, 24 YALE L. J. 617, 640 (1915) [hereinafter *Lewis II*].

12. See *Crane I*, *supra* note 10, at 773; see also Jensen, *supra* note 10, at 379.

13. Joseph H. Drake, *Partnership Entity and Tenancy in Partnership: The Struggle for Definition*, 15 MICH. L. REV. 609, 630 (1917).

14. See Jensen, *supra* note 10, at 381.

courts look to any underlying purpose in deciding which approach is appropriate in areas outside those specifically covered by the Act.

Under the leadership of Dean Ames, the first two drafts of the UPA specifically adopted the entity theory. Upon Dean Ames' death in 1910, Dean Lewis replaced him as the primary drafter.<sup>15</sup> Dean Lewis reported:

When the writer was selected to continue the work of Mr. Ames, it was not long before the difficulties created by the entity theory in other branches of the law of partnership began to appear, and I began to doubt the possibility of drafting a satisfactory act on this theory. It appeared to me that the proper way to settle the controversy was to present to the Committee on Commercial Law two drafts, one drawn on the entity and the other on the common law theory of partnership, and ask the Committee . . . to discuss the drafts and the respective theories underlying them.<sup>16</sup>

According to Dean Lewis, the members of the committee "all joined" in recommending the aggregate theory.<sup>17</sup> Professor Judson Crane of Harvard Law School, Dean Lewis' leading critic, commented that if a believer in the entity theory had presented it, another result might have occurred.<sup>18</sup>

In Dean Lewis' view, a major advantage of the entity theory was that it provided an answer to questions related to the rights of a partner and the separate creditors of a partner in partnership property.<sup>19</sup> Nevertheless, Dean Lewis ultimately departed from the UPA's advocacy of the entity theory.

Dean Lewis' primary justification for abandoning the entity theory was that creditors of the partnership would not be creditors of the individual partners:

And it is proper to emphasize here that to adopt the legal-person theory itself changes existing law in a matter of vital importance, because [it] is based on an assumption false in fact, namely, that third persons dealing with a partnership do not deal directly with the partners as principals. They do. Partnership creditors are not persons who have trusted primarily a partnership fund of the sufficiency of which the partners are guarantors; they have trusted the partners as individuals with the reputation of possessing property and conducting a successful business.<sup>20</sup>

It is questionable, in an era of legal or accounting partnerships with over one hundred partners, whether creditors are looking to the individual partners as the basis of making their decision to extend credit. However, creditors of a closely held corporation may look to the personal credit of a majority shareholder, and not to the corporation, in lending funds or in selling goods.

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15. See Drake, *supra* note 13, at 622.

16. Lewis II, *supra* note 11, at 640.

17. *Id.*

18. Judson A. Crane, *The Uniform Partnership Act and Legal Persons*, 29 HARV. L. REV. 838, 850 (1915) [hereinafter *Crane II*].

19. Lewis I, *supra* note 10, at 162.

20. Lewis I, *supra* note 10, at 166.

Lewis' second objection to the entity theory was that it required some efficient system of registration. It is possible for a partnership to exist even if the principals are unaware that they have in fact created a partnership.<sup>21</sup> Consequently, such principals will be unaware that registration is required. One response to the second objection is that in most states some sort of registration is in effect for assumed names under which the partnership operates,<sup>22</sup> and this system of registration seems to function satisfactorily. Some states require all partnerships to register.<sup>23</sup>

Did the UPA exclusively adopt the aggregate theory, or as Crane suggested, did it implicitly adopt the entity theory to some degree? In order to avoid one of the most unsatisfactory elements of the aggregate theory, the UPA created the concept of tenancy in partnership. Tenancy in partnership provides that each partner has an equal right to possess partnership property for partnership purposes, but no right to possess the property for any other purpose without the consent of his partners.<sup>24</sup> Each partner's interest in the partnership is limited to a share of profits and surplus.<sup>25</sup> None of the existing forms of co-ownership adequately addressed the problems of property owned by a partnership. One infamous English case, *Heydon v. Heydon*,<sup>26</sup> held that the ownership by a partnership was a joint tenancy which allowed the creditor of a separate partner to levy upon partnership property.

Professor Crane saw the concept of the entity theory throughout the UPA in terms of the mere concept of "partnership property"—the ability to own real estate in the partnership name in Section 8(3); the duty to contribute to losses sustained by the partnership, not by his partners (section 18(a)); and the obligation of the partnership, not the partners, to indemnify a partner for certain expenses (section 18(b)).<sup>27</sup> Dean Lewis' reply to these observations and to Professor Crane's criticism followed immediately.<sup>28</sup> Consequently, the debate whether the committee to some degree adopted the entity approach continued.<sup>29</sup>

### C. *The American Bar Association Recommendations*

In 1987, the Business Law Section of the American Bar Association completed an extensive study of the UPA with recommendations for change.<sup>30</sup> The first section in the "Summary of Recommendations," is entitled "Increased emphasis on the entity theory."<sup>31</sup> Implicit in this title is the idea that there was at least some emphasis on the entity theory in the original UPA. Areas where such increased emphasis was recommended include:

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21. *Id.* at 168.

22. 59A AM. JUR. 2d *Partnership* § 64 (1987).

23. *Id.* § 70.

24. UPA § 25.

25. UPA § 26.

26. 91 Eng. Rep. 340 (1693).

27. *Crane I*, *supra* note 10, at 770-71.

28. *See Lewis II*, *supra* note 11.

29. *See Jensen*, *supra* note 10.

30. UPA Subcommittee (Harry J. Haynsworth IV, Chairman) of the Committee on Partnerships and Unincorporated Business Organizations, *Should the Uniform Partnership Act Be Revised?*, 43 BUS. LAW. 121 (1987).

31. *Id.* at 124.

- Limitation of a partner's rights in specific partnership property to the right to use such property in the conduct of the partnership business;
- A requirement that a short form must be filed for foreign general partnerships doing business in the state, the penalty for any such failure is the inability to enforce claims until filing;
- Specific authorization for a partnership agreement to contain a provision that prevents a technical dissolution if the remaining partners agree to buy out the interest of a withdrawing partner;
- Specific authorization for a partnership to sue and be sued in the partnership name;
- Clarification that a partner may be guilty of embezzlement against the partnership; and
- A requirement that any creditor of the partnership must exhaust collection remedies against the partnership before seeking to enforce the judgment against the individual assets of the partners.<sup>32</sup>

The report went so far as to recommend that the entity theory be adopted as a general proposition and that the aggregate theory be retained only to the extent necessary.<sup>33</sup> The emphasis on the entity theory will help any revision of the UPA "focus on resolving the practical problems that have arisen under the existing statute . . . between the entity and the aggregate theories that divided the original drafting committee."<sup>34</sup>

#### D. *The Revised Uniform Partnership Act*

The National Conference of Commissioners on Uniform State Law issued the first draft of the RUPA on November 2, 1992,<sup>35</sup> the second draft on October 14, 1993,<sup>36</sup> and the final draft on January 18, 1994.<sup>37</sup> The 1994 draft leaves no doubt as to where it stands on the aggregate versus entity debate: "A partnership is an entity distinct from its partners."<sup>38</sup>

The Comment which accompanies Section 201 does not shed light on the issue of whether or not a partner can be an employee:

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32. *Id.* at 124-25.

33. *Id.* at 153.

34. *Id.* at 184.

35. The Uniform Partnership Act (1993), *supra* note 8, superseded the 1992 version. RUPA Historical Notes.

36. RUPA §§ 101-1006. The 1993 version is reviewed by its drafters and some critics. See Donald J. Weidner and John W. Larson, *The Revised Uniform Partnership Act: The Reporter's Overview*, 49 BUS. LAW. 1 (1993).

37. Uniform Partnership Act (1994) (unpublished manuscript, on file with the National Conference of Commissioners on Uniform State Laws, Chicago, Illinois) [hereinafter Manuscript].

38. Manuscript § 201. The words "distinct from its partners" were added in the 1994 draft and are not part of the statutes of Montana and Wyoming, the only two states which as of the date of this publication have adopted RUPA. See *infra* note 45.

RUPA embraces the entity theory of the partnership. There has been widespread criticism of the aggregate theory. . . . In light of the UPA's ambivalence on the nature of partnerships, an explicit statement is deemed appropriate as an expression of the increased emphasis on the entity theory.

Giving clear expression to the entity nature of a partnership is intended to allay previous concerns stemming from the aggregate theory, such as the necessity of a deed to convey title from the "old" partnership to the "new" partnership every time there is a change of cast among the partners. Under RUPA, there is no "new" partnership just because of membership changes.<sup>39</sup>

The basis upon which one partner may sue the other partners or the partnership is explicitly expanded in the RUPA: "(a) A partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with authority of the partnership."<sup>40</sup> This section is not designed only to apply to third parties. The Comment ensures that a partner can sue the entity partnership "on a tort or other theory during the term of the partnership, rather than being limited to the remedies of dissolution and an accounting."<sup>41</sup> Section 405 of the 1994 draft is even more explicit: "(b) A partner may maintain an action against the partnership or another partner for legal or equitable relief, with or without an accounting as to partnership business, to: . . . (3) enforce the rights and otherwise protect the interests of the partner, including rights and interests arising independently of the partnership relationship."<sup>42</sup> According to committee comments to the 1993 version, this section allows a partner to "bring a direct suit against the partnership or another partner for almost any cause of action arising out of the conduct of the partnership business" without the necessity of bringing an action for an accounting.<sup>43</sup>

It is curious that the RUPA does not address the issue of whether a partner can be an employee because the issue surfaces in important areas. There is the potential to reverse the current thinking of most courts in the areas of Workers' compensation, Title VII, and the Age Discrimination in Employment Act (ADEA).<sup>44</sup> All existing cases were decided prior to the introduction of the RUPA which, as of the writing of this Article, has been enacted in only two states, although it has been introduced in a few others.<sup>45</sup>

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39. RUPA § 201 cmt. Comments were not changed from the 1993 draft to the 1994 draft and were not reprinted in the 1994 draft.

40. RUPA § 305.

41. RUPA § 305 cmt.

42. Manuscript § 405.

43. RUPA § 405 cmt. 2.

44. 29 U.S.C. §§ 621-34 (1985).

45. MONT. CODE ANN. § 35-10-101 to -644 (1993). WYO. STAT. § 17-21-101 to -1003. Bills are currently pending in Minnesota and Virginia.

## II. THE RAMIFICATIONS OF THE DEBATE

### A. Workers' Compensation

With few exceptions, state workers' compensation statutes do not permit partners who receive only a share of profits to bring workers' compensation claims against the partnership. Several states, by statute, have provided that partners who receive set wages for labor usually performed by employees or for whom workers' compensation premiums have been paid are covered by the act. The majority of cases, however, adhere to the aggregate theory and do not allow a partner to bring workers' compensation action against the partnership.

*Hays v. Wyoming*<sup>46</sup> is typical among the recent cases. Martin Hays, a partner in Hays Transportation Co., suffered a fatal head injury during the course of his employment. The District Court denied coverage on the ground that he was not an employee within the meaning of the Wyoming's workers' compensation statute. The Wyoming Supreme Court affirmed the District Court and held:

The plain and unambiguous language of §27-12-102(a)(viii) mandates the conclusion that partners could not receive benefits as "employees" under the Act. The language specifically defined an "employee" as one who had "entered into the employment of or works under contract of services or apprenticeship with an employer." To accept appellant's argument that a partner was an employee under the Act would be to ignore the plain language of §27-12-102(a)(viii) and the legal characteristics of a partner. The language of the statute clearly anticipated that an employer and employee would be *separate legal entities*. Thus, a partner-employer could not be included in the language of the statute as one covered under the Act, as the Act was intended to cover employees only.<sup>47</sup>

One judge concurred solely on the basis that workers' compensation premium payments had not been paid on behalf of the partner. Thus, there was no need to establish an employer/employee relationship. However, the judge indicated that he would certainly be open to reviewing the broader issue presented if a "claimant partner who, having been listed for coverage with premium paid, sustains a job related injury."<sup>48</sup> It will be interesting to see the effect of RUPA in view of the court's reference to "separate legal entities." Wyoming is one of the two states that have adopted RUPA as of the writing of this Article.<sup>49</sup>

Twenty-three other states follow the same general rule as Wyoming, at least where there is no express payment of wages.<sup>50</sup> Only Oklahoma gives partners the unconditional benefit

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46. 768 P.2d 11 (Wyo. 1989).

47. *Id.* at 14 (emphasis added).

48. *Id.* at 17 (Urbigkit, J., concurring).

49. *See supra* note 45.

50. *Ford v. Mitcham*, 298 So. 2d 34 (Ala. Civ. App. 1974); *Brinkley Heavey Hauling Co. v. Youngman*, 264 S.W.2d 409 (Ark. 1954); *Cooper v. Industrial Accident Comm'n*, 171 P. 684 (Cal. 1918); *Fink v. Fink*, 64 So. 2d 770 (Fla. 1953); *United States Fidelity & Guar. Co. v. Neal*, 3 S.E.2d 80 (Ga. 1939); *Scoggins v. Aetna Casualty & Sur. Co.*, 229 S.E.2d 683 (Ga. Ct. App. 1976); *Metro Constr., Inc. v. Industrial Comm'n*, 235 N.E.2d 817 (Ill. 1968); *In re W. A. Montgomery & Son*, 169 N.E. 879 (Ind. Ct. App. 1930); *Wallins Creek Lumber Co. v. Blanton*, 15 S.W.2d 465 (Ky. 1929); *Carpenter v. New Amsterdam Casualty Co.*, 159 So. 2d 757 (La. Ct. App.

of the workers' compensation statute. In *Ohio Drilling Co. v. State Industrial Commission*,<sup>51</sup> the Oklahoma Supreme Court reached the conclusion that partners could be employees within the meaning of the Oklahoma workers' compensation law. Each of the four partners shared equally in the profits and losses of the partnership and received a draw of \$14 per day for living expenses. The court stated:

We think that the construction of the Workmen's Compensation Act that a member of a partnership, who works for the partnership, and while so engaged is injured, is not an employee within the meaning of the act, is an exceedingly narrow construction of the act . . . and to so hold in the instant case would fail to satisfy the rule announced that the act should be liberally construed so as to effect the legislative intent. We see no good reason why the members of a partnership cannot jointly or severally perform the work or labor incident to the success of the joint undertaking and at the same time draw wages from the earnings of the partnership.<sup>52</sup>

Notwithstanding the reference to "wages," it is clear from a later case<sup>53</sup> that Oklahoma does not require that wages be paid to the injured partner in order for such partner to collect under the Oklahoma Workmen's Compensation Act. However, the distinction between (i) a partner who receives wages instead of, or in addition to, a share of profits and (ii) one who receives only a share of profits is crucial to recovery in a number of states who adhere to the general rule that a partner cannot be an employee within the meaning of workers' compensation statutes.

Without statutory authority specifically holding that a salaried partner is an employee, the payment of wages appears not to help the partner's case. In *Rasmussen v. Trico Feed Mills*,<sup>54</sup> the only working partner in a three person partnership operating a grain elevator received \$250 per month. In holding against Rasmussen in his action under the Nebraska workers' compensation statute, the Nebraska Supreme Court used reasoning similar to that used in *Hays*: "The statutory definition speaks of in the service of the employer. . . . But the statutory definition contemplates two persons, the employer and the employee, the master and the servant. It does not contemplate a dual relationship in one."<sup>55</sup> The *Rasmussen* court buttressed its decision in dicta:

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1964), *cert. denied*, 161 So. 2d 276 (La. 1964); *Black v. Black Bros. Constr. Co.*, 381 A.2d 648 (Me. 1978); *Thurston v. Detroit Asphalt & Paving Co.*, 198 N.W. 345 (Mich. 1924); *Pederson v. Pederson*, 39 N.W.2d 893 (Minn. 1949); *American Sur. Co. v. Cooper*, 76 So.2d 254 (Miss. 1954); *Chambers v. Macon Wholesale Grocer Co.*, 70 S.W.2d 884 (Mo. 1934); *Leventhal v. Atlantic Rainbow Painting Co.*, 172 A.2d 710 (N.J. Super. Ct. App. Div. 1961); *Lyle v. H.R. Lyle Cider & Vinegar Co.*, 153 N.E. 67 (N.Y. 1926); *Goldberg v. Industrial Comm'n of Ohio*, 3 N.E.2d 364 (Ohio 1936); *Herman v. Kandrat Coal Co.*, 208 A.2d 51 (Pa. Super. Ct. 1965); *Tidwell v. Walden*, 330 S.W.2d 317 (Tenn. 1959); *Superior Ins. Co. v. King*, 327 S.W.2d 422 (Tex. 1959); *Rockefeller v. Industrial Comm'n of Utah*, 197 P. 1038 (Utah 1921); *Johnson v. Department of Labor and Industries*, 205 P.2d 896 (Wash. 1949). These cases are conveniently summarized in 78 ALR4th 973-1020 (1990).

51. 207 P. 314 (Okla. 1922).

52. *Id.* at 317.

53. *Stephens Produce Co. v. Stephens*, 332 P.2d 674 (Okla. 1958).

54. 29 N.W.2d 641 (Neb. 1947).

55. *Id.* at 643.

But observe Rasmussen's own interpretation of his status. He has practically sole control of the business and yet, without knowledge of his partners, did not include a premium for himself in the compensation insurance. He made no payments in social security tax for himself as an employee. His failure to deduct the \$250 per month as an expense item in making out income tax returns may have been due to the revenue department's refusal to consider such as deductible, and therefore should carry no weight. But it never occurred to Rasmussen that he was an employee, and his interpretation, agreeing with current thought, should be some index to his status.

Analyzing the work Rasmussen did as a test, no evidence appears, and probably none can be shown, that any of his work and all the time he devoted to the enterprise was not that contemplated by the title of "general manager."<sup>56</sup>

This dicta implies that the court might have reached a different result if Rasmussen had covered himself in the insurance payments. As to the court's reference to the partnership's income tax return, the nondeductibility of the fixed payment has been changed since the adoption of the Internal Revenue Code of 1954.<sup>57</sup> It is now a deductible expense just as if the partnership were dealing with an outsider.<sup>58</sup>

Several states have enacted statutes permitting a partner's claim under workers' compensation where the partner receives wages regardless of profits. Such statutes were upheld by the courts. Consequently, non-equity partners of a two-tier partnership appear to be covered by such statutes. In *Johnson v. Industrial Accident Commission*,<sup>59</sup> the California Supreme Court considered the constitutionality of a statute which provided recovery to a working or salaried partner and held that such statute was constitutional. Similarly, in *Gallie v. Detroit Auto Accessory Co.*,<sup>60</sup> the Michigan Supreme Court held that there was no reason why the Michigan legislature could not redefine "employee" to include a working partner.

### B. Employment Discrimination

1. *Overview.*—Title VII of the Civil Rights Act of 1964,<sup>61</sup> which prohibits discrimination in employment based on race, sex, religion, or national origin, was the first comprehensive national attack on the problem of employment discrimination.<sup>62</sup> Section 703(a) of the Act provides:

It shall be an unlawful employment practice for an employer—

- (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms,

56. *Id.*

57. I.R.C. § 707(c) (1988 & West Supp. 1993). Unless otherwise indicated, all references to the Internal Revenue Code are to this version.

58. *See infra* text accompanying notes 140-44.

59. 244 P. 321 (Cal. 1926).

60. 195 N.W. 667 (Mich. 1923).

61. 42 U.S.C. § 2000e (Supp. 1994).

62. MICHAEL J. ZIMMER ET AL., *CASES AND MATERIALS ON EMPLOYMENT DISCRIMINATION* 24 (2d ed. 1982).

conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or

- (2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.<sup>63</sup>

The Age Discrimination Employment Act (ADEA)<sup>64</sup> provides similar protection for individuals over age forty and could have a significant impact in the context of professional partnerships such as law or accounting firms. While one does not expect any law firm to fire all employees whose ancestors emigrated from a certain country, one certainly can expect conflict over the issue of mandatory retirement age.<sup>65</sup>

A sharp dichotomy can be seen between court decisions in employment discrimination cases and scholarly commentary. Articles in various law reviews have favored a broad definition of "employee" to bring partners within the protection of the employment discrimination statutes. In contrast, the courts have generally been more restrictive.<sup>66</sup>

However, it should be noted that it is possible to bring partners within the protection of the employment discrimination statutes without ever deciding whether a partner can be considered an employee. The United Kingdom has done precisely that:

It is unlawful for a firm consisting of six or more partners,<sup>67</sup> in relation to a position as partner in the firm, to discriminate against a woman (a) in the arrangements they make for the purpose of determining who should be offered that position, or (b) in the terms on which they offer her that position, or (c) by refusing or deliberately omitting to offer her that position, or (d) in the case where the woman [is already a partner, it is unlawful to discriminate against her] (i) in the way they afford her access to any benefits, facilities or services . . . or (ii) by expelling her from that position or subjecting her to any other detriment.<sup>68</sup>

Legislative history of this section is elusive, but this situation does not seem to be the result of any case holding that a partner is not an employee. This statute was enacted in 1975, yet until 1989 the courts had not decided whether a partner can be considered an employee.<sup>69</sup>

63. 42 U.S.C. § 2000e-2 (1974).

64. 29 U.S.C. §§ 621-34 (1985).

65. See Rod Doty, *The Age Discrimination in Employment Act and Mandatory Retirement of Law Firm Partners*, 53 S. CAL. L. REV. 1679 (1980).

66. Compare, e.g., *Wheeler v. Main Hurdman*, 825 F.2d 257, 266 (10th Cir. 1987), cert. denied, 484 U.S. 986 (1987) and *Coleen Eck, Title VII and the Age Discrimination in Employment Act: Should Partners be Protected as Employees?*, 36 KAN. L. REV. 581 (1988).

67. The words "consisting of six or more partners" were removed by the Sex Discrimination Act of 1986 (Eng.).

68. Sex Discrimination Act, *supra* note 9.

69. *Cowell v. Quilter Goodison Co. v. QG Management Services Ltd.*, Court of Appeal (Civil Division), [1989] IRLR 393. The plaintiff brought suit for unfair dismissal. Such a claim required continuous employment for two years. Plaintiff had been an equity partner of a predecessor partnership which became incorporated less than two years prior to the dismissal. The Court of Appeal held that plaintiff was not an employee prior to incorporation.

Treatises clearly show that the British statute contemplates that this result is an extension of the statute to a relationship other than employer/employee rather than an expansion of the definition of an employee.<sup>70</sup>

2. *The United States Supreme Court.*—The United States Supreme Court's landmark decision in *Hishon v. King & Spalding*<sup>71</sup> laid the groundwork for cases involving a partnership's discrimination based on gender. Elizabeth Hishon was an associate of King & Spalding, a large law firm in Atlanta, Georgia. After performing as an associate for the requisite amount of time to be considered a partner, she was passed over for partnership, and the firm ultimately asked her to leave. She brought suit alleging that her denial was based on prohibited sex discrimination. The issue before the United States Supreme Court was whether admission to partnership could be a term or condition of employment. The Court held that admission to partner status was a term and condition of employment as an associate and accordingly, that denial of such status could not be based on discriminatory criteria.<sup>72</sup>

Hishon, in her status as an associate attorney, was clearly an employee. Hence, the court did not have to address the issue of whether a partner could ever be an employee. Nevertheless, in his concurring opinion, Justice Powell explained how the case may have been decided had Hishon been a partner:

I write to make clear my understanding that the Court's opinion should not be read as extending Title VII to the management of a law firm by its partners. The reasoning of the Court's opinion does not require that the relationship among partners be characterized as an "employment" relationship to which Title VII would apply. The relationship among law partners differs markedly from that between employer and employee—including that between the partnership and its associates. The judgmental and sensitive decisions that must be made among the partners embrace a wide range of subjects. The essence of the law partnership is the common conduct of a shared enterprise. The relationship among law partners contemplates that decisions important to the partnership normally will be made by common agreement . . . or consent among the partners.<sup>73</sup>

In a footnote to the cited text, Justice Powell clarified that "an employer may not evade the strictures of Title VII simply by labeling its employees as 'partners.' Law partnerships usually have many of the characteristics that I describe generally here."<sup>74</sup> A sham labeling cannot defeat the Title VII rights of true employees. What remains unresolved is the degree to which the label of "partner" can be challenged when one with the name of "partner" has at least some characteristics that one normally associates with that term.

3. *Lower Courts.*—Lower courts show some division on the issue of whether a partner can be an employee, but a slight majority of cases say that they cannot. The Seventh Circuit seems to be close to a per se rule. In *Burke v. Friedman*,<sup>75</sup> the Seventh Circuit faced a

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70. See DAVID PANNICK, *SEX DISCRIMINATION LAW* 64 (1985); see also RICHARD W. PAINTER AND KEITH PUTTICK, *EMPLOYMENT RIGHTS: A REFERENCE HANDBOOK* 120-21 (1993).

71. 467 U.S. 69 (1984).

72. *Id.* at 74.

73. *Id.* at 79-80 (Powell, J., concurring) (footnotes and citations omitted).

74. *Id.* at 79 n.2.

75. 556 F.2d 867 (7th Cir. 1977).

jurisdictional question in a case brought by one who was clearly an employee. The firm had fewer than fifteen common law employees and a number of partners who, when added to the common law employees, brought the total in the firm to over fifteen, the jurisdictional threshold of Title VII.<sup>76</sup> The court made no attempt to analyze whether the status of any partner was a sham perhaps because there was no alleged partner who was the victim of discrimination. The court simply stated that in light of the case law and the Uniform Partnership Act, "we do not see how partners can be regarded as employees rather than as employers who own and manage the operation of the business."<sup>77</sup> The Seventh Circuit did not have RUPA before it. One recent article on RUPA appearing in a recent issue of *The Business Lawyer* do not even acknowledge the issue of the application of Title VII to partnerships as an issue that the RUPA should address.<sup>78</sup>

The Seventh Circuit further clarified the classification of partners in *Equal Employment Opportunity Commission v. Dowd & Dowd, Ltd.*<sup>79</sup> Like the *Burke* case, *Dowd* involved a fifteen-employee jurisdictional issue. The difference between the two cases was that *Dowd & Dowd* was not a partnership but a professional corporation. Applying an economic realities test to the defendant, the court held that the defendant was much like a professional partnership and that the *Burke* principles controlled.<sup>80</sup> In effect, the Seventh Circuit allowed the one who chose the corporate form to assert that substance should control over form. Would the Seventh Circuit have denied shareholders in a C corporation<sup>81</sup> the right to participate in a cafeteria plan on the same basis?<sup>82</sup>

On the narrow issue of who can be deemed an employee in a professional corporation which otherwise has characteristics of a partnership, the Eleventh Circuit agreed with the Seventh Circuit.<sup>83</sup> However, the Second Circuit in *Hyland v. New Haven Radiology Associates*,<sup>84</sup> reached the opposite conclusion. The court held that "an individual's status as major stockholder, officer, or director of a corporation has been found to be compatible with his or her status as employee."<sup>85</sup> *Hyland* was not dealing with a jurisdictional issue but whether one of the four shareholders was entitled to the protection under the ADEA as an employee. The Second Circuit answered in the affirmative. The court did not challenge the proposition that anti-discrimination acts do not generally extend to partners, and based its decision on the form of organization chosen by the defendants.

The United States District Court for the Southern District of New York has on two occasions denied motions to dismiss actions brought by partners, although in one of those

76. *Id.* at 868-69. It was agreed between plaintiff and defendants that subject matter jurisdiction was dependent on the partners being considered employees for purposes of Title VII.

77. *Id.* at 869.

78. See Weidner & Larson, *supra* note 36.

79. 736 F.2d 1177 (7th Cir. 1984).

80. *Id.* at 1178.

81. A C corporation is a corporation which is taxed as a separate entity under I.R.C. § 11. The alternative to a C corporation is an S corporation which is taxed much the same as a partnership under I.R.C. §§ 1361-1379. An S corporation is treated as a partnership for purposes of welfare benefit plans under I.R.C. § 1372.

82. See *infra* text accompanying notes 138-39.

83. *Fountain v. Metcalf, Zima & Co.*, 925 F.2d 1398 (11th Cir. 1991).

84. 794 F.2d 793 (2nd Cir. 1986).

85. *Id.* at 796.

cases, judgment for the defendant was entered on motion for summary judgment. The first case, *Caruso v. Peat, Marwick, Mitchell & Co.*,<sup>86</sup> in the context of one of the "Big Six" accounting firms, held that the plaintiff qualified as an employee<sup>87</sup> notwithstanding the fact that he had been admitted to partnership. *Ehrlich v. Howe*<sup>88</sup> involved a partnership with seven partners.<sup>89</sup> The court, in denying defendant's motion to dismiss, stated that it was unlikely that plaintiff could survive a motion for summary judgment.<sup>90</sup> Summary judgment on this issue was in fact granted sixteen months later.<sup>91</sup> The difference between the size of the two partnerships involved seemed to be an important difference between the two cases rather than any shift in emphasis by the court. The court examined similar factors in both cases.

In *Caruso*, the court was dealing with a firm of approximately 1350 partners of whom approximately 300 were in a management position.<sup>92</sup> In the New York office, where plaintiff had been a partner, there were 128 partners, of whom thirty-six were in a management position.<sup>93</sup> Plaintiff had no control over personnel decisions and was subject to formal annual evaluations of his performance. Plaintiff could make personnel recommendations to the partner in charge of his office, but the weight given to his recommendations changed little before or after his promotion to partner.<sup>94</sup>

The *Caruso* court looked primarily at three factors in holding that the plaintiff was an employee. First, plaintiff did not have the "ability to control and operate" the business, as is characteristic of a partner. Rather, the term partner "is not normally applied to an individual whose employment duties are unilaterally dictated by another member of the business."<sup>95</sup> The second factor was the degree to which plaintiff shared in the profits of the enterprise. The court found that the plaintiff's relatively low number of partnership points meant his salary would change very little with the profits of the firm.<sup>96</sup> The third factor was whether or not plaintiff was considered a permanent employee of the firm to be removed only "in extraordinary circumstances."<sup>97</sup> Here the court found that the plaintiff received annual evaluations in which his job performance was closely scrutinized. If he failed to meet certain standards, the firm could, and subsequently did, ask for his resignation.<sup>98</sup>

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86. 664 F. Supp. 144 (S.D.N.Y. 1987).

87. *Id.* at 150.

88. No. 92 Civ. 1079, 1992 WL 373266 (S.D.N.Y. Dec. 1, 1992).

89. This is stated nowhere in the original decision. The 1992 listing for Martindale-Hubbell lists the firm with seven partners (including Mr. Ehrlich, the plaintiff), one of counsel and one associate. MARTINDALE-HUBBELL LAW DIRECTORY NYC935B-936B (1992).

90. 1992 WL 373266, at \*4.

91. *Ehrlich v. Howe*, 848 F. Supp. 482 (S.D.N.Y. 1994).

92. *Caruso v. Peat, Marwick, Mitchell & Co.*, 664 F. Supp. 144, 145 (S.D.N.Y. 1987).

93. *Id.*

94. *Id.* at 146.

95. *Id.* at 149.

96. *Id.* at 150.

97. *Id.* at 149.

98. *Id.* at 150.

In *Ehrlich v. Howe*,<sup>99</sup> the plaintiff, a former partner in a law firm, alleged that the defendants had terminated his status with the firm to avoid his vesting in a non-qualified plan that was covered by ERISA. In order to come within ERISA, the plan had to cover at least one employee. Therefore, establishing his status as an employee was crucial to plaintiff's claim. Plaintiff based his claim of employee status on the fact that he did not share in decision-making and had to accept their partnership agreement on a take-it-or-leave-it basis.<sup>100</sup> Defendant responded that the plaintiff not only alleged he was a partner several times in his complaint, but also shared proportionally in the firm's profits. Consequently, the *Ehrlich* court suggested strongly that Plaintiff could not establish that he was an employee.<sup>101</sup>

*Caruso* and *Ehrlich* can be reconciled because of the vast differences in the size of the partnerships and other characteristics which accompany differences in size. *Caruso* cannot, however, be reconciled with the Tenth Circuit's decision in *Wheeler v. Main Hurdman*.<sup>102</sup> Like Peat, Marwick, Mitchell & Co. in *Caruso*, Main Hurdman is one of the nation's "Big Six" accounting firms. Approximately 500 of the 3570 personnel were partners.<sup>103</sup> The court noted the following partnership characteristics:

Partnership consisted at least of the following: election to the partnership and execution of the Firm's partnership agreement; change in compensation from salary to a share of the Firm's profits, paid by draw and an allocation of profits based on points; a contribution to capital; establishment of a capital account; unlimited personal liability for the debts and obligations of the partnership; rights under the partnership agreement to vote on such matters as amendments of the partnership agreement, approval of mergers with other accounting firms of a certain size, admission of new partners, termination of a partner's interest, approval of draws, shares of net profits, special distributions, and any other income to be allocated to any partners and dissolution of the firm. In addition, Wheeler became eligible for certain rights and privileges which were enjoyed only by partners of the firm, such as the right to sign audit reports and tax returns and the right to be reimbursed for membership dues in certain clubs; and, she was subject to involuntary termination [by certain votes of the entire partnership or various governing bodies].<sup>104</sup>

The facts in *Wheeler* quoted above are similar to the facts in *Caruso*, but offer more detail. In addition, it was adduced that Wheeler's duties remained unchanged after elevation to partner and that she was supervised in her work and assignments by the same department head.<sup>105</sup> Other characteristics she shared with *Caruso* were: a personnel file was maintained on her, the amounts charged for her services were set by managing partners, her partnership points for sharing income were set by her managing partner, the decision of her managing partner to terminate her was, as a practical matter, the final word.<sup>106</sup>

99. No. 92 Civ. 1079, 1992 WL 373266 (S.D.N.Y. Dec. 1, 1992).

100. *Id.* at \*3.

101. *Id.*

102. 825 F.2d 257 (10th Cir. 1987), *cert. denied*, 484 U.S. 986 (1987).

103. *Id.* at 260.

104. *Id.* at 260-61 (footnotes omitted).

105. *Id.* at 261.

106. *Id.*

In its opinion, the Tenth Circuit starts by agreeing with the plaintiff and the EEOC that absolutes in this area are difficult to sustain.<sup>107</sup> The court did not, however, agree with the plaintiff on her argument that whether or not she was an employee depended on an "economic realities" test. First, most of the cases cited by the plaintiff and the EEOC to distinguish a "true" partner from an "employee" partner were cases where the issue was whether a party was an employee or an independent contractor. The court found those cases useless in determining whether a general partner could be considered an employee.<sup>108</sup> Second, the court found that the theory espoused by the EEOC could cover almost all partners nationwide:

The heart of the standard proposed to us is a theory that any individual who is organizationally or economically dominated is an employee. In applying the domination theory to partnerships, there is an underlying assumption by its proponents that a "true" general partnership operates like a New England town meeting; that "true" general partners are not employees because they personally control management of the business and their own affairs within the business; that "true" general partners are not "dominated;" they are not controlled; they enjoy equality of bargaining power. . . .

With due respect, those arguments and assumptions are not likely to translate to the real world with any discernible limits. . . . Indeed, large partnerships may operate more democratically overall than small partnerships, which are frequently vulnerable to domination by a single partner or a small group of partners. "Domination" of a partner in assignment and supervision of work, billing, share of profits, and other matters can result from a myriad of wholly practical reasons existing from time to time in any partnership. . . . When the EEOC asserts that status depends upon the "individual's ability *actually to control* factors such as the management of the firm and critical elements of his or her work". . . we must wonder just how many partners the "actual control" requirement describes in the real world, and if *any* partnership of any duration would not have employee partners. What the EEOC and Wheeler are describing as true partners are sole proprietors and a limited number of dominant partners nationwide.<sup>109</sup>

After reviewing certain issues it considered as practical problems, such as the possibility of a partner drifting in and out of employee status or having employee status depend on how autocratic the managing partner was in a given regional office, the court noted the principal weakness of the plaintiff's case:

The central problem with the approach by Wheeler and the EEOC, however, is that it either ignores or relegates to insignificance the economic reality of partnership status itself. We view that as a fatal flaw. Status as a general partner carries important economic reality as well. Employees do not assume the risks of loss and liabilities of their employers; partners do. It is no small thing to be exposed to unlimited liability, to be personally at risk for a partner's mistakes, and

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107. *Id.* at 268.

108. *Id.* at 271-72.

109. *Id.* at 273.

to have one's share of profits always potentially conditional upon the outcome of claims, suits, and obligations generated by another partner. . . . Even if the partnership is viewed as an entity separate from its partners for some purposes, it cannot shield the partners from risk, including liabilities arising from suits by other partners. There is simply no equivalent to unlimited liability in *any* case dealing with the definition of employee, nor is there any equivalent in any understood definition of the term.<sup>110</sup>

The penultimate sentence of the last quotation answers one very important question *vis-à-vis* RUPA. Making the partnership an entity does not by itself change the ultimate result reached by the Tenth Circuit. The court also quickly disposed of the plaintiff's argument for broad coverage in view of the remedial goals of the legislation. Plaintiff's argument would make the act of discrimination *ipso facto* proof of employee status. If Congress had wanted to cover all services rather than merely those performed by an employee, it could have done so.<sup>111</sup> There is no indication that Congress considered the issue. Thus, the Tenth Circuit's argument simply employs a default categorization in the absence of Congressional intent.

Notwithstanding the Court's statement that absolutes are difficult to sustain, the Tenth Circuit makes a compelling argument for an all-or-nothing standard with such observations as the plaintiff's argument knows no "discernible limits" or that her argument would cause some partners to drift in and out of employee status. The court's observation, however, that the plaintiff's argument would make discrimination *ipso facto* proof of employee status is a good argument for giving all partners the protection of the law. Discrimination in the work place is what Title VII and ADEA seek to avoid, and one who suffers such discrimination almost by definition has insufficient power to avoid being fired or subject to other detriment from which the partner cannot escape by quitting without serious loss of revenue. The Tenth Circuit has made the argument for, and RUPA gives the statutory authority for, partner coverage.

The United States District Court for the Southern District of Ohio, in *Simpson v. Ernst and Young*,<sup>112</sup> denied a motion for summary judgment, holding that a "partner" of Ernst & Young, another "Big Six" accounting firm, was in fact an employee for purposes of ADEA.<sup>113</sup> The District Court purported to cite all the factors listed by the Tenth Circuit in *Wheeler*, but shows some very strong prejudices of its own. In setting out the issues as stated by the parties to the litigation, the court stated:

Ernst & Young asserts that neither Simpson nor any other Party discharged during 1990 and 1991 is entitled to the protection afforded by the employment discrimination laws because these individuals are not employees, but partners. The inescapable logic of this position is that Ernst & Young claims to be free to discriminate against hundreds of its accountants due to age, race, sex, religion, national origin, and handicap because it asserts they are not employees.<sup>114</sup>

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110. *Id.* at 274.

111. *Id.* at 275.

112. 850 F. Supp. 648 (S.D. Ohio 1994).

113. *Id.* at 665.

114. *Id.* at 654.

The court's discussion of the various factors supports its decision, that Simpson did not share in profits, had no access to firm books and records, and did not have a vote on the makeup of the management committee. However, in purporting to follow *Wheeler* as well as other cases such as *Caruso*, the court skirts over the issue of unlimited liability by not only ignoring the statement in *Wheeler* that the existence of unlimited liability was a fatal flaw in *Wheeler's* case, but also in suggesting without authority that Simpson's agreement to unlimited liability might be unenforceable as unsupported by consideration.<sup>115</sup> The court does not explain why Simpson's salary is insufficient consideration.

### C. ERISA and Keogh Plans

Pension plans and welfare benefit plans must be for the exclusive benefit of employees.<sup>116</sup> Thus, the issue of whether a partner is an employee turns on the partner's participation in such plans. For support of either position on this issue, there is much contradictory language in ERISA and predecessor language in the Internal Revenue Code (the "Code"). In particular, one can find authority in the Self-Employed Individuals Tax Retirement Act of 1962,<sup>117</sup> which created qualified plans for the self-employed. These plans are commonly referred to as "Keogh plans" after Eugene J. Keogh, the author of the legislation who introduced it at various times over a period in excess of ten years, or "H.R. 10 plans," for the bill number of an earlier version of the bill.<sup>118</sup>

The greatest support for the concept of a partner being a common law employee comes from the Code's definition of the term "owner-employee." The Code made clear that a self-employed individual was an employee.<sup>119</sup> The Code makes a distinction between owner-employees and other employees that puts some partners in the category of other employees.<sup>120</sup>

The term "owner-employee" now stands almost naked in the Code without significant application.<sup>121</sup> At the time of the enactment of ERISA, there were significant restrictions on

115. *Id.* at 663.

116. I.R.C. § 401(a).

117. Pub. L. No. 87-792, 76 Stat. 809 (1962) (codified in scattered sections of 26 U.S.C.).

118. EMPLOYEE BENEFIT RESEARCH INSTITUTE, FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 113 (4th ed. 1990).

119. The pertinent part of I.R.C. § 401(c)(1)(A) provides:

(c) Definitions and rules relating to self-employed individuals and owner-employees.

For purposes of this section—

(1) Self-employed individual treated as employee:

(A) In general. The term "employee" includes, for any taxable year, an individual who is a self-employed individual for such taxable year.

120. I.R.C. § 401(c)(3) provides:

(3) Owner-employee.

The term "owner-employee" means an employee who—

(A) owns the entire interest in an unincorporated trade or business, or

(B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

To the extent provided in regulations prescribed by the Secretary, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence.

121. See I.R.C. § 401(d). This section provides in effect that two or more businesses controlled by such

the degree to which a plan could benefit an "owner-employee."<sup>122</sup> When the Tax Equity and Fiscal Responsibility Act of 1982<sup>123</sup> established parity between plans for the self-employed and other plans, it also established "top-heavy" rules,<sup>124</sup> which limited benefits for highly compensated employees and therefore eliminated the necessity of many of the rules that had applied to "owner-employees."<sup>125</sup>

What is significant is that only partners with an ownership interest of more than ten percent are "Bad Guys," people who cannot receive the benefit of discriminatory practices. Partners with less than a ten percent interest are classified the same as other employees for at least some purposes, while some restrictions apply to all self-employed persons.<sup>126</sup> Further, "a partnership shall be treated as the employer of its partners who are self-employed individuals."<sup>127</sup>

In hearings on the Self-Employed Individuals Tax Retirement Act of 1962, Senator Long stated directly that one can be both employer and employee at the same time:

When a person is both the employer and the employee, it is fair to say that half of the income which could be attributable to the employer should not be taxed at that time, because every retirement program that we set up for our own employees and every retirement program that we vote for the general public maintains that principle.<sup>128</sup>

Senator Long attempted to analogize the proposed act to the treatment of partners under Social Security where, at that time, self-employed individuals were not covered by Social Security.<sup>129</sup> However, one must also allow for the possibility that, as an oral statement, the choice of words may not have been made with the same precision that might have been made with a written statement. Prepared statements by witnesses indicated the viewpoint that becoming a partner of a professional partnership meant forfeiting employee status in terms of rights to pension contributions and that fairness dictates that this result be reversed.<sup>130</sup>

With regard to non-pension benefits covered by ERISA, regulations issued by the Department of Labor unequivocally state that a partner is not an employee: "A partner in a

partner must be aggregated, and only a partner's earnings from self-employment of the trade or business of the plan can be used to determine the owner's share of contributions to the plan. *Id.*

122. I.R.C. § 401(d) (West Supp. 1961).

123. Pub. L. No. 97-248, 96 Stat. 324 (1982).

124. I.R.C. § 416 (1988 & West Supp. 1993).

125. EMPLOYEE BENEFIT RESEARCH INSTITUTE, *supra* note 118, at 114.

126. H.R. REP. NO. 378, 87th Cong., 1st Sess. 6 (1961).

127. *Id.* at 20. Language of identical import is found at S. REP. NO. 992, 87th Cong., 1st Sess. 31 (1961), reprinted in 1962 U.S.C.C.A.N. 2964.

128. *Self-Employed Individuals' Retirement Act: Hearings on H.R. 10 Before the Senate Finance Comm.*, 87th Cong., 1st Sess. 20, 44 (1961) (statement of Honorable Stanley S. Surrey, Assistant Secretary of the Treasury).

129. *Id.*

130. *Self-Employed Individuals' Retirement Act of 1959: Hearings on H.R. 10 Before the Comm. on Finance*, 86th Cong., 1st Sess. 296-98 (1959) (statement of J. Milton Edelstein, chair of the Legislative Committee of the Association of Advanced Underwriters); *Id.* at 325-333 (statement of Richmond Corbett on behalf of the Chicago Bar Association).

partnership and his or her spouse shall not be deemed to be employees with respect to the partnership.”<sup>131</sup>

The Department of Labor, in its notice of proposed rule making,<sup>132</sup> said that this issue was one of protection:

In ordinary usage and under common law, the term “employee” is generally not considered to include a partner. In addition, in a plan or program covering only partners, the protection which Title I was designed to provide is unnecessary, because partners are generally capable of protecting their own interests under existing law.<sup>133</sup>

In order to give this protection, Title I of ERISA<sup>134</sup> imposes on employers certain disclosure requirements, such as summary plan descriptions,<sup>135</sup> which must be given to employees. A question of cost is also relevant here:

The definition of the term “employee” in section 3(6) . . . could be read as broadly as section 401(c) (1) [*i.e.*, to include partners as employees] of the Code, which sweeps almost any working individual under the term “employee” for purposes of section 401, regardless of common law or other established concepts of the employment relationship. In view of the policies set forth in section 2 of the Act, however, the basic thrust of the protection which Congress provided in Title I is not directed toward so wide a class of individuals. In situations where Title I protection are unnecessary—where the abuses which Congress sought to prevent are unlikely to occur—enforcement of Title I would not only impose unnecessary costs on benefit plans, but also divert resources of the Department of Labor from administering Title I in situations where genuine abuses existed or could arise.<sup>136</sup>

Shareholder employees are covered because the corporate relationships are more complex:

In many instances an executive of a smaller or medium-sized corporation who is also shareholder of the corporation occupies a position with respect to an employee benefit plan maintained by the corporation similar to the position occupied by a partner with respect to a plan maintained by a partnership. No provision for plans covering only such corporate executive-shareholders has been included in proposed §2510.3-6. In view of the greater complexity of corporate relationships, and in view of the fact that virtually every individual who is an employee of a publicly traded corporation may readily acquire a few shares of the corporation, a blanket exclusion of corporate shareholders from the term “employee” would obviously be inappropriate.<sup>137</sup>

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131. 29 C.F.R. § 2510.3-3(c)(2) (1993).

132. 40 Fed. Reg. 24642 (1975) (proposed June 9, 1975).

133. *Id.* at 24643.

134. 29 U.S.C. §§ 1021-1168 (1988 & Supp. 1993).

135. 29 U.S.C. §1021(a) (Supp. 1993).

136. 40 Fed. Reg. 24642, 24643 (1975) (proposed June 9, 1975).

137. *Id.* at 24643-44.

There was no attempt here to distinguish between a shareholder with a ten percent or more interest in a corporation (which can happen even in a publicly traded corporation) and a General Motors employee who owns 100 shares of General Motors stock, even though the Internal Revenue Code made such a distinction with partnerships.

#### *D. Cafeteria Plans*

With regard to Cafeteria Plans under Code Section 125, proposed regulations make clear that a partner is not an employee.<sup>138</sup> The statute itself merely says that in a Cafeteria Plan, all participants must be employees.<sup>139</sup> The Committee Report of the Joint Committee gives no guidance on how this should apply to partners.

Because a partner does not need the disclosure protection that ERISA makes available to rank and file employees, the partner suffers a substantive disadvantage by being unable to participate in welfare benefits plans such as a Cafeteria Plan. This disadvantage simply does not follow from the premise of not needing disclosure protection. If the Treasury and the Department of Labor wish to have a consistent public policy, the exclusion of partners as employees is curious. Excluding partners should have nothing to do with a lack of any need of disclosure because this restriction affects basic eligibility.

#### *E. Partners as Employees Under Partnership Income Tax Provisions of the Internal Revenue Code of 1954*

When the Internal Revenue Code was overhauled in 1954, the legislative comments made it clear that, with regard to partnership income tax provisions,<sup>140</sup> the new Code was adopting an entity theory of partnership in viewing transactions between a partner and the partnership with a few exceptions to stop abuses.<sup>141</sup>

When a partner sells property to, or performs services for the partnership, the problem arises whether the transaction is to be treated in the same manner as though the partner were an outsider dealing with the partnership (the "entity" approach). An alternative ("aggregate" approach) is to view the partner as dealing with himself to the extent of his own interest and as dealing with the partnership with respect to the balance of the transaction. The present code fails to cover the problem and judicial decisions on the subject go in both directions. Because of its simplicity of operation, the "entity" rule has been adopted by the House and your committee.<sup>142</sup>

138. See 49 Fed. Reg. 19321-19329 (proposed May 7, 1984).

139. I.R.C. § 125(d)(1)(A).

140. I.R.C. §§ 701-761.

141. The two exceptions both involve sale of assets from a partner to a partnership. If a partner owns directly or indirectly more than a fifty percent interest in the partnership, no loss will be allowed on the sale. I.R.C. § 707(b)(1) (1988). If a partner owns directly or indirectly more than an eighty percent interest in the partnership, any gain which will be ordinary income in the hands of the transferee shall be ordinary income to the partner. I.R.C. § 707(b)(2) (1988). See also J. Rex Dibble, *Partnership Changes in General*, 1955 SO. CALIF. TAX INST. 177, 187-188.

142. S. REP. NO. 1622, 83rd Cong., 2d Sess. 92 (1954).

The aggregate approach proved unworkable for a partnership in a year in which the partnership profits were insufficient to cover the partnership salary expense. Treasury regulations under the Internal Revenue Code of 1939 were clear that a salary was merely an adjustment of the distributive incomes among the partners.<sup>143</sup> This was satisfactory if there were sufficient profits to cover the salary, but not if profits were insufficient:

Let us consider the *C* and *D* partnership. Each partner invests \$10,000 and is to share equally in profits and losses after an annual salary of \$3,000 is paid to *C*. In its first year the partnership loses \$2,000, and in addition pays *C* his salary. The result is that *C* has made \$500 while *D* has lost \$2,500. It is somewhat anomalous to speak of *C*'s income as a distributive share of partnership income, when the partnership return shows a loss. And it can be easily be imagined that a revenue agent would be dubious about the allowance of a \$2,500 partnership loss to *D*, when the entire partnership loss appears on its return as \$2,000.<sup>144</sup>

The result was the enactment of Code Section 707(c) which states that if the partnership pays a partner for services, and if such payments are not dependent on the income of the partnership, the payments are treated as having been made to an outsider. In the example above, *C* would be treated as having received a \$3,000 salary, the partnership would report a loss of \$5,000 and both *C* and *D* would report losses of \$2,500.

#### CONCLUSION

The treatment of partners under various areas of the law is uncoordinated and inconsistent. Courts are loathe to upset long-standing precedent without clear statutory authority. Some of the developments in the welfare benefits area have been anomalous, primarily excluding partners from participation when the stated reason for not including them as employees is that they have no need for procedural protection provided by ERISA. One solution to the erratic treatment of partners is the enactment of legislation that would override the inconsistent positions taken by courts and various administrative agencies. Because the relationship among partners and the definition of partnership is generally a matter of state law,<sup>145</sup> RUPA is the most logical, effective cure for the current inconsistencies in the law. If the adoption of the entity theory in RUPA is not sufficient to establish that partners are employees of the partnership, then RUPA should be amended to explicitly state that partners are employees.

In addition to those changes in state partnership law, federal legislation is desirable to cure the inconsistencies in the treatment of a partner's welfare benefits if the Department of Labor does not respect the changes of RUPA. If courts do not respect the changes of RUPA, then legislation treating partners as employees is desirable for Title VII. This legislation should define the circumstances under which a partner is considered an employee or otherwise receives the protection of various laws. This legislation should clarify the current

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143. Treas. Reg. § 19.183-1(2) (as amended in 1940).

144. Jacob Rabkin & Narklt Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909, 921 (1942).

145. The Internal Revenue Code contains its own definition of a partnership for income tax purposes. See Treas. Reg. § 3-1/88-1-2 (as amended in 1977).

law, which has evolved from court decisions attempting to discern what Congress would have thought about a matter that Congress in fact did not consider.

What is the disadvantage of giving partners blanket protection? The Tenth Circuit in *Wheeler*, in considering the application of Title VII to partners, decided that the unlimited liability of partners so distinguished them from common law employees that Congress could not have intended to cover partners.<sup>146</sup> However, is a partner in any different position than three shareholders in a closely held business who own all of the corporation's stock and who are compelled to guaranty all loans from banks or credit from vendors? Under appropriate conditions, the shareholders of such a corporation can be treated as partners in a partnership for purposes of reporting their income under the Internal Revenue Code.<sup>147</sup> Yet if these shareholders are employed by the corporation, they are clearly covered by Title VII.<sup>148</sup>

The countervailing argument, at least for partners who receive remuneration based primarily or solely on the profits of the partnership, is that such partner's interest is an ownership interest and that, with the exception of Subchapter K of the Internal Revenue Code, legislation discussed in this Article is not directed at owners. Such owners financially resemble shareholders. The exclusion of a partner from the definition of an employee is well established and RUPA does not explicitly change the definition of employee. Only a very specific statute, such as the one in the United Kingdom, would change the result.

RUPA's adoption of the entity theory should have a significant impact. However, as the decisions discussed in this Article illustrate, judicial interpretation of RUPA may not be uniform. Treating the partnership as an entity separate and distinct from its partners does not explicitly answer the question whether a working partner is always an employee. If courts do not find that RUPA affects a change in the status of partners, the current confusion will remain. The English statutes demonstrate a possible solution to the current ambiguity in the law. The objective of providing clarity and consistent treatment under workers' compensation, Title VII, pension and welfare benefits, and partnership provisions of the Internal Revenue Code is obtainable. Legislation should be enacted that unequivocally answers in the affirmative the question whether or not a partner is an employee. This legislation will eliminate the problems of varying decisions by courts and administrative agencies.

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146. *Wheeler v. Main Hurdman*, 825 F.2d 257 (10th Cir. 1987), *cert. denied*, 484 U.S. 986 (1987).

147. I.R.C. §§ 1361-79 (1988 & West Supp. 1993).

148. *Equal Employment Opportunity Comm'n v. Dowd & Dowd, Ltd.*, 736 F.2d 1177 (7th Cir. 1984), provides an exception. *See supra* text accompanying notes 79-82.