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Employment Taxes: An Identity Crisis for Disregarded Entities

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Tax directors of corporations owning disregarded entities should take note of the recent revision to Treas. Reg. sec. 301.7701-2. The revision marks a major change to the classification of disregarded entities for employment tax purposes. The new rule is likely to affect current and future business organizational structures, state and local employment tax filings, and employee relations. Prudent tax professionals should act now to deal with the state level consequences of the new rule.

Under Treas. Reg. § 301.7701-2(c)(2)(iv)(B), entities that are disregarded for federal income tax purposes ("DE" or "disregarded entity"), such as single member limited liability companies ("SMLLC") and qualified subchapter S subsidiaries ("QSubs"), will be treated as employers for withholding and unemployment tax purposes. This treatment is effective for wages paid on or after January 1, 2009.[1]

Currently, the Internal Revenue Service, through Notice 99-6, provides taxpayers with a choice regarding which entity will be responsible for employment tax purposes. SMLLCs may designate either the SMLLC or its sole member as the responsible party for the disregarded entity's employment obligations. Similarly, QSubs may designate either the QSub or its S corporation parent as the employer. The new rule in Treas. Reg. § 301.7701-2 eliminates the ability to choose which entity will be the employer. DEs will be required to obtain federal employer identification numbers ("FEIN") and comply with all of the associated filing requirements for payroll withholding and unemployment taxes.

At first glance, determining the impact of Treas. Reg. § 301.7701-2 at the state level appears quite simple. The vast majority of states follow the federal employer classification. Unfortunately, achieving compliance with the new rule at the state level is anything but simple.

[1] The effective date of the regulation, except with respect to employment taxes, is August 16, 2007. In order to provide sufficient time to prepare and take the necessary steps to comply with the new rule, the effective date of the regulation with respect to employment taxes was intentionally delayed until January 1, 2009.

The following example illustrates some of the challenges in complying with the new rule. Consider the situation of an SMLLC, treated as a DE, whose sole member currently has responsibility for employment tax purposes with respect to both the member and DE. In such a situation, it is likely that the DE never obtained an FEIN. Under the new rule, the DE is now required to obtain an FEIN. While obtaining an FEIN is not a difficult task, it is merely the first step.

The DE will now likely be required to file an employer application or register as an employer at the state level. This task is usually not overly burdensome, unless the DE has employees performing services in multiple jurisdictions. As the number of jurisdictions involved increases, so does the compliance burden for the DE. Another challenge for the DE is determining which entity, the DE or the sole member, is the actual employer of a particular employee. In many situations, it is difficult to determine the entity for which a particular employee performs services. In some instances, the answer to this question will be both.

The new rule will also impact the business's payroll and human resource departments. Tax departments should confirm that the payroll and human resource departments are aware of the new rule. All three departments likely will need to work together with the business's payroll service provider to achieve compliance with each state's periodic withholding and unemployment insurance tax filings. It is likely that the final step in the process will be dealing with employee relations issues. Specifically, informing employees that their future paychecks will identify a new employer and responding to any related questions (*e.g.*, inquiries from employees regarding how or whether the change will affect their 401k or other benefits).

With respect to future organizational restructurings and the formation of new entities, it is prudent to proceed as if the new rule is in effect today. By doing so, businesses will avoid having to make the necessary changes in the coming months to comply with the new rule, which becomes effective in 2009.

Due to the need for internal coordination between multiple departments (*i.e.*, tax, payroll and human resources) and outside service providers, it is recommended that taxpayers start the process of dealing with the new rule as soon as possible.

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