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Disregarded Entities Are Now Responsible for Their Own Employment Taxes

By Wayne R. Strasbaugh, Wendi L. Kotzen, Jeffrey R. Davine, Christopher A. Jones and Louis W. Ricker
(Ballard Spahr Andrews & Ingersoll, LLP)

Tax directors of corporations that own disregarded entities, including single-member limited liability companies (LLCs) and qualified subchapter S subsidiaries (QSubs), should be aware of a major change affecting federal withholding obligations for wages paid to employees of such disregarded entities.

Generally, for federal tax purposes, a business entity that is not a corporation and has a single owner is disregarded. This means that for federal income tax purposes, a disregarded entity's items of income, gain, loss, deductions, and credits are treated as those of its owner. Before 2009, the owners of disregarded entities also were permitted to withhold and pay employment taxes at the owner level.

Changes from Recent Regulations

Treasury Department regulations effective on January 1, 2009, no longer allow owners to treat a single-member LLC or a QSub as a disregarded entity for employment tax purposes. Accordingly, even a disregarded entity must calculate, withhold, pay, and report employment taxes in its own name.

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Generally, employers are required to *(i)* withhold employment and income taxes from employees' wages and *(ii)* pay the employer portion of Social Security and Medicare (FICA) taxes and unemployment compensation (FUTA) taxes. An employer also must comply with other administrative obligations, such as issuing IRS Forms W-2 to its employees and filing IRS Forms 940 (annual return for FUTA taxes) and IRS Forms 941 (quarterly return for FICA and income taxes).

Compliance Issues

To comply with the new regulations, tax directors should be aware of the following issues:

- A disregarded entity must determine whether, under the common law (i.e., general state law principles), it is an "employer" for tax purposes.
- Every disregarded entity that has common law employees must have its own employer identification number (EIN). Before 2009, a disregarded entity generally was not required to obtain an EIN for federal tax purposes; instead a disregarded entity could use its owner's EIN for all purposes, including employment tax purposes.
- A disregarded entity that is an employer for tax purposes must withhold, report, and deposit FICA and FUTA taxes in its own name.
- A disregarded entity may file IRS Form 2678, designating an agent (such as, for example, the owner of the disregarded entity) for employment taxes. This designation cannot be made retroactively and must be filed at least 60 days before the requested effective date. A payroll agent designated by IRS Form 2678 may file FICA tax returns (IRS Forms 941) on behalf of one or more entities. However, the EIN of the common law employer must be reported on IRS Form W-2 each year. Moreover, an entity may not designate a payroll agent for purposes of FUTA taxes (IRS Forms 940). Accordingly, related entities that use a single payroll agent nevertheless must keep entity-specific employment records.

Companies that fail to comply with the new regulations face a substantial risk.

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- When an employee works for one or more related entities (regarded or disregarded), one of the entities may be designated as the "common paymaster" of the employee for employment tax purposes. The common paymaster rule is designed to prevent related employers from overpaying their share of FICA and FUTA taxes, but it can be used only when one or more employees have multiple common law employers.
- State and local withholding and payroll tax rules for employees of disregarded entities may differ from the federal procedures described in this article.

Companies that fail to comply with the new regulations face a substantial risk. A disregarded entity now owes employment tax returns in its own name and is itself required to pay employment taxes. If the owner of a disregarded entity continues to report and pay employment taxes in its name, and the disregarded entity does not file employment tax returns and pay employment taxes, no statute of limitations will run to prevent the IRS from assessing those taxes against the disregarded entity. The employment taxes paid by the owner on behalf of the disregarded entity will be an overpayment of taxes by the owner. The owner may claim a refund of those taxes for only three years. As a result, if the IRS assesses the disregarded entity after the owner's right to claim a refund has expired, the disregarded entities could owe tax even though the owner no longer has the opportunity to seek a refund of the overpayment. ❑

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