EMPLOYMENT TAXES AND DISREGARDED ENTITIES AFTER JANUARY 1, 2009

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As of January 1, 2009, the rules governing federal employment taxes for disregarded entities changed in a very important manner. Prior to January 1, 2009, a disregarded entity, such as a single member limited liability company (LLC) or a qualified S subsidiary (QSub), had two options for meeting employment tax obligations: 1) the single member / owner could calculate, report and pay all employment tax obligations with respect to the employees of the disregarded entity as though the employees were employed directly by the owner; or 2) the entity could separately calculate, report and pay all employment tax obligations with respect to its employees under its own name and taxpayer identification number. See Notice 99-6, 1999-3 IRB 12. Effective January 1, 2009, the final regulations disseminated in Internal Revenue Bulletin 2007-39 allow a disregarded entity only the second option.

Under the final regulations, a disregarded entity such as a single member LLC or QSub will be treated as a corporation for purposes of employment taxes and must separately account for all of its employment tax obligations at the subsidiary level, rather than the single member or parent level. Treas. Reg. §§ 1.1361-4(a)(7)(i) and 301.7701-2(c)(2)(iv)(B). The entity, be it an LLC or QSub, continues to be disregarded for all other federal tax purposes.

It is important to note that an individual (i.e. human) owner of a disregarded entity (e.g., a single member of an LLC) will continue to be treated as self-employed for self-employment tax purposes, and not as an employee of the entity. An implied effect of these new rules will be the necessity of obtaining a separate taxpayer identification number (TIN) for the disregarded entity that will only be used to report employment taxes. Taxable income or loss will continue to pass through to the owner and be reported on the appropriate form for that individual or entity. A

string of multi-tier single member LLCs could end up reporting under multiple TINs for employment tax purposes but a single TIN (at the common or ultimate parent level) for income tax purposes.

An interesting issue arises in the context of a wholly-owned foreign entity (WOFE) formed under the laws of a foreign jurisdiction that has "checked the box" to be disregarded as separate from its US parent for income tax purposes. Under the new rules, the WOFE is *not* disregarded from its parent and is considered its own corporate taxpayer for employment tax purposes. If the WOFE employs US taxpayers who provide all of their services in the foreign jurisdiction, the WOFE is not required to withhold or report to the IRS for US employment taxes because it is a foreign entity with no employees performing services in the US. It is uncertain whether Treasury intended this result so it is yet to be seen whether they attempt to alter the rule, but for now that is the proper employment tax treatment for a WOFE.

Other than in the WOFE context, the impact of the final regulations is really only administrative. That said, they cannot be ignored and could prove to be a trap to the unwary.