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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

REG-114371-05

RIN 1545-BE43

Disregarded Entities; Employment and Excise Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under which qualified subchapter S subsidiaries and single-owner eligible entities that currently are disregarded as entities separate from their owners for federal tax purposes would be treated as separate entities for employment tax and related reporting requirement purposes. These regulations also propose to treat such disregarded entities as separate entities for purposes of certain excise taxes reported on Forms 720, 730, 2290, and 11-C; excise tax refunds or payments claimed on Form 8849; and excise tax registrations on Form 637. These proposed regulations would affect disregarded entities and the owners and employees of disregarded entities in the payment and reporting of federal employment taxes. These regulations also would affect disregarded entities and their owners in the payment and reporting of certain Federal excise taxes and in registration and claims related to certain Federal excise taxes.

DATES: Written or electronic comments and requests for a public hearing must be received by January 17, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-114371-05), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-114371-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at www.irs.gov/reg or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-114371-05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John Richards at (202) 622-6040 (on the employment tax provisions) or Susan Athy at (202) 622-3130 (on the excise tax provisions); concerning the submission of comments or requests for a hearing, Robin Jones at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

1. Disregarded Entities

Under the Internal Revenue Code (Code) and its regulations, qualified subchapter S subsidiaries (QSubs) (under section 1361(b)(3)(B)) and certain single-owner eligible entities (under §§301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations) are disregarded as entities separate from their owners ("disregarded entities"). The disregarded entity rules of section 1361(b)(3)(A) and §§301.7701-1 through 301.7701-3 apply for all purposes of the Code, including employment and excise taxes.

2. Employment Taxes

Employers are required to deduct and withhold income and Federal Insurance Contributions Act (FICA) taxes from their employees' wages under sections 3402(a) and 3102(a), and are separately liable for their share of FICA taxes as well as for Federal Unemployment Tax Act (FUTA) taxes under sections 3111 and 3301 (the withholding, FICA and FUTA taxes are collectively referred to herein as employment taxes). Sections 3403, 3102(b), 3111, and 3301 provide that the employer is the person liable for the withholding and payment of employment taxes. In addition, the employer is required to make timely tax deposits, file employment tax returns, and issue wage statements (Forms W-2) to employees (collectively, other employment tax obligations). An employer is generally defined as the person for whom an individual performs services as an employee. Sections 3401(d), 3121(d), and 3306(a). Because a disregarded entity is not recognized for Federal tax purposes, the owner of the disregarded entity is treated as the employer for purposes of employment tax liabilities and all other employment tax obligations related to wages paid to employees performing services for the disregarded entity.

If an entity is disregarded for Federal tax purposes under section 1361(b)(3)(A) or §§301.7701-1 through 301.7701-3, Notice 99-6 (1999-1 C.B. 321) provides that employment taxes and other employment tax obligations with respect to employees performing services for the disregarded entity may be satisfied in one of two ways: (1) calculation and payment of all employment taxes and satisfaction of all other employment tax obligations with respect to employees performing services for the disregarded entity by its owner under the owner's name and employer identification number (EIN); or (2) separate calculation and payment of all employment taxes and

satisfaction of all other employment tax obligations by the disregarded entity with respect to employees performing services for the disregarded entity by the disregarded entity under its own name and EIN. The notice states that ultimate liability for employment taxes remains with the owner of the disregarded entity regardless of which alternative is chosen.

3. Excise Taxes

A. Liability for excise taxes

Liability for federal excise taxes is imposed on certain transactions and activities under the following chapters of the Internal Revenue Code (Code).

Chapter 31 imposes retail excise taxes on the sale or use of special fuels (section 4041); the use of fuel in commercial transportation on inland waterways (section 4042); and the sale of heavy trucks and trailers (section 4051).

Chapter 32 imposes manufacturers excise taxes on the sale of gas guzzler automobiles (section 4064); the sale of highway-type tires (section 4071); the removal, entry, or sale of taxable fuel (section 4081); the sale of coal (section 4121); the sale of vaccines (section 4131); and the sale of sporting goods (section 4161).

Chapter 33 imposes excise taxes on payments for communications facilities and services (section 4251); payments for transportation of persons by air (section 4261); and payments for transportation of property by air (section 4271).

Chapter 34 imposes excise taxes on policies issued by foreign insurers (section 4371).

Chapter 35 imposes excise taxes on wagers (sections 4401 and 4411).

Chapter 36 imposes excise taxes on transportation by water (section 4471) and

the use of heavy highway vehicles (section 4481).

Chapter 38 imposes excise taxes on the sale of ozone-depleting chemicals and imported taxable products (section 4681).

The IRS does not administer, and these regulations have no effect on the chapter 32 tax on firearms (section 4181) or the chapter 36 tax on port use (section 4461).

B. Excise tax registration

A person may be required to register with the IRS for certain excise tax purposes. Registration may be required under section 4101 with respect to the taxes imposed on motor fuels or under section 4412 in the case of persons subject to the occupational tax on wagering. In addition, section 4222 generally permits sales for certain exempt purposes to be made on a tax-free basis only if the sellers and purchasers are registered.

C. Excise tax credits, refunds, and payments

The Code allows excise taxpayers to claim credits or refunds for overpayments, including overpayments determined under sections 4081(e), 6415, 6416, and 6419 (section 6402). The Code generally allows non-excise taxpayers to claim credits or payments for fuels used for nontaxable purposes (sections 6420, 6421, and 6427) and allows blenders to claim credits or payments for the production of alcohol and biodiesel mixtures (sections 6426 and 6427(e)). Section 34 provides an income tax credit for amounts payable for the nontaxable use of fuels under sections 6420, 6421, and 6427, if these amounts have not been previously claimed, and section 38 provides an income tax credit (general business credit) for alcohol or biodiesel used as a fuel (under

sections 40 and 40A).

4. Reason for Change

Administrative difficulties have arisen from the interaction of the disregarded entity rules and the federal employment tax provisions. Problems have arisen for both taxpayers and the IRS with respect to reporting, payment and collection of employment taxes, particularly where state employment tax law also sets requirements for reporting, payment and collection that may be in conflict with the federal disregarded entity rules. The Treasury Department and the IRS believe that treating the disregarded entity as the employer for purposes of federal employment taxes will improve the administration of the tax laws and simplify compliance.

Difficulties also have arisen from the interaction of the disregarded entity rules and certain federal excise tax provisions. Many of these provisions rely on state law, rather than federal law, to determine liability for an excise tax, attachment of a tax, and allowance of a credit, refund, or payment. For example, §48.0-2(b) of the Manufacturers and Retailers Excise Tax Regulations provides that such excise taxes attach when title to an article passes to the purchaser. In general, determining when title passes depends on the intention of the parties. Absent express intention, however, the laws of the jurisdiction where the sale is made govern this determination. Such a determination is required also in applying certain excise tax credit, refund, and payment provisions that allow claims by ultimate purchasers, ultimate vendors, and producers.

Explanation of Provisions

These proposed regulations would treat QSubs and single-owner eligible entities that are disregarded entities for Federal tax purposes as separate entities for purposes

of employment taxes and other requirements of law arising under subtitle C of the Code, certain excise taxes, and the application of the rules under subtitle F of the Code relating to matters such as reporting, assessment, collection, and refunds regarding employment and certain excise taxes. Under the proposed regulations, these entities generally would continue to be treated as disregarded entities for other federal tax purposes.

1. Employment Taxes

The proposed regulations would eliminate disregarded entity status for purposes of federal employment taxes. A disregarded entity would be regarded for employment tax purposes, and, accordingly, become liable for employment taxes on wages paid to employees of the disregarded entity, and be responsible for satisfying other employment tax obligations (e.g., backup withholding under section 3406, making timely deposits of employment taxes, filing returns, and providing wage statements to employees on Forms W-2). The owner of the disregarded entity would no longer be liable for employment taxes or satisfying other employment tax obligations with respect to the employees of the disregarded entity. The disregarded entity would continue to be disregarded for other Federal tax purposes. The proposed regulations contain an example illustrating the interaction of the income tax provisions and employment tax provisions. For example, the proposed regulations illustrate that an individual owner of a disregarded entity would continue to be treated as self-employed for purposes of Self Employment Contributions Act (SECA) taxes (section 1401 et sequitur), and not as an employee of the disregarded entity for employment tax purposes.

The employment tax provisions of these regulations are proposed to apply to wages paid on or after January 1 following the date these regulations are published as final regulations in the **Federal Register**. QSubs, single-owner eligible entities disregarded under §§301.7701-1 through 301.7701-3, and the owners of such entities may continue to use the procedures permitted by Notice 99-6 to satisfy the owners' employment tax liabilities and other employment tax obligations for periods before the effective date of these regulations. As required by Notice 99-6, if the owner currently satisfies the employment tax liabilities and other employment tax obligations with respect to wages paid to employees performing services for the disregarded entity, then the owner must continue to satisfy such liabilities and obligations until these regulations become final and effective, at which time Notice 99-6 will be obsolete.

2. Excise Taxes

The proposed regulations would eliminate disregarded entity status for purposes of certain excise taxes. An entity that is disregarded for other federal tax purposes would be required to pay and report excise taxes, required and allowed to register, and allowed to claim any credits (other than income tax credits), refunds, and payments. The excise tax provisions that are excluded from the proposed regulations are specified. Because a disregarded entity does not file an income tax return, the credit on Form 4136 under section 34 is claimed on the owner's income tax return and appropriate identification of the single-owner entity and its taxpayer identification number is required. The income tax credit under section 38 (including any credit under sections 40 and 40A) is not affected by these proposed regulations.

The excise tax provisions in these regulations are proposed to apply to liabilities imposed and actions first required or permitted in periods beginning on or after January 1 following the date these regulations are published as final regulations in the **Federal Register**. For periods beginning before the effective date of these regulations, the IRS will treat payments made by a disregarded entity, or other actions taken by a disregarded entity, with respect to the excise taxes affected by these regulations as having been made or taken by the sole owner of that entity. Thus, for such periods, the owner of a disregarded entity will be treated as satisfying the owner's obligations with respect to the excise taxes affected by these regulations, provided that those obligations are satisfied either (i) by the owner itself or (ii) by the disregarded entity on behalf of the owner.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these proposed regulations, and because these proposed regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed regulations and how they may be made easier to understand. In addition, comments are requested specifically on any transition issues that might arise with respect to employment taxes, and any transition relief that should be provided with respect to employment tax obligations. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Susan Athy, Office of Associate Chief Counsel (Passthroughs and Special Industries), and John Richards, Office of Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1--INCOME TAX

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.34-1 is revised to read as follows:

§1.34-1 Special rule for owners of certain business entities.

Amounts payable under sections 6420, 6421, and 6427 to a business entity that is treated as separate from its owner under §1.1361-4(a)(8) (relating to certain qualified subchapter S subsidiaries) or §301.7701-2(c)(2)(v) of this chapter (relating to certain wholly-owned entities) are, for purposes of section 34, treated as payable to the owner of that entity.

§§1.34-2 through 1.34-6 [Removed]

Par. 3. Sections 1.34-2 through 1.34-6 are removed.

Par. 4. Section 1.1361-4 is amended as follows:

1. In paragraph (a)(1), the language “Except as otherwise provided in paragraphs (a)(3) and (a)(6)” is removed, and “Except as otherwise provided in paragraphs (a)(3), (a)(6), (a)(7), and (a)(8)” is added in its place.

2. Paragraphs (a)(7) and (a)(8) are added.

The additions read as follows:

§1.1361-4 Effect of QSub election.

(a) * * *

(7) Treatment of QSubs for purposes of employment taxes--(i) In general. A QSub is treated as a separate corporation for purposes of Subtitle C – Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(ii) Effective date. This paragraph (a)(7) applies with respect to wages paid on or after January 1 following the date these regulations are published as final regulations in the **Federal Register**.

(8) Treatment of QSubs for purposes of certain excise taxes--(i) In general. A QSub is treated as a separate corporation for purposes of--

(A) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), and 38 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

(B) Collection of tax imposed by Chapter 33 of the Internal Revenue Code;

(C) Registration under sections 4101, 4222, and 4412; and

(D) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (a)(8)(A) of this section.

(ii) Effective date. This paragraph (a)(8) applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1 following the date these regulations are published as final regulations in the **Federal Register**.

Par 5. Section 1.1361-6 is amended as follows:

The language “Except as otherwise provided in §§1.1361-4(a)(3)(iii), 1.1361-4(a)(5)(i), and 1.1361-5(c)(2)” is removed, and “Except as provided in §§1.1361-4(a)(3)(iii), 1.1361-4(a)(5)(i), 1.1361-4(a)(6)(iii), 1.1361-4(a)(7)(ii),

1.1361-4(a)(8)(ii), and 1.1361-5(c)(2)” is added in its place.

PART 301--PROCEDURE AND ADMINISTRATION

Par. 6. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 7. Section 301.7701-2 is amended as follows:

1. In paragraph (a), a sentence is added at the end.

2. In paragraph (c)(2)(i), the language “A business” is removed, and “Except as otherwise provided in this paragraph (c), a business” is added in its place.

3. Paragraphs (c)(2)(iv), (c)(2)(v), (e)(3), and (e)(4) are added.

The additions read as follows:

§301.7701-2 Business entities; definitions.

(a) * * * But see paragraphs (c)(2)(iv) and (v) of this section for special employment and excise tax rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.

* * * * *

(c) * * *

(2) * * *

(iv) Special rule for employment tax purposes--(A) In general. Paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply to taxes imposed under Subtitle C -- Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(B) Example. The following example illustrates the application of paragraph (c)(2)(iv) of this section:

Example. (i) LLCA is an eligible entity owned by individual A and is generally disregarded as an entity separate from its owner for federal tax purposes. However, LLCA is treated as an entity separate from its owner for purposes of subtitle C of the Internal Revenue Code. LLCA has employees and pays wages as defined in sections 3121(a), 3306(b), and 3401(a).

(ii) LLCA is subject to the provisions of subtitle C of the Internal Revenue Code and related provisions under 26 CFR subchapter C, Employment Taxes and Collection of Income Tax at Source, parts 31 through 39. Accordingly, LLCA is required to perform such acts as are required of an employer under those provisions of the Code and regulations thereunder that apply. All provisions of law (including penalties) and the regulations prescribed in pursuance of law applicable to employers in respect of such acts are applicable to LLCA. Thus, for example, LLCA is liable for income tax withholding, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes. See sections 3402 and 3403 (relating to income tax withholding); 3102(b) and 3111 (relating to FICA taxes), and 3301 (relating to FUTA taxes). In addition, LLCA must file under its name and EIN the applicable Forms in the 94X series, for example, Form 941, "Employer's Quarterly Employment Tax Return," Form 940, "Employer's Annual Federal Unemployment Tax Return;" file with the Social Security Administration and furnish to LLCA's employees statements on Forms W-2, "Wage and Tax Statement;" and make timely employment tax deposits. See §§31.6011(a)-1, 31.6011(a)-3, 31.6051-1, 31.6051-2, and 31.6302-1 of this chapter.

(iii) A is self-employed for purposes of subtitle A, chapter 2, Tax on Self-Employment Income, of the Internal Revenue Code. Thus, A is subject to tax under section 1401 on A's net earnings from self-employment with respect to LLCA's activities. A is not an employee of LLCA for purposes of subtitle C of the Code. Because LLCA is treated as a sole proprietorship of A for income tax purposes, A is entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through LLCA, including the employer's share of employment taxes imposed under sections 3111 and 3301, on A's Form 1040, Schedule C, "Profit or Loss for Business (Sole Proprietorship)."

(v) Special rule for certain excise tax purposes--(A) In general. Paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply for purposes of-

(1) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), and 38 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

- (2) Collection of tax imposed by Chapter 33 of the Internal Revenue Code;
- (3) Registration under sections 4101, 4222, and 4412; and
- (4) Claims of a credit (other than a credit under section 34), refund, or payment

related to a tax described in paragraph (c)(2)(v)(A)(1) of this section.

(B) Example. The following example illustrates the provisions of this paragraph (c)(2)(v).

Example. (i) LLCB is an eligible entity that has a single owner, B. LLCB is generally disregarded as an entity separate from its owner. However, under paragraph (c)(2)(v) of this section, LLCB is treated as an entity separate from its owner for certain purposes relating to excise taxes.

(ii) LLCB mines coal from a coal mine located in the United States. Section 4121 of chapter 32 of the Internal Revenue Code imposes a tax on the producer's sale of such coal. Section 48.4121-1(a) of this chapter defines a "producer" generally as the person in whom is vested ownership of the coal under state law immediately after the coal is severed from the ground. LLCB is the person that owns the coal under state law immediately after it is severed from the ground. Under paragraph (c)(2)(v)(A)(1) of this section, LLCB is the producer of the coal and is liable for tax on its sale of such coal under chapter 32 of the Internal Revenue Code. LLCB must report and pay tax on Form 720, "Quarterly Federal Excise Tax Return," under its own name and taxpayer identification number.

(iii) LLCB uses undyed diesel fuel in an earthmover that is not registered or required to be registered for highway use. Such use is an off-highway business use of the fuel. Under section 6427(l), the ultimate purchaser is allowed to claim an income tax credit or payment related to the tax imposed on diesel fuel used in an off-highway business use. Under paragraph (c)(2)(v) of this section, for purposes of the credit or payment allowed under section 6427(l), LLCB is the person that could claim the amount on its Form 720 or on a Form 8849, "Claim for Refund of Excise Taxes." Alternatively, if LLCB did not claim a payment during the time prescribed in section 6427(i)(2) for making a claim under section 6427, §1.34-1 of this chapter provides that B, the owner of LLCB, could claim the income tax credit allowed under section 34 for the nontaxable use of diesel fuel by LLCB.

* * * * *

(e) * * *

(3) Paragraph (c)(2)(iv) of this section applies with respect to wages paid on or after January 1 following the date these regulations are published as final regulations in the **Federal Register**.

(4) Paragraph (c)(2)(v) of this section applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1 following the date these regulations are published as final regulations in the **Federal Register**.

Deputy Commissioner for Services and Enforcement.