Notice 99-6

PURPOSE

This notice solicits comments from taxpayers and practitioners regarding issues related to employment tax reporting and payment by qualified subchapter S subsidiaries and other entities that are disregarded as entities separate from their owners for federal tax purposes. This notice also discusses two methods of employment tax compliance that will be accepted by the Service until such time as formal reporting procedures are provided in other guidance.

Since the recent enactment of legislation and promulgation of regulations providing that certain wholly owned entities will be disregarded as entities separate from their owners, the Service has received many questions from taxpayers concerning the treatment of disregarded entities for federal employment tax purposes. To help employers comply with the employment tax requirements, the Department of the Treasury and the Internal Revenue Service intend to issue guidance illustrating the proper method for reporting employment taxes with respect to these entities.

BACKGROUND

Under § 1361 of the Internal Revenue Code (as amended by § 1308 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 and § 1601 of the Taxpayer Relief Act of 1997, Public Law 105-34, 111 Stat. 788), an S corporation may own a qualified subchapter S subsidiary. Section 1361 (b)-(3) (B) defines the term "qualified subchapter S subsidiary" (QSub) as a domestic corporation that is not an ineligible corporation (as defined in § 1361 (b) (2)), if (1) an S corporation holds 100 percent of the stock of the corporation, and (2) that S corporation elects to treat the subsidiary as a QSub. Except as otherwise provided in regulations, a corporation for which a QSub election is made is not treated as a separate corporation for federal tax purposes, and all assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation. Similar rules apply to qualified REIT subsidiaries under § 856 (i).

Regulations issued under § 7701 of the Code provide for another type of disregarded entity. Section 301.7701-2 (c) (2) of the Procedure and Administration Regulations provides that a business entity that has a single owner and that is not a corporation under § 301.7701-2 (b) is disregarded as an entity separate from its owner for all federal tax purposes.

In general, employment tax responsibilities rest with an employer. For federal employment tax purposes, the common law rules for determining the identity of the employer ordinarily apply. Under these rules, the person for whom services are performed as an employee is generally considered the employer for purposes of the employment tax provisions. An employer generally is required to withhold and pay over applicable taxes from employees' wages, pay employer

taxes, make timely tax deposits, file employment tax returns, and issue wage statements to employees (collectively, "employment tax obligations").

REQUEST FOR COMMENTS

Section 1361 (b) (3) and § 301.7701-2 (c) (2) cause the owner of a disregarded entity to be treated as the employer of the disregarded entity's employees for federal employment tax purposes. Thus, the owner generally is responsible for complying with all the employment tax obligations related to those employees.

Since enactment of the QSub statute and promulgation of the disregarded entity provision of the regulations, however, many taxpayers have mistakenly interpreted § 1361 (b) (3) and § 301.7701-2 (c) (2) as applying only for federal income tax purposes. In addition, the Service has received numerous comments and questions from other taxpayers that have properly interpreted the statute concerning the difficulties that arise from application of these provisions. Some of these taxpayers have expressed a strong preference for the continued recognition for employment tax purposes of the separate state law entities. Other taxpayers have expressed a preference for a literal application of the provisions, resulting in the treatment of the owner of the disregarded entity as the employer.

Prior to issuing formal guidance, the Service is requesting comments concerning employment tax and certain reporting issues relating to disregarded entities that should be addressed in future guidance. This notice solicits comments from taxpayers and practitioners regarding the following issues:

1) Any increase or decrease in the administrative burden on taxpayers created by a system of filing employment tax returns under the owner's name and taxpayer identification number where employees are actually employed by a state law entity that is disregarded as an entity separate from its owner for federal tax purposes;

2) Whether different rules should apply to newly formed disregarded entities with no previous employment tax history as opposed to entities in existence prior to the time when they became disregarded;

3) Different results (both in amount of tax, type of tax, and time and method of deposits) that arise from filing as one employer as compared to filing as separate employers;

4) Appropriate methods for notifying the service center about changes in employment tax obligations when an entity's status as a disregarded entity changes;

5) Possible issues arising in situations where the owner or the disregarded entity is formed or domiciled in a country other than the United States;

6) Additional issues relating to employment taxes and disregarded entities including, but not limited to, confusion for employees, employers, and state and federal agencies resulting from a single entity reporting structure for employment tax purposes; and

7) Whether any guidance issued should also apply to qualified REIT subsidiaries (as defined in § 856 (i)).

Comments are also requested concerning issues related to disregarded entities but outside the employment tax area. Those issues include but are not limited to the following:

1) Information reporting on IRS Form 1099s issued by, or with respect to, disregarded entities and their owners; and

2) Issues related to qualified or nonqualified deferred compensation plans, fringe benefit and welfare plans, and other compensation arrangements.

Written comments should be sent to the following address:Internal Revenue Service
CC:DOM:CORP (NT 99-6;
CC:DOM:P&SI:1)
P.O. Box 7604
, Ben Franklin Station
Washington, DC 20044

In the alternative, comments may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to the courier's desk at 1111 Constitution Avenue, NW, Washington, DC, or submitted electronically via the IRS Internet site at
http://www.irs.usreas.gov/prod/tax_regs/comments.html.

Because the Service and Treasury would like to receive comments early in the developmental stages of potential guidance, comments should be forwarded to one of the addresses above prior to April 20, 1999. However, to the extent possible, consideration will be given to comments received after that date.

TEMPORARY EMPLOYMENT TAX PROCEDURES

Until additional guidance is issued, the Service generally will accept reporting and payment of employment taxes with respect to the employees of a QSub or an entity disregarded as an entity separate from its owner under § 301.7701-2 (c) (2) if made in one of two ways:

1) Calculation, reporting, and payment of all employment tax obligations with respect to employees of a disregarded entity by its owner (as though the employees of the disregarded entity are employed directly by the owner) and under the owner's name and taxpayer identification number; or

2) Separate calculation, reporting, and payment of all employment tax obligations by each state law entity with respect to its employees under its own name and taxpayer identification number.

If the second method is chosen, the owner retains ultimate responsibility for the employment tax obligations incurred with respect to employees of the disregarded entity. This method merely permits the employment tax obligations of the owner incurred with respect to the disregarded entity to be fulfilled through the separate calculation, reporting, and payment of employment taxes by the disregarded entity. Accordingly, the Service will not proceed against the owner for employment tax obligations relating to employees of a disregarded entity if those obligations are fulfilled by the disregarded entity using its own name and taxpayer identification number, even if

there are differences in the timing or amount of payments or deposits as calculated under the second method. If the first method is selected, a final employment tax return should be filed with respect to a disregarded entity that formerly calculated, reported, and paid its employment tax obligations on a separate basis.

An owner of multiple disregarded entities may choose the first method with respect to some disregarded entities and the second method with respect to its other disregarded entities. The fact that an owner of a disregarded entity chooses to calculate, report, and pay its employment tax obligations under the second method with respect to a given disregarded entity for one taxable year will not preclude the owner from switching to the first method in a subsequent taxable year. However, if the owner uses the first method of calculating, reporting, and paying employment tax obligations with respect to a given disregarded entity for a return period that begins on or after April 20, 1999, the taxpayer must continue to use the first method unless and until otherwise permitted by the Commissioner.

DRAFTING INFORMATION

The principal authors of this notice are Deanna Walton of the Office of Assistant Chief Counsel (Passthroughs and Special Industries) and John Richards of the Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this notice contact Ms. Walton at (202) 622-3050 or Mr. Richards at (202) 622-6040 (not toll-free calls).