

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Rollin Thorley, CC:SB:5:LV

from: Joseph W. Clark
Chief, Branch 3 (Collection, Bankruptcy and Summonses)
CC:PA:CBS:BR3

subject: **Disregarded Entity and Section 3505(a)**

This memorandum responds to your request for advice dated May 01, 2003. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

ISSUES

Whether a disregarded Limited Liability Company (LLC) is an "other person" for purposes of collecting employment taxes under section 3505(a).

CONCLUSIONS

For federal tax purposes, a disregarded LLC is not an "other person."

FACTS

Taxpayer, a debtor in a Chapter 11 bankruptcy, is a single member LLC. Because the taxpayer did not elect to be treated as a corporation for federal tax purposes, the taxpayer is a disregarded entity. The business has a balance due for Form 941 payroll taxes. The LLC paid the business's payroll and reported the Form 941 tax liability under its name and EIN.

LAW AND ANALYSIS

An LLC is a hybrid entity created under state law, which has attributes of both a partnership and a corporation. See generally, Uniform Limited Liability Company Act (1995). See also, N.Y. Ltd. Liab. Co. Law §§ 101-1403 (McKinney 2000). The owners/members of an LLC generally are not liable for the debts of the LLC. An LLC may own property in its own name. The members have no interest in such property. The laws of most states permit the organization of multi-member or single member LLCs.

Treas. Reg. § 301.7701-1 et seq. provides a framework for the federal tax classification of entities. Under the regulation, the classification of an LLC depends on whether the LLC is multi-member or single member and whether the LLC has elected how it wants to be treated. For example, a multi-member LLC may elect to be treated as an association taxable as a corporation. Treas. Reg. § 301.7701-3(a). If no election is made, section 301.7701-3(b)(1)(i) provides that the multi-member LLC will be treated as a partnership.

A single member owner may elect to have the LLC classified as a corporation. Treas. Reg. § 301.7701-3(a). If the single member owner fails to make an election, section 301.7701-3(b)(1)(ii) provides that the LLC will be disregarded as an entity separate from its owner. A disregarded LLC's "activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." Treas. Reg. § 301.7701-2(a).

Because a disregarded LLC is not separate from its owner for federal tax purposes, the single member owner is the taxpayer with respect to liabilities arising from the LLC's business. The IRS may collect these liabilities by assessing the single member owner and pursuing administrative collection action. The IRS may file a notice of federal tax lien and levy on the single member owners property and rights to property. 26 U.S.C. §§ 6325 and 6331.

As the taxpayer liable for federal income taxes arising from the LLC's operations, the single member owner must file the federal income tax returns from which the IRS can make assessments. The assessment considerations become more complicated in the context of employment taxes. Notice 99-6, 1999-3 I.R.B. 12 provides a single member owner with two choices for filing employment tax returns. The first choice allows a single member owner to calculate, report, and pay the employment taxes of the LLC employees under the owner's own name and employee identification number ("EIN"). The second choice allows the disregarded LLC to separately calculate, report, and pay the employment tax obligations incurred with respect to employees of the LLC under the name and EIN of the LLC. The Notice states that, regardless of the choice made, the single member owner of an LLC disregarded as a separate entity is the employer for purposes of employment tax liability.

I.R.C. § 6321 provides that if any taxpayer neglects or refuses to pay the tax liability after demand, the amount shall be a lien in favor of the United States upon all of the taxpayer's property and rights to property. I.R.C. § 6331(a) authorizes the IRS to collect a tax liability by levy upon a taxpayer's property or rights to property after a taxpayer's CDP rights are satisfied. I.R.C. § 7403(a) authorizes the Government to file suit to foreclose the federal tax lien on property.

In Drye v. United States, 528 U.S. 49 (1999), the Supreme Court articulated a two-prong test to determine a taxpayer's property and rights to property. See also, United States v. National Bank of Commerce, 472 U.S. 713 (1985), Aquilino v. United States, 363 U.S. 509 (1960), and United States v. Bess, 357 U.S. 51 (1958). First, a taxpayer's interests or rights must be determined under state law. Second, one must determine whether such interests or rights are property or rights to property under the Internal Revenue Code. If under the first prong, a taxpayer has no interest in or rights to particular property under state law, it follows that the IRS has no right to levy the particular property under the Internal Revenue Code.

Under the first prong of the Drye test, one looks to state law to determine a taxpayer's interest. Under state law, the taxpayer/single member owner has no interest in the LLC's property. Thus, as a general rule, even though an LLC is disregarded as an entity separate from the single member owner, and its activities are treated in the same manner as a sole proprietorship, branch, or division of its single member owner, for federal tax liability purposes, the IRS cannot satisfy the single member owner's tax liability from the disregarded LLC's assets.

The IRS may try to pierce the corporate veil of the LLC or file nominee liens under state law. To do this the IRS must establish that the LLC is the alter ego of the single member owner or that there has been a fraudulent conveyance between the single member owner and the LLC. This may or may not be a practical solution depending on the facts of the specific case.

Section 3505(a) provides the IRS with another way to collect withheld taxes. Under section 3505(a), if a lender, surety, or other person, who is not an employer, directly pays the wages of the employees of taxpayer/employer, the lender, surety, or other person is liable to the United States in an amount equal to the amount required to be withheld from such wages by the employer. An "other person" means any person who directly pays the wages of the employees of another person. It does not include a person acting only as agent of the employer. 26 C.F.R. 31.3505-1(c)(1).

Whether the LLC is an "other person" for purposes of section 3505(a) is complicated by the fact that state and federal law view the business from different perspectives. Under state law, the taxpayer/single member owner has no interest in the LLC's property. From this perspective, it appears that the LLC is a separate entity, which, as the direct payer of the payroll, may be held liable for the failure to remit withholdings. However,

for the purpose of federal tax law, the LLC has been disregarded as an entity separate from the taxpayer/single member owner. It has been treated like a trade name by which the company's single member owner conducts business. For purposes of assessing federal employment taxes, Notice 99-6 allows the single member owner to calculate, report, and pay the employment tax obligations under his own name and EIN. It also authorizes the disregarded LLC to separately calculate, report, and pay the employment tax obligations incurred with respect to employees of the LLC under its own name and EIN. Notice 99-6, 1999-3 I.R.B. 12. Having disregarded the LLC for federal tax purposes and having treated it like the taxpayer/single member owner for purposes of assessment, we doubt the efficacy of now treating the LLC as an "other person" for purposes of collection.

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