Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel (Small Business/Self Employed)

from: Mary Beth Carchia, Senior Technician Reviewer, Branch 3
(Passthroughs & Special Industries)

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subject:

This Chief Counsel Advice responds to your request for assistance dated June 6, 2008, in which you asked us to review your memorandum on the issue of who is liable for employment taxes following the administrative dissolution of a corporation in State. This memorandum has been coordinated with the Procedure and Administration Division and the Tax Exempt and Government Entities Division. This Chief Counsel Advice may not be used or cited as precedent.

LEGEND

X =

State =

H =

W =

Business =

Periods =

a =

b =

c =

d =

e =

ISSUE

For purposes of federal employment taxes, who is the employer with respect to wages paid to employees of an entity, X, whose corporate status was administratively dissolved under the laws of State, a community property state?

CONCLUSION

After its corporate dissolution, X is a disregarded entity and W and H, as husband and wife community property owners, are sole proprietors of the business and, thus, the employers for purposes of federal employment taxes.

FACTS

X was incorporated on a, under the laws of State, a community property state. H and W, who are husband and wife, were equal shareholders of X. X is engaged in the business of Business, which was formerly operated by W as a sole proprietorship. X was administratively dissolved by State on b, for failure to file an initial report with State's Secretary of State. X was never reinstated as a corporation by State.

In c, the Service audited X, and H and W to determine their federal income tax liability for taxable years d through e. X never filed Form 1120, U.S. Corporation Income Tax Return, for taxable years d through e. The Service asserted deficiencies in income tax liability against X, and H and W for those taxable years.

During the audit, X filed Form 1120S, U.S. Income Tax Return for an S Corporation, for each of taxable years d through e, though there is no evidence that X ever made an S corporation election. In addition, X petitioned the United States Tax Court for review of the deficiencies in income tax liability asserted against it by the Service. H and W filed an amended Form 1040, U.S. Individual Income Tax Return, for each of taxable years d through e, on which they, as sole proprietors, reported on

Schedule C (1040), Profit or Loss From Business, all receipts and expenses relating to the business operated by X.

Also in c, the Service separately investigated the liability for unpaid federal employment taxes incurred on wages paid in the business. The employment taxes at issue are for specified periods, Periods, after X's administrative dissolution. The Service concluded that X no longer existed as a corporation operating the business. Therefore, the employment taxes were assessed against W as the employer in a sole proprietorship.

LAW AND ANALYSIS

A. Classification of X

The core test of corporate existence for purposes of federal income taxation is always a matter of federal law. Whether an organization is to be taxed as a corporation under the Internal Revenue Code (Code) is determined by federal, not state, law. United States v. McDonald & Eide Inc., 865 F.2d 73, 76 (3d Cir. 1989) citing Ochs v. United States, 305 F.2d 844, 847 (Ct. Cl. 1962).

Under federal law, § 301.7701-1(a) of the Procedure and Administration Regulations provides that the Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. (Sections 301.7701-1 through 301.7701-3 are referred to as the "check-the-box" regulations).

Section 301.7701-2(a) provides that for purposes of §§ 301.7701-2 and 301.7701-3, a "business entity" is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-2(b) provides, in part, that for federal tax purposes, the term "corporation" means (1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; or (2) An association (as determined under § 301.7701-3). Thus, the check-the-box regulations confer automatic corporate status on organizations established under designated domestic corporation statutes (a "per se" corporation).

Section 301.7701-2(c)(1) provides that for federal tax purposes, the term "partnership" means a business entity that is not a corporation under § 301.7701-2(b) and that has at least two members.

Section 301.7701-2(c)(2) provides, in part, that for federal tax purposes, except as otherwise provided in § 301.7701-2(c), a business entity that has a single owner and is not a corporation under § 301.7701-2(b) is disregarded as an entity separate from its owner.

Section 301.7701-3(a) provides, in part, that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an "eligible entity") can elect its classification for federal tax purposes as provided in § 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Section 301.7701-3(b) provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in § 301.7701-3(d)) until the entity makes an election to change that classification under § 301.7701-3(c)(1).

Section 301.7701-3(b)(1) provides that except as provided in § 301.7701-3(b)(3), unless the entity elects otherwise, a domestic eligible entity is—(i) A partnership if it has two or more members; or (ii) Disregarded as an entity separate from its owner if it has a single owner.

Under Rev. Proc. 2002-69, 2002-2 C.B. 831, a "qualified entity" may be classified for federal tax purposes as either a disregarded entity or a partnership. A "qualified entity" is a business entity that (1) is wholly owned by a husband and a wife as community property under the laws of a state, a foreign country, or a possession of the United States; (2) has no person other than one or both spouses considered an owner for federal tax purposes; and (3) is not treated as a corporation under § 301.7701-2. If the qualified entity, and the husband and wife as community property owners, treat the entity as a disregarded entity for federal tax purposes, the Service will accept the position that the entity is a disregarded entity for federal tax purposes. If the qualified entity, and the husband and wife as community property owners, treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the Service will accept the position that the entity is a partnership for federal tax purposes.

Your memorandum indicates that under State law, a corporation that fails to file its initial report or its annual report when it is due, or to pay the annual license fees or

penalties when they become due may be administratively dissolved by State's Secretary of State. In addition, an administratively dissolved corporation continues its corporate existence but may not carry on any business, except that necessary to wind up and liquidate its business affairs in a manner consistent with State law. Moreover, amendments to the State Business Corporations Act abolished the de facto corporation and the corporation-by-estoppel doctrines. Thus, under the laws of State, an administratively dissolved corporation is no longer recognized as an operating corporate body, unless reinstated.

In this case, X was incorporated in State on a, after the effective date of the check-the-box regulations, by filing articles of incorporation with State's Secretary of State. Because X was a business entity organized under a state statute, no check-the-box election was required and X was classified as a per se corporation under § 301.7701-2(b) for federal tax purposes. X operated for approximately six months as a corporation under state law. However, X never submitted its required initial report and thus was administratively dissolved by State on b. As a result, X was no longer recognized as a corporate entity under State law. Consequently, X's status as a per se corporation for federal tax purposes terminated on b, and X became an eligible entity for purposes of § 301.7701-3(a).

As an eligible entity, X determines its entity classification under the check-the-box regulations. X made no check-the-box election pursuant to § 301.7701-3(a) to be classified as either an association or a partnership. Accordingly, X's entity classification is determined by the default classification rules under § 301.7701-3(b). Under the default classification rules, X ordinarily would be a partnership, because it has two members. However, X was owned solely by a husband and wife, H and W, as community property under the laws of State and was not treated as a corporation under § 301.7701-2. Thus, X, and H and W fall within the scope of Rev. Proc. 2002-69.

Relevant to Rev. Proc. 2002-69, X has been wholly owned by H and W, husband and wife, as community property under the laws of State since X's incorporation. No other person has been considered an owner for federal tax purposes. After X was administratively dissolved, X made no check-the-box election to be an association under § 301.7701-3. Thus, X constituted a "qualified entity" for purposes of Rev. Proc. 2002-69 and, at the choice of H and W, could be classified for federal tax purposes as either a disregarded entity or a partnership.

X, and H and W as community property owners, did not treat X as a partnership and file partnership returns after X's administrative dissolution. Thus, X is not a partnership for federal tax purposes. Instead, X filed no returns until c, when X filed Form 1120S for each of taxable years d through e. However, there is no evidence that X ever made an election to be treated as an S corporation either before or after its administrative dissolution by State.

During their audit for federal income taxes, H and W submitted an amended Form 1040 for each of taxable years d through e. On those amended returns, H and W reported all receipts and expenses from X's business on Schedule C as sole proprietors. Thus, H and W as community property owners of X chose to treat X as a disregarded entity for federal tax purposes. In accordance with Rev. Proc. 2002-69, the Service should accept that position taken by H and W. Consequently, after X's administrative dissolution on b, X should be treated as a disregarded entity owned by H and W, who are the sole proprietors of the business.

B. Employer with respect to wages paid to X's employees

Employment taxes consist of the Federal Insurance Contributions Act tax ("FICA"), the Federal Unemployment Tax Act tax ("FUTA") and the Collection of Income tax at the Source on Wages (income tax withholding), imposed under Chapters 21, 23, and 24 of Subtitle C of the Code, respectively. In general, the Code imposes liability for employment taxes on the "employer". An employer generally is required to withhold and pay over applicable taxes from employee's wages, pay employer taxes, make timely tax deposits, file employment tax returns, and issue wage statements to employees.

For purposes of income tax withholding, the employer is defined as the person for whom an individual performs any service as the employee of such person. Section 3401(d). The term "person" includes an individual, a trust, estate, partnership, association, company, or corporation. Section 7701(a)(1). Section 31.3401(d)-1(c) of the Employment Tax Regulations provides that the term "employer" may mean an individual or other unincorporated organization, group, or entity. The employer is required to withhold income taxes from wages paid to the employee and remit those taxes to the government. Section 3402.

FICA taxes are imposed on wages paid to employees with respect to employment. Section 3121(a). Section 3101 requires the employer to pay the employer share of FICA, and § 3102 requires the employer to deduct the employee share of FICA from wages paid to the employee. Every person is an employer for FICA tax purposes if he employs one of more employees. Section 31.3121(d)-2(a). An "employer" may be an individual or other incorporated organization, group, or entity. Section 31.3121(d)-2(b).

For FUTA purposes, an employer is defined as any person who "(A) during any calendar quarter in the calendar year or the preceding year paid wages of $1,500 or more, or (B) on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least one individual in employment for some portion of the day." Section 3306(a)(1).

In the case of a corporation, the Service does not generally assert direct employment tax liability against corporate officers. The reason for such treatment is that the corporation is recognized under federal tax law as a separate legal entity which

is primarily liable for employment taxes on wages paid to its own employees. However, in the instant case, the corporation has been dissolved by State. Following such dissolution, the business entity continued to operate as a disregarded entity. The activities of a disregarded entity are treated in the same manner as a sole proprietorship, branch, or division of the owner. Section 301.7701-2(a). Unlike a corporation, a sole proprietorship, branch, or division of the owner is not recognized as a separate legal entity under federal tax law. The owner of a disregarded entity is therefore primarily liable for employment taxes on wages paid to its own employees. See e.g. Littriello v. United States, 484 F.3d 372 (6th Cir. 2006); McNamee v. Department of Treasury, Internal Revenue Service, 488 F.3d. 100 (2nd Cir. 2007).

In this case, X was jointly owned and operated by H and W as husband and wife in a community property state, and treated as a disregarded entity pursuant to § 301.7701-2(a) and Rev. Proc. 2002-69. Accordingly, H and W are the employers liable for employment taxes on wages paid to employees of X.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call this office at (202) 622-3070 if you have any further questions.