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## The Employment Tax Challenge to The Check-the-Box Regulations

By Brant J. Hellwig and  
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When the check-the-box regulations were proposed roughly a decade ago, there was an extensive discussion regarding the Treasury Department's authority to implement such a sweeping change without congressional action.<sup>1</sup> Commentators often characterized the debate as academic because, as the regulations appeared to favor taxpayers across the board, it was widely believed that no one would have the standing and incentive to challenge their validity. In the recent case of *Littriello v. United States*,<sup>2</sup> however, the taxpayer challenged the validity of the regulations in the employment tax context — a context not considered in the original debate.

In *Littriello*, a single-member limited liability company failed to remit the full amount of income tax withholding and FICA taxes for compensation the LLC had paid to its employees. Because the check-the-box regulations classify the LLC as a disregarded entity for federal tax

purposes,<sup>3</sup> the IRS treated the sole owner of the entity as the employer liable for the relevant employment taxes.<sup>4</sup> The taxpayer responded by arguing that Treasury lacks the authority to abrogate the limited liability afforded to him under state law.

Thus far, the employment tax challenge to the check-the-box regulations has proven unsuccessful, as the district court in *Littriello* granted summary judgment in favor of the government. An appeal of the decision, however, is currently pending before the Sixth Circuit. This article analyzes the merits of that particular challenge to the check-the-box regulations and concludes that the position has considerable merit.

### I. Standard of Review

Under the seminal decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council*,<sup>5</sup> administrative regulations are subject to a two-step review.<sup>6</sup> The reviewing

<sup>3</sup>See reg. section 301.7701-3(b)(1) ("unless the entity elects otherwise, a domestic eligible entity is — ... (ii) Disregarded as an entity separate from its owner if it has a single owner").

<sup>4</sup>In discussing that case with colleagues, the first question often raised is why the government did not simply pursue the individual owner of the LLC under section 6672, which imposes a 100 percent penalty on any person who willfully fails to truthfully account for and pay over a required tax. The range of persons potentially subject to a section 6672 penalty, however, does not include the person who is required to collect, account for, and pay over the tax in the first place (in other words, the taxpayer bearing primary liability for the tax). See reg. section 301.6672-1. Because the check-the-box regulations disregard the existence of the single-member LLC and treat the LLC owner as the employer who is statutorily liable for the relevant employment taxes, the government would be foreclosed from pursuing collection against the LLC owner on a section 6672 responsible-party theory. (The government could have made the section 6672 argument in the alternative, assuming *arguendo* that the regulations are invalid regarding employment tax collection, but the government apparently chose not to do so.)

<sup>5</sup>467 U.S. 837 (1984).

<sup>6</sup>It is not entirely clear whether *Chevron* or a somewhat less deferential standard of review applies to tax regulations promulgated under the general delegation found in section 7805(a). See generally American Bar Association Section of Taxation Task Force on Judicial Deference (drafted by Irving Salem, Ellen P. Aprill, and Linda Galler), reprinted in *Tax Notes*, Sept. 13, 2004, p. 1231. See also *Swallows Holding, Ltd. v. Comm'r*, 126 T.C. No. 6 at 125-140, *Doc 2006-1541*, 2006 TNT 18-10 (2006) (J. Holmes dissenting). In this article, we assume the check-the-box regulations would be scrutinized under a *Chevron* standard of review. Because we conclude that the regulations are invalid under that standard, we would reach the same conclusion if a less deferential standard were to apply.

<sup>1</sup>See, e.g., William S. McKee, Willaim Nelson, and Robert Whitmire *Federal Taxation of Partnerships and Partners*, para. 3.08, at 3-102 (3d ed. 1997) (arguing that the regulations could be invalid); Philip F. Postlewaite and John S. Pennell, "JCT's Partnership Tax Proposal's — 'Houston, We Have a Problem,'" *Tax Notes*, July 28, 1997, p. 527 (same); American Bar Association Section of Taxation, "Comments on Notice 95-14, 1995-14 IRB 7, Proposed Revisions to Entity Classification Rules," *Doc 95-7226*, 95 TNT 145-25 (July 17, 1995) (arguing that the regulations are valid); Association of the Bar of the City of New York, Committee on Taxation of Partnerships and Other Pass-Through Entities, "Report on 'Check the Box' Proposal for Entity Classification," *Doc 95-8069*, 95 TNT 166-43 (June 27, 1995) (same); Victor E. Fleischer, "'If It Looks Like a Duck': Corporate Resemblance and the Check-the-Box Elective Tax Classification," 96 *Colum. L. Rev.* 518, 532-537 (1996) (same); Staff of Joint Committee on Taxation, 105th Cong., *Review of Selected Entity Classification and Partnership Tax Issues* 13-17 (Joint Comm. Print 1997).

<sup>2</sup>95 AFTR2d 2005-2581, 2005 WL 1173277, *Doc 2005-12029*, 2005 TNT 106-20 (W.D. Ky. 2005).

court first must determine whether Congress "has directly spoken to the precise question at issue,"<sup>7</sup> employing traditional tools of statutory construction. That analysis is a contextual one, in which statutory terms must be construed "with a view to their place in the overall statutory scheme,"<sup>8</sup> and to "fit, if possible, all parts into an harmonious whole."<sup>9</sup> If the reviewing court concludes that Congress has addressed the specific issue at hand, then the agency interpretation must yield to the unambiguous intent of Congress as expressed in the statute.<sup>10</sup> If, however, the court determines that Congress has not directly addressed the issue, the court will proceed to examine whether the agency's resolution of the issue represents a "reasonable policy choice."<sup>11</sup>

## II. Relevant Statutes

The dispute in *Littriello* concerned the identification of the proper taxpayer for employment tax purposes in the context of a single-member LLC. Under the check-the-box regulations, a single-member LLC is disregarded as an entity separate from its owner.<sup>12</sup> By definition, that approach leaves the owner of the entity as the party bearing primary liability for employment taxes.<sup>13</sup> The issue is whether that treatment constitutes a permissible interpretation of the employment tax statutes under a *Chevron* analysis. As discussed below, the various employment tax statutes impose liability for the tax on the employer. Therefore, in terms of the first step of the *Chevron* analysis, the "precise question at issue" is whether the single-member LLC or the owner constitutes the employer for employment tax purposes. Our analysis begins with the text of the relevant statutes.

### A. Income Tax Withholding

Section 3402(a) requires every employer that makes a payment of wages to withhold appropriate income taxes on behalf of the employee. Section 3403 provides that the employer shall be liable for the payment of the withheld amounts. The term "employer" for income tax withhold-

ing purposes is defined as "the person for whom an individual performs or performed any service . . . as the employee of such person."<sup>14</sup>

### B. FICA Taxes

Section 3102(a) requires the employer to withhold an individual's share of the taxes due under FICA. Under section 3102(b), the employer is liable for payment of the withheld amounts. Turning to the employer's share of the FICA taxes, section 3111(a) imposes liability for those amounts on the employer. The FICA provisions do not contain an express definition of the term "employer." Nonetheless, its meaning can be gleaned from the definition of employment for FICA tax purposes, which includes "any service . . . performed . . . by an employee for the person employing him."<sup>15</sup> For FICA tax purposes, therefore, the employer is the person who employs the employee.

### C. FUTA Taxes

Section 3301 imposes liability on every employer for taxes due under FUTA. An "employer" for that purpose is defined as "any person" who paid a threshold amount of wages or employed at least one individual for a threshold number of days.<sup>16</sup>

All of the above statutes impose liability for the appropriate tax on the employer. Those statutes, in one form or another, all define the employer as the "person" who employs the employee. The definition of a person thus takes on critical importance in that context. From a contractual standpoint, the LLC serves as the employer of its employees.<sup>17</sup> Thus, if the LLC constitutes a person for tax purposes, then the entity would unambiguously constitute the employer statutorily liable for the various employment taxes. Alternatively, if the single-member LLC is not a person for tax purposes (consistent with the default classification of the entity under the check-the-box regulations), the LLC owner is the employer statutorily liable for the employment taxes. Resolution of the dispute in *Littriello* thus ultimately turns on whether the

<sup>7</sup>*Id.* at 842.

<sup>8</sup>*Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) (quoting *Davis v. Mich. Dep't of Treasury*, 489 U.S. 803, 809 (1989)).

<sup>9</sup>*Id.* (quoting *F.T.C. v. Mandel Bros., Inc.*, 359 U.S. 385, 389 (1959)).

<sup>10</sup>*Chevron*, 467 U.S. at 842-843.

<sup>11</sup>*Id.* at 843.

<sup>12</sup>A single-member LLC could elect to be classified as a corporation. See reg. section 301.7701-3(a). In that case, the IRS takes the position that the LLC is the party primarily liable for employment taxes. For purposes of this article, we assume that, except where otherwise indicated, all single-member LLCs do not elect to be classified as a corporation.

<sup>13</sup>The phrase "primary liability" in this article is used to indicate the initial liability for the tax imposed by the statute. The phrase is intended to distinguish between this initial liability and various types of third-party liability for the relevant tax, such as liability under section 6672 (imposing a responsible party penalty) or under various theories of transferee liability (such as fraudulent conveyance).

<sup>14</sup>Section 3401(d) (emphasis added).

<sup>15</sup>Section 3121(d) (emphasis added). The FICA regulations confirm that the employer is the person who employs the employee. See reg. section 31.3121(d)-2(a). ("Every person is an employer if he employs one or more employees.")

<sup>16</sup>Section 3306(a) (emphasis added).

<sup>17</sup>By that we mean the LLC is the party contractually obligated to pay the employees' compensation and the LLC is the beneficiary of the services of the employees. If the owner were the beneficiary of the employees' services and if, nevertheless, the employees were paid by the LLC, the LLC could be disregarded under a sham entity theory. Cf. *Comm'r v. Bollinger*, 485 U.S. 340 (1988) (disregarding corporation that lacks economic substance). For example, if a person formed a single-member LLC solely to employ a nanny for the person's children, the entity could be disregarded as the employer under the sham entity theory. The same result would apply if the person formed a corporation for the same purpose. In *Littriello*, the LLC operated a nursing home; therefore, the sham entity doctrine would not apply. We assume in this article that all entities are bona fide operating businesses that would not be disregarded under the sham entity doctrine.

regulatory treatment of a single-member LLC as a "non-person" is foreclosed by the statute.

### III. Definition of Person

None of the employment tax statutes contain a definition of the term "person."<sup>18</sup> Section 7701(a)(1), however, provides a default definition for the entire code. Under that subsection, a "person" includes "an individual, a trust, estate, partnership, association, company or corporation."

Given the emphasis that the current Supreme Court places on plain meaning in statutory interpretation,<sup>19</sup> it would be tempting to conclude that an LLC constitutes a person for tax purposes simply on the basis that section 7701(a)(1) defines a person as including a "company." However, that reference in the statute was probably intended to refer to a "joint-stock company," a forerunner to the modern corporation. For instance, section 7701(a)(3) defines a corporation as including "associations, joint-stock companies and insurance companies."<sup>20</sup> That interpretation of the word "company" is supported by the fact that LLCs did not appear on the scene until the late 1980s, many years after section 7701(a)(1) was enacted.<sup>21</sup>

Assuming that a single-member LLC is not a "company," could it be considered a "partnership" for purposes of section 7701(a)(1)? Section 7701(a)(2) defines a partnership as "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."<sup>22</sup> A single-member LLC quite clearly satisfies the literal terms of that definition; it is an unincorporated state law entity

that carries on a business, financial operation, or venture.<sup>23</sup> The only hesitation in reaching that conclusion stems from the state law requirement that a partnership must have at least two members.<sup>24</sup> That state law requirement is reflected in the regulations interpreting section 7701. Reg. section 301.7701-1(a)(2) provides that a partnership exists if "participants" carry on a trade or business, or if "co-owners" lease an apartment building. More to the point, reg. section 301.7701-2(c)(1) flatly states that a "partnership" means a business entity other than a corporation that has at least two members.<sup>25</sup> Although nothing in the statutory definition of a partnership expressly requires the existence of multiple owners,<sup>26</sup> the historical state law connotation of the term may create sufficient ambiguity that Treasury's multiple-member requirement is permissible.

Ultimately, it is not necessary to determine whether a single-member LLC constitutes a company or a partnership to resolve whether the LLC constitutes a person for tax purposes. Several courts have found that the enumerated list of entities that constitute a "person" under section 7701(a)(1) is nonexclusive.<sup>27</sup> The breadth of the statutory term was explored by the Tenth Circuit in

simply refer to the regulations interpreting the definition of a partnership under section 7701(a)(2). See reg. section 1.761-1(a)(1).

<sup>23</sup>This assumes that the LLC is not a sham entity lacking economic substance.

<sup>24</sup>See Uniform Partnership Act (1997), section 101(6); Revised Uniform Limited Partnership Act (1976 with 1985 amendments), section 101(7). Here again, it is worth noting that when section 7701(a)(2) was enacted in its current form, no noncorporate single-member business entities existed under state law.

<sup>25</sup>See also reg. section 1.708-1(b)(1) (sale of partnership interests to the sole remaining partner, or death of one partner in a two-person partnership, terminates the partnership).

<sup>26</sup>See Jerry S. Williford and Donald H. Standley, "How Should Single Member LLCs Be Classified for Federal Tax Purposes?" 2 J. *Lim. Liab. Companies* 27, 34 (1995) (noting that "there appears to be no requirement for federal tax purposes that a partnership actually consist of more than one partner"). Cf. *Nichols v. Comm'r*, 32 T.C. 1322 (1959) (holding that an arrangement between a medical doctor and his nondoctor spouse constituted a federal tax partnership even though state law precluded them from forming a partnership). For an article advocating that the definition of a partnership for tax purposes should be interpreted narrowly to apply only when flow-through tax treatment is necessary, see Bradley T. Borden, "The Federal Definition of Tax Partnership," 43 *Hous. L. Rev.* — (forthcoming 2006).

<sup>27</sup>See, e.g., *Estate of Wycoff v. Comm'r*, 506 F.2d 1144, 1151 (10th Cir. 1974) (definition includes individual states and the United States); *Chickasaw Nation v. United States*, 208 F.3d 871, 879, Doc 2000-10466, 2000 TNT 69-19 (10th Cir. 2000) (definition includes Native American tribes and tribal organizations); *Flandreau Santee Sioux Tribe v. United States*, 197 F.3d 949, Doc 1999-37646, 1999 TNT 230-11 (8th Cir. 1999) (definition includes Native American tribes); *Fairfax County Economic Development Authority v. Comm'r*, 77 T.C. 546, 557 (1981) (definition includes U.S. government and agencies thereof). See also section 7701(c) (providing that the terms "includes" and "including" when used in a definition shall not be deemed to exclude other things otherwise within the meaning of the defined term).

<sup>18</sup>Although there is no statutory definition of a person that is unique to the employment tax context, reg. section 31.0-2(a)(8) defines a person for purposes of the various employment taxes to include "an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or syndicate, group, pool, joint venture or other unincorporated organization or group, through or by means of which any business, financial operation, or venture is carried on." That definition would appear to include a single-member LLC that operates a business. As a result, it is inconsistent with the check-the-box regulations' treatment of those LLCs.

<sup>19</sup>See Noel B. Cunningham and James R. Repetti, "Textualism and Tax Shelters," 24 *Va. Tax Rev.* 1, 14-17 (2004).

<sup>20</sup>Section 7701(a)(3). That interpretation of "company" would render the term superfluous as used in the definition of person because persons include corporations (under section 7701(a)(1)) and corporations include joint-stock companies (under section 7701(a)(3)). Nevertheless, the term "association" in section 7701(a)(1) is already transparently superfluous because persons include both associations and corporations (under section 7701(a)(1)) and corporations include associations (under section 7701(a)(3)).

<sup>21</sup>See Patrick E. Hobbs, "Entity Classification: The One Hundred-Year Debate," 44 *Cath. U. L. Rev.* 437, 515-517 (describing the proliferation of LLCs).

<sup>22</sup>Section 7701(a)(2) (emphasis added). Section 761(a) provides a virtually identical definition of a partnership for subchapter K purposes. In fact, the regulations under section 761(a)

(Footnote continued in next column.)

*Chickasaw Nation v. United States*.<sup>28</sup> The issue in *Chickasaw Nation* was whether a tribal organization's activities were subject to certain excise taxes, which in turn depended on whether a tribal organization was a person under section 7701(a)(1). After determining that "Congress must have intended to incorporate a broad definition" of the term, the Tenth Circuit concluded that "Congress unambiguously intended for the word 'person' . . . to encompass all legal entities, including Indian tribes and tribal organizations, that are the subject of rights and duties."<sup>29</sup> A single-member LLC is a legal entity that is statutorily endowed with rights and duties under state law, and those rights and duties are separate and distinct from those of its owner. The analysis in *Chickasaw Nation* thus suggests, rather strongly, that a person unambiguously includes a single-member LLC under section 7701(a)(1).

Long-standing regulations that substantially predate the check-the-box regulations support that conclusion. Reg. section 301.7701-6(a), which interprets section 7701(a)(1), defines a person as including "an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group."<sup>30</sup> Similarly, reg. section 31.0-2(a)(8) defines a person for employment tax purposes as including "an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or syndicate, group, pool, joint venture or other unincorporated organization or group, through or by means of which any business, financial operation, or venture is carried on."<sup>31</sup> Those regulations cannot be reconciled with the treatment of a single-member LLC as a disregarded entity (that is, a non-person) under the check-the-box regulations.<sup>32</sup> By itself, that inconsistency would not be fatal — one could argue that the check-the-box regulations supersede the prior regulations. We offer the existence of those long-standing regulations simply as evidence that the most natural

reading of the term "person" under section 7701(a)(1) is a broad one that includes any legal entity recognized under state law.

Because the LLC in *Littriello* constitutes a person for federal tax purposes, it is the employer for purposes of sections 3403, 3102, and 3301. One might argue, nevertheless, that the owner could be considered the employer under those statutes as well.<sup>33</sup> The recent Supreme Court decision in *United States v. Galletti*,<sup>34</sup> however, precludes that argument. In *Galletti*, a general partnership failed to pay significant amounts of employment tax. Although the IRS timely assessed the deficiency against the partnership as the employer primarily liable for that tax, the general partners argued that the IRS was prohibited from collecting the tax from them because the IRS failed to timely assess the tax against them in their individual capacities. Citing their joint and several liability for the partnership's debts, the partners argued that they, like the partnership, were taxpayers from whom a tax could not be collected without a prior assessment.<sup>35</sup> Somewhat surprisingly, the general partners' argument prevailed before the bankruptcy court as well as before the district court and Ninth Circuit on appeal.<sup>36</sup> The Supreme Court granted certiorari and, in a unanimous decision, reversed. In doing so, the Court determined that the government needed only to assess the tax against the person who bore primary liability for payment of the tax.<sup>37</sup> Because *Galletti* involved employment taxes, that person was the employer, according to sections 3403, 3102, and 3301. The Court then concluded that only the partnership — and not any of its general partners — was the employer because "under California's partnership principles, a partnership and its general partners are separate entities."<sup>38</sup> At that point, the joint and several liability that general partners bear for the entity's debts under applicable state law permitted the IRS to collect from the partners in their individual capacity, without the necessity of a separate assessment.<sup>39</sup> Like partnerships formed under state law, LLCs are entities separate and distinct from their owners under local law. Therefore, under *Galletti*, if the LLC is the employer, its owner(s)

<sup>28</sup>208 F.3d 871 (10th Cir. 2000).

<sup>29</sup>*Id.* at 879 (emphasis added). See also *Estate of Wycoff v. Comm'r*, *supra* note 27, at 1151 (concluding that the definition of person under sections 2056(b)(5) and 7701(a)(1) includes individual states and the United States). In *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 125 S. Ct. 2688 (2005), a majority of the Supreme Court concluded that executive agencies are generally not bound by prior judicial interpretations of the statutes they are charged with administering unless the prior judicial interpretation stems from a *Chevron* step-one-type of analysis. *Id.* at 2700. It is notable, therefore, that in *Chickasaw Nation* the Tenth Circuit found that its broad construction of section 7701(a)(1) was based on unambiguous congressional intent.

<sup>30</sup>Reg. section 301.7701-6(a) (emphasis added). That definition originated in old reg. section 301.7701-1(a), which was promulgated on Nov. 11, 1980, see T.D. 6503, 1960-2 C.B. 409, and superseded by reg. section 301.7701-6(a) on Dec. 18, 1996. See T.D. 8697, 61 Fed. Reg. 66584.

<sup>31</sup>Reg. section 31.0-2(a)(8) (emphasis added). That definition was originally promulgated on Dec. 20, 1960. See T.D. 6516.

<sup>32</sup>The employment tax regulations treat the LLC as a person for employment tax purposes, while the check-the-box regulations treat the LLC as a tax nothing for federal tax purposes (including employment tax purposes).

<sup>33</sup>If that argument were to prevail, owners of single-member LLCs also would be primarily liable for their LLC's employment taxes, and *Littriello's* challenge to the regulations would fail.

<sup>34</sup>541 U.S. 114, Doc 2004-6422, 2004 TNT 57-17 (2004).

<sup>35</sup>*Id.* at 120.

<sup>36</sup>See *In re Galletti*, 86 AFTR2d 2000-6433, 2000 WL 1682960, Doc 2000-26676, 2000 TNT 202-12 (Bankr. C.D. Cal. 2000); *In re Galletti*, 88 AFTR2d 2001-5580, 2001 WL 752652, Doc 2001-22549, 2001 TNT 166-49 (C.D. Cal. 2001); *In re Galletti*, 314 F.3d 336, Doc 2002-18473, 2002 TNT 155-9 (9th Cir. 2002).

<sup>37</sup>In other words, the Court determined that no separate assessment was necessary for the IRS to collect the tax debt of an entity owner who was liable for the tax because of the owner's joint and several liability for the entity's debts under applicable state law.

<sup>38</sup>*Supra* note 34, at 121-122.

<sup>39</sup>In *Galletti*, the general partners were responsible for the partnership's employment tax debts because, under state law partners were jointly and severally liable for all of a general partnership's debts. *Id.* at 116. In the LLC context, however, owners are generally not responsible for the entity's debts.

will not be considered the employer(s) simply by virtue of their ownership interests in the LLC.<sup>40</sup>

#### IV. Statutory Context

Thus far, we have concluded that, based on the statutory scheme and the *Galletti* decision, (1) an LLC is a person under section 7701(a)(1);<sup>41</sup> (2) if the LLC employs employees, it will be considered the employer for purposes of sections 3403, 3102, and 3301; and (3) if the LLC is considered the employer for those purposes, its owners will not be considered an employer merely by virtue of their ownership interests in the LLC. As a result, the LLC — and not its owner(s) — is the party responsible for paying employment taxes. Thus, the check-the-box regulations, to the extent they treat the owner of an LLC as the employer bearing primary liability for those taxes, would appear to be invalid under step one of the *Chevron* analysis.

As noted above, however, the *Chevron* analysis is a contextual one. We will now analyze how the regulations' treatment of a single-member LLC comports with other provisions of the code and existing government rulings. In the end, this contextual analysis confirms the existence of a backdrop principle that, absent explicit statutory authorization, the IRS is governed by state limited liability law rules in determining whether owners of an entity are responsible for the entity's employment tax debts. As a result, this contextual analysis supports the view that the regulations' treatment of a single-member LLC — which effectively abrogates the limited liability protections afforded by state law — is invalid.

For example, several courts have recognized that the enactment of section 6672 is based on the notion that state law limited liability principles will be respected except when Congress legislates to the contrary.<sup>42</sup> Section 6672 imposes a 100 percent penalty on "responsible persons" who fail to collect and remit employment taxes owed by

the employer.<sup>43</sup> The Ninth Circuit concluded that "it is evident from the face of the section that it was designed to cut through the shield of organizational form and impose liability on those actually responsible for an employer's failure to withhold and pay over the tax."<sup>44</sup> That "shield of organizational form" refers to an entity owner's limited liability for entity-level debts. Congress's enactment of section 6672 thus appears to confirm the existence of the backdrop principle that limited liability protections under state law generally will be respected for federal tax purposes.

Existing case law<sup>45</sup> and IRS rulings<sup>46</sup> are also based on this presumed respect for state law limited liability principles. For example, in Rev. Rul. 2004-41,<sup>47</sup> the IRS considered whether members of a multiple-member LLC could be held responsible for the LLC's unpaid employment taxes. The IRS first determined that none of the owners of an LLC bear joint and several liability for the debts of the entity under state law, in contrast with general or limited partnerships. As a result, the IRS concluded that it could not pursue collection of the employment taxes from any of the members in their individual capacities. The ruling noted, however, that in some situations the IRS could proceed against some or all of the members under a fraudulent conveyance theory (under applicable state law) or a responsible person theory (under section 6672). That ruling, together with cases that adopt a similar analysis,<sup>48</sup> suggests that limited liability protections of state law are respected in tax collection matters except when Congress legislates to the contrary.

Because the check-the-box regulations effectively abrogate state law limited liability protection with respect to federal tax debts of single-member LLCs, they violate this backdrop principle. As a result, the statutory context serves only to support the view that the check-the-box regulations are invalid to the extent they impose primary liability on the owner for federal employment tax debts of a single-member LLC.

<sup>40</sup>As discussed in note 29 *supra*, a majority of the Supreme Court recently determined that executive interpretations generally trump prior *Chevron* step-two judicial interpretations. See *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, *supra* note 29, at 2700. In analyzing whether Treasury would be bound by *Galletti*, it would be necessary to determine whether *Galletti* was based on a *Chevron* step-one analysis (which would bind Treasury) or step-two analysis (which would allow Treasury to trump the Court's interpretation through regulations). Based on the text of the Court's opinion in *Galletti*, it would appear that *Galletti* was based on a *Chevron* step-one analysis and as such would bind Treasury. In any event, even if Treasury could conceivably argue that it is not absolutely bound by *Galletti*, it must be remembered that *Galletti* was a recent 9-0 government victory. It would be unlikely that the government would reverse course and argue a theory that would result in taxpayers like *Galletti* now prevailing.

<sup>41</sup>As discussed in note 17 *supra*, that assumes the LLC would not be disregarded under the sham entity doctrine.

<sup>42</sup>See, e.g., *Pacific National Insurance Company v. United States*, 422 F.2d 26, 31 (9th Cir. 1970); *McGlothlin v. United States*, 720 F.2d 6, 8 (6th Cir. 1983); *Turner v. United States*, 423 F.2d 448, 449 (9th Cir. 1970).

<sup>43</sup>For a discussion of why the government in *Littriello* did not proceed under a section 6672 theory, see note 4 *supra*.

<sup>44</sup>See *Pacific Nat'l Ins. Co.*, *supra* note 42, at 31 (emphasis added).

<sup>45</sup>See, e.g., *United States v. Papandon*, 331 F.3d 52, 55-56, Doc 2003-13583, 2003 TNT 110-61 (2d Cir. 2003); *Remington v. United States*, 210 F.3d 281, 283, Doc 2000-11107, 2000 TNT 74-63 (5th Cir. 2000); *United States v. Hays*, 877 F.2d 843, 844 note 3 (10th Cir. 1989); *Calvey v. United States*, 448 F.2d 177, 180 (6th Cir. 1971) (each concluding that state law determines whether owners are jointly and severally liable for federal tax debts of an entity).

<sup>46</sup>See, e.g., Rev. Rul. 54-213, 1954-1 C.B. 285 (limited partners are generally not responsible for a partnership's tax debts); Rev. Rul. 2004-41, 2004-1 C.B. 845, Doc 2004-9361, 2004 TNT 85-14 (members of a multimember LLC are generally not responsible for the LLC's tax debts).

<sup>47</sup>Rev. Rul. 2004-41 C.B. 845.

<sup>48</sup>See authorities cited in note 45 *supra*.



## V. The Elective Nature of the Regulations

One counterargument to our conclusion is based on the elective nature of the check-the-box regulations. Under the regulations, a single-member LLC can elect to be disregarded, which would subject its owner to potential employment tax liability. Alternatively, the LLC can elect to be treated as a corporation, thereby insulating the owner from that liability.<sup>49</sup> If corporate treatment is elected, the LLC would be respected as an entity separate from its sole owner, with the LLC (and not the owner) thus constituting the employer liable for payment of employment taxes attributable to compensation paid to the LLC's employees. The argument can be made that, if the member chooses noncorporate treatment, it is effectively waiving whatever rights to limited liability it otherwise would have had under state law regarding federal tax debts of the LLC.<sup>50</sup> This is an estoppel-type argument: The sole owner cannot complain about the adverse results that flow from a choice he has made.

Whatever merits this argument might have as a policy matter, it is quite difficult to reconcile with the statutory structure. Recall that the critical statutory provision is the definition of person under section 7701(a)(1) and that the definition has been held to unambiguously include all entities vested with rights and obligations under state law.<sup>51</sup> The question whether something is or is not a person thus depends on an analysis of state law. In that regard, the check-the-box election is irrelevant. From a state law perspective, the check-the-box election has no effect on the entity's rights and obligations.<sup>52</sup> Further, there is nothing in section 7701(a)(1) that suggests that an entity recognized under state law could waive its status as a person or that "personhood" under the statute is somehow elective.

Even if one remained sympathetic to the estoppel argument, it should be noted that the election of a single-member LLC to be classified as a corporation carries potentially significant costs. For instance, corporate treatment would trigger tax on the distribution of appreciated property from the entity to the owner, even if a subchapter S election were made. Further, if an S election were made, the entity would be precluded from (1) admitting some individuals (namely, nonresident aliens) and entities as new members and (2) offering a preferred equity interest as a means of attracting new

investment, provided that the corporation wanted to preserve flow-through income tax treatment. Simply put, a single-member LLC's ability to insulate the member from employment tax liability is not as painless as merely checking the appropriate box on Form 8832.

## VI. Policy Implications

The primary purpose of this article is to examine the validity of the check-the-box regulations regarding the employment tax treatment of a single-member LLC under the *Chevron* framework. Nevertheless, it is worth noting that our conclusion is justified on policy grounds as well. If the taxpayer in *Littriello* were to prevail, it would mean that the IRS could not treat the LLC owner as the employer statutorily liable for the employment taxes attributable to compensation paid to the employees of the LLC. Instead, to proceed against the owner, the IRS would be forced to use section 6672 or a third-party liability theory, just as it would in cases involving a state law corporation (whether wholly owned or otherwise and whether or not an S election is made), a multimember LLC, or a single-member LLC that checked the box. From a state law limited liability perspective, those entities are entirely indistinguishable from a single-member LLC; accordingly, treating a single-member LLC that does not check the box so differently from those entities regarding employment tax liabilities makes little sense.

Further, the regulations create traps for the unwary. For example, in choosing between forming a wholly owned S corporation and a single-member LLC, the owner would need to consider, in addition to the other choice-of-entity considerations, the effective waiver of limited liability for federal tax debts if the LLC form were chosen. Similarly, the regulations create an unfortunate incentive to form multimember LLCs (taxed under subchapter K) rather than single-member LLCs to avoid the problem in some instances. A taxpayer sometimes might be well-advised to create a nominal second owner to create a partnership rather than a disregarded entity.<sup>53</sup> In pushing taxpayers into subchapter K, the regulations create additional and unnecessary administrative costs for both taxpayers and the government.<sup>54</sup>

The recent proposed amendments to the check-the-box regulations are based on the notion that the employment tax treatment of single-member LLCs under the current regulations is not ideal. In late 2005 Treasury

<sup>49</sup>Reg. section 301.7701-3(a).

<sup>50</sup>Indeed, that argument recently prevailed at the trial court level in *Kandi v. United States*, 97 AFTR2d 2006-721, 2006 WL 83463 (W.D. Wash. 2006). That case involved facts and circumstances almost identical to *Littriello*. In *Kandi*, however, the taxpayer did not challenge the validity of the check-the-box regulations and instead asserted that the IRS was misreading and misapplying the regulation. In rejecting the taxpayer's position, the court concluded that "any personal liabilities . . . are attributable to [taxpayer's] effective waiver of the LLC's limited liability protection, rather than affirmative IRS attempts to pierce the veil." *Id.* at note 5.

<sup>51</sup>See notes 27-29 *supra* and accompanying text.

<sup>52</sup>While the election may have an effect on the state tax obligations of the owner or the company, it has no effect on its rights and obligations under state nontax law.

<sup>53</sup>That planning option would be most relevant when section 6672 would be difficult for the IRS to utilize against the owner. For example, if the LLC were manager-managed and the owner had little or no day-to-day participation in the business, the owner might not constitute a responsible person under section 6672. If so, forming a partnership would insulate the owner from liability if the manager were to abscond with withheld taxes.

<sup>54</sup>It could also result in litigation on the issue of whether the nominal owner should be respected as an owner or disregarded. If the nominal owner were disregarded, the LLC would be disregarded and, under the regulations, the IRS could proceed against the real owner directly.

issued proposed regulations that would treat a single-member LLC as a separate entity for employment tax reporting and collection purposes, even if the LLC elects to be treated as a disregarded entity.<sup>55</sup> The preamble to the regulations states that Treasury 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."<sup>56</sup>

### VII. Conclusion

In current form, the check-the-box regulations disregard a single-member LLC as an entity separate from its owner for federal tax purposes unless the entity elects to be taxed as a corporation. In the employment tax context,

the regulations have the effect of rendering the owner the person primarily liable for the employment taxes attributable to compensation paid to the entity's employees. The relevant employment tax statutes, however, impose that liability on the employer. Because a single-member LLC satisfies the definition of a person under section 7701(a)(1), the LLC constitutes the employer that is statutorily liable for the relevant employment taxes. The current treatment of a single-member LLC under the check-the-box regulations as a disregarded entity or "tax nothing" thus contradicts the statutes it interprets. Further, by disregarding the LLC as an entity for employment tax purposes, the regulations ignore the traditional respect that has been afforded to state limited liability law in the federal tax collection arena. While Congress could certainly impose liability for an LLC's unpaid employment taxes on the entity's owners (and, in fact, has done so through section 6672 in some circumstances), Treasury appears to have exceeded its authority when it attempted to do so by regulation.

<sup>55</sup>See REG-114371-05, 2005-45 IRB 930, Doc 2005-21024, 2005 TNT 200-8.

<sup>56</sup>*Id.* at 931.

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