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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 31 and 301

[TD 9554]

RIN 1545-BJ07

Extending Religious and Family Member FICA and FUTA Exceptions to  
Disregarded Entities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations amending 26 CFR parts 31 and 301. These regulations extend the exceptions from taxes under the Federal Insurance Contributions Act (“FICA”) and the Federal Unemployment Tax Act (“FUTA”) under sections 3121(b)(3) (concerning individuals who work for certain family members), 3127 (concerning members of religious faiths), and 3306(c)(5) (concerning persons employed by children and spouses and children under 21 employed by their parents) of the Internal Revenue Code (“Code”) to entities that are disregarded as separate from their owners for federal tax purposes. The temporary regulations also clarify the existing rule that the owners of disregarded entities, except for qualified subchapter S subsidiaries, are responsible for backup withholding and related information reporting requirements under section 3406. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the

notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability see §§31.3121(b)(3)-1T(e), 31.3127-1T(d), 31.3306(c)(5)-1T(e), 301.7701-2T(e)(5).

FOR FURTHER INFORMATION CONTACT: Joseph Perera (202) 622-6040 (not a toll free call).

SUPPLEMENTARY INFORMATION:

### **Background**

This document contains final and temporary regulations amending the Employment Tax Regulations (26 CFR part 31) and the Procedure and Administration Regulations (26 CFR part 301) to extend the FICA and FUTA exceptions for family members and religious sect members to certain entities that are disregarded as separate from their owners for federal tax purposes under §301.7701-2(c). Section 301.7701-2(c)(2)(i) provides that generally, except as otherwise provided, 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. Prior to 2009, single-member entities disregarded as separate from their owners were generally disregarded for employment taxes and certain other requirements of law arising under subtitle C. 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). Prior to 2009, the owner of the disregarded entity

was 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.

Recent changes to §301.7701-2(c)(2)(iv) provide that, with respect to wages paid after December 31, 2008, a disregarded entity is treated as a separate entity for purposes of employment taxes imposed under Subtitle C and related reporting requirements. In addition, the separate entity is treated as a corporation for purposes of employment taxes imposed under Subtitle C and related reporting requirements. Therefore, the entity, rather than the owner, is considered to be the employer of any individual performing services for the entity.

Sections 3111 and 3301 of the Code impose FICA and FUTA taxes, respectively, on the employer in an amount equal to a percentage of the wages paid by that employer with respect to employment. Under section 3101, FICA tax is also imposed on the employee. Sections 3121(b) and 3306(c) define employment for FICA and FUTA purposes as any service, of whatever nature, performed by an employee for the person employing him. However, there are some services which are explicitly excepted from the definition of employment. For example, section 3121(b)(3)(A) provides that service performed by a child under the age of 18 in the employ of his father or mother is not considered employment for FICA purposes. Section 3121(b)(3)(B) provides that service performed by an individual under the age of 21 employed by his father or mother, or performed by an individual employed by his spouse or son or daughter (subject to certain conditions) for domestic service in a private home of the

employer is not considered employment for FICA purposes. Section 3306(c)(5) provides that service performed by an individual in the employ of his son, daughter, or spouse, and service performed by a child under the age of 21 in the employ of his father or mother are not considered employment for FUTA purposes.

Prior to the recent changes to §301.7701-2(c), the services a family member performed for a disregarded entity wholly owned by another family member could qualify for the exceptions under sections 3121(b)(3) and 3306(c)(5) if all the requirements were satisfied, as the individual family member owner was treated as the employer. However, due to the recent changes to the regulations, family members can no longer qualify for the FICA and FUTA exceptions that apply to family employment because §301.7701-2(c)(2)(iv) regards the disregarded entity as a separate entity and treats the separate entity as a corporation for employment tax purposes. Sections 31.3121(b)(3)-1(c) and 31.3306(c)(5)-1(c) explicitly state that services performed in the employ of a corporation are not within the exceptions from employment that apply because of the existence of a family relationship between the employee and the individual employing him.

Section 3127 provides an exception from FICA taxes where both the employer and the employee are members of a religious faith opposed to participation in the Social Security Act. Both the employer and the employee must be members of a recognized religious sect and both must have filed and had approved an application certifying that they are members of a qualifying

religious faith. Prior to the recent changes made to §301.7701-2(c), service performed by a member of a qualifying religious sect for a disregarded entity wholly owned by another member of a qualifying religious sect could qualify for this exception as the individual sect member was considered to be the employer. However, as a result of the recent changes to §301.7701-2(c)(2)(iv), the disregarded entity is regarded as a separate entity for employment tax purposes and the separate entity is treated as a corporation. As a corporation, the entity cannot be considered a member of a qualifying religious sect. Therefore, the exception cannot apply, as the employer would not be a member of a qualifying religious sect.

Section 301.7701-2(c)(2)(iv) treats disregarded entities as corporations for employment tax purposes. Such entities cannot qualify for the FICA and FUTA exceptions contained in sections 3121(b)(3), 3127, and 3306(c)(5) because the individual owner is no longer considered the employer. The IRS and the Treasury Department did not intend to render these exceptions inapplicable to disregarded entities that were eligible for the exceptions prior to the effective date of the new regulations in §301.7701-2(c). The inability of these entities to benefit from the exceptions for family employees and members of religious faiths has an adverse impact on small businesses. Accordingly, a change is necessary to correct this problem.

While §301.7701-2(c)(2)(iv) treats an entity that is disregarded as an entity separate from its owner as a corporation for employment tax purposes, such entity remains disregarded for backup withholding and related information

reporting purposes. The preamble to Treasury Decision 9356, 2007-39 I.R.B. 675, which finalized the changes to §301.7701-2(c) indicates that these regulations do not apply to reportable payments under section 3406.

Accordingly, the owner of the disregarded entity is responsible for any backup withholding that is required with respect to reportable payments considered made by the owner rather than the disregarded entity, other than a qualified subchapter S subsidiary. However, the final regulations themselves do not explicitly state that such disregarded entities are not responsible for information reporting and backup withholding. This has caused some confusion as to the responsible party for filing information returns for reportable payments and related backup withholding requirements. Therefore, language has been added to these regulations to clarify the existing rules with respect to backup withholding and related information reporting responsibilities.

### **Explanation of Provisions**

The temporary regulations would allow certain disregarded entities under §301.7701-2 to qualify for the FICA and FUTA exceptions of sections 3121(b)(3), 3127 and 3306(c)(5). The disregarded entity will continue to be treated as a corporation for all employment tax purposes, except the entity will be disregarded for the limited purposes of applying the FICA and FUTA exceptions found in sections 3121(b)(3), 3127 and 3306(c)(5). For purposes of applying these exceptions only, the owner of the disregarded entity will be treated as the employer and the employee will be considered to be an employee of the owner. Additionally, the regulations clarify the existing rule that disregarded entities

under §301.7701-2 are not responsible for backup withholding and information reporting of reportable payments under section 3406. Rather, the owner of a disregarded entity under §301.7701-2 is responsible for backup withholding and information reporting of reportable payments under section 3406. This does not change the existing rule.

### **Special Analyses**

It has been determined that this Treasury Decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the 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 regulation will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal author of these regulations is Joseph Perera, Office of Associate Chief Counsel (Tax Exempt & Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

### **List of Subjects**

#### **26 CFR Part 31**

Employment taxes, Income Taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

## **26 CFR Part 301**

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

### **Amendments to the Regulations**

Accordingly, 26 CFR parts 31 and 301 are amended as follows:

#### [PART 31--EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE](#)

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

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

Par. 2. Section 31.3121(b)(3)-1 is amended by revising paragraph (c) and adding paragraphs (d) and (e) to read as follows:

#### §31.3121(b)(3)-1 Family employment.

\* \* \* \* \*

(c) [Reserved]. For further guidance, see §31.3121(b)(3)-1T(c).

(d) [Reserved]. For further guidance, see §31.3121(b)(3)-1T(d).

(e) [Reserved]. For further guidance, see §31.3121(b)(3)-1T(e).

Par. 3. Section 31.3121(b)(3)-1T is added to read as follows:

#### §31.3121(b)(3)-1T Family employment (temporary).

(a) [Reserved]. For further guidance, see §31.3121(b)(3)-1(a).



(b) [Reserved]. For further guidance, see §31.3121(b)(3)-1(b).

(c) Services performed in the employ of a corporation are not within the exceptions, except as provided in paragraph (d). Services performed in the employ of a partnership are not within the exception unless the requisite family relationship exists between the employee and each of the partners comprising the partnership.

(d) A disregarded entity that is treated as a corporation under §301.7701-2(c)(2)(iv)(B) of this chapter (Procedure and Administration Regulations) shall not be treated as a corporation for purposes of applying section 3121(b)(3). For purposes of applying section 3121(b)(3), the owner of the disregarded entity will be treated as the employer.

(e) Paragraphs (c) and (d) of this section apply with respect to wages paid on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. However, taxpayers may apply paragraphs (c) and (d) of this section to wages paid on or after January 1, 2009.

(f) Expiration date. The applicability of paragraphs (c) and (d) of this section expires on or before October 31, 2014.

Par. 4. Section 31.3127-1T is added to subpart B to read as follows:  
§31.3127-1T Exemption for employers and their employees where both are members of religious faiths opposed to participation in Social Security Act programs (temporary).

(a) If an employer (or if the employer is a partnership, each partner therein) and their employee are members of a recognized religious sect or

division described in section 1402(g)(1) of the Code, both the employer and employee adhere to the tenets and teachings of that sect, and both the employer and employee have filed and had approved applications under section 3127(b) for exemption from the taxes imposed by sections 3111 and 3101 then the employer is exempt from taxes imposed by section 3111 with respect to the wages paid to the eligible employee, and the employee is exempt from the taxes imposed by section 3101 with respect to the wages paid by that employer.

(b) Services performed in the employ of a corporation are not within the exception, except as provided in paragraph (c) of this section.

(c) A disregarded entity that is treated as a corporation under §301.7701-2(c)(2)(iv)(B) of this chapter (Procedure and Administration Regulations) shall not be treated as a corporation for purposes of applying section 3127. For purposes of section 3127, the owner of the disregarded entity will be treated as the employer and the payor of the employee's wages.

(d) This section applies with respect to wages paid on or after **INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**. However, taxpayers may apply this section to wages paid on or after January 1, 2009.

(e) Expiration date. The applicability of this section expires on or before [October 31, 2014].

Par. 5. Section 31.3306(c)(5)-1 is amended by revising paragraph (c) and adding paragraphs (d) and (e) to read as follows:

§31.3306(c)(5)-1 Family Employment.

\* \* \* \* \*

(c) [Reserved]. For further guidance, see §31.3306(c)(5)-1T(c).

(d) [Reserved]. For further guidance, see §31.3306(c)(5)-1T(d).

(e) [Reserved]. For further guidance, see §31.3306(c)(5)-1T(e).

Par. 6. Section 31.3306(c)(5)-1T is added to read as follows:

§31.3306(c)(5)-1T Family employment (temporary)

(a) [Reserved]. For further guidance, see §31.3306(c)(5)-1(a).

(b) [Reserved]. For further guidance, see §31.3306(c)(5)-1(b)

(c) Services performed in the employ of a corporation are not within the exception, except as provided in paragraph (d) of this section. Services performed in the employ of a partnership are not within the exception unless the requisite family relationship exists between the employee and each of the partners comprising the partnership.

(d) A disregarded entity that is treated as a corporation under §301.7701-2(c)(2)(iv)(B) of this chapter (Procedure and Administration Regulations) shall not be treated as a corporation for purposes of applying section 3306(c)(5). For purposes of applying section 3306(c)(5), the owner of the disregarded entity will be treated as the employer.

(e) Paragraphs (c) and (d) of this section apply with respect to wages paid on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. However, taxpayers may apply paragraphs (c) and (d) of this section to wages paid on or after January 1, 2009.

(f) Expiration date. The applicability of paragraphs (c) and (d) of this section expires on or before [October 31, 2014].

PART 301—PROCEDURE AND ADMINISTRATION.

Par. 7. The authority citation for part 301 continues to read in part as follows:

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

Par. 8. Section 301.7701-2 is amended by:

1. Revising paragraph (c)(2)(iv)(A).
2. Redesignating paragraph (c)(2)(iv)(C) as paragraph (c)(2)(iv)(D) and adding new paragraph (c)(2)(iv)(C).

§301.7701-2 Business entities; definitions

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iv) \* \* \*

(A) [Reserved]. For further guidance, see §301.7701-2T(c)(2)(iv)(A).

\* \* \* \* \*

(C) [Reserved]. For further guidance, see §301.7701-2T(c)(2)(iv)(C).

\* \* \* \* \*

Par. 9. Section 301.7701-2T is revised to read as follows:

§301.7701-2T Business entities; definitions (temporary).

(a) through (c)(2)(iv) [Reserved]. For further guidance, see §301.7701-2(a) through (c)(2)(iv).

(A) In general. Section §301.7701-2(c)(2)(i) (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). However, §301.7701-2(c)(2)(i) does apply to withholding requirements imposed under section 3406 (backup withholding). The owner of a business entity that is disregarded under §301.7701-2 is subject to the withholding requirements imposed under section 3406 (backup withholding). Section 301.7701-2(c)(2)(i) also applies to taxes imposed under Subtitle A, including Chapter 2—Tax on Self Employment Income. The owner of an entity that is treated in the same manner as a sole proprietorship under §301.7701-2(a) will be subject to tax on self-employment income.

(B) [Reserved]. For further guidance, see §301.7701-2(c)(2)(iv)(B).

(C) Exceptions. For exceptions to the rule in §301.7701-2(c)(2)(iv)(B), see sections 31.3121(b)(3)-1(d), 31.3127-1(c), and 31.3306(c)(5)-1(d).

(D) through (e)(4) [Reserved]. For further guidance, see §301.7701-2(c)(2)(iv)(D) through (e)(4).

(5) Paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section apply to wages paid on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. For rules that apply to paragraph (c)(2)(iv)(A) of this section before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, see 26 CFR part 301 revised as of April 1, 2009. However, taxpayers may apply paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section to wages paid on or after January 1, 2009.

(e)(6) through (e)(7) [Reserved]. For further guidance, see §301.7701-2(e)(6) through (e)(7).

(8) Expiration Date. The applicability of paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section expires on or before [October 31, 2014].

Steven T. Miller  
Deputy Commissioner for Services and  
Enforcement

Approved: November 19, 2010

Michael Mundaca  
Assistant Secretary of the Treasury (Tax  
Policy)

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