

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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date: December 23, 2005

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

from: Chief, Branch 2, Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

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subject: Withholding Credits

This significant Service Center Advice responds to your request for assistance dated September 27, 2005. This advice may not be used or cited as precedent.

ISSUES

Whether and how withholding credits under § 31 of the Internal Revenue Code for income paid by employers or other parties (Payors) to trusts, estates, partnerships, or S corporations (Passthrough Entities) may be allowed to beneficiaries of a trust or estate, partners in a partnership, or shareholders in a S corporation (Individuals) on the Individuals' federal income tax returns.

CONCLUSIONS

The "recipient" of the income subject to withholding, as defined in § 31, is the person entitled to the credit. Payments made to a Passthrough Entity in its capacity as a separate legal entity are not wages and are not subject to income tax withholding. However, we understand that instead of making wage payments directly to an individual performing services as an employee, employers sometimes make the payments to a Passthrough Entity, subjecting the payments to income tax withholding in the same manner as if the payments were made directly to the employee. If an Individual is the recipient, then the Individual may claim the credit even if the income was in fact paid to

the Passthrough Entity. Current Internal Revenue Service procedures do not offer a method for ensuring that the credit is allocated to the account of the correct taxpayer. Therefore, Payors, Individuals, and Passthrough Entities may have to file amended returns (including Forms W-2 or 1099) to receive proper treatment if they did not initially file consistent with the proper determination of the recipient. Those offices with jurisdiction over relevant forms and procedures, including the Internal Revenue Manual, should consider any changes necessary to avoid duplicative filings and ensure proper reporting. We will be happy to provide any necessary assistance to those offices on the revision of forms and procedures dealing with issues under our jurisdiction.

## FACTS

Payors have made payments of amounts subject to withholding to Passthrough Entities and withheld amounts from those payments pursuant to § 3402. We assume, for purposes of this advice, that the payments made to the Passthrough Entities should have been paid directly to an individual as remuneration for services performed by the individual as an employee of the Payor employer. Passthrough Entities and Individuals have filed returns, with the § 31 withholding credit included on the Individuals' Forms 1040, U.S. Individual Income Tax Return, rather than on the federal income tax returns of the Passthrough Entities. Some Passthrough Entities and Individuals have attached additional forms or statements purporting to allocate the credit to the Individuals. As the Forms W-2, Wage and Tax Statement, filed by Payors were directed to the Passthrough Entities, this results in a mismatch in the accounts of the Passthrough Entities (processed by the Internal Revenue Service as "BMF accounts") and Individuals ("IMF accounts").

## LAW AND ANALYSIS

### Withholding

Section 31(a) of the Code provides that (1) in general, the amount withheld as tax under chapter 24 (collection of income tax at source on wages) shall be allowed to the recipient of the income as a credit against the tax imposed by subtitle A (income taxes) and (2) the amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. Section 1.31-1(a) of the Income Tax Regulations provides that the tax deducted and withheld at the source upon wages under chapter 24 is allowable as a credit against the tax imposed by subtitle A, upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property state for federal income tax purposes make separate returns, each reporting for income tax purposes one-half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

Section 3402 provides in general that, except as otherwise provided in § 3402, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. Section 3402 also requires withholding for certain payments other than wages in some circumstances (including supplemental unemployment compensation, annuities, and sick pay under § 3402(o), gambling winnings under § 3402(q), and taxable payments of Indian casino profits under § 3402(r)).

### Trusts and Estates

Estates and trusts are taxpayers which, under § 641(a), are generally subject to income tax under § 1(e). Estates and trusts may receive an income tax deduction for their distributable net income (DNI), as defined in § 643(a), to the extent it is distributed to their beneficiaries. The DNI distributed is generally taxable on the beneficiaries' own federal income tax returns. Certain trusts which must currently distribute all of their income ("simple trusts") use §§ 651 and 652 to determine what amounts of income (whether actually distributed or not) are taxed at the trust level and what amounts are taxable to the beneficiaries. Most other trusts ("complex trusts"), as well as estates, use §§ 661 and 662 to allocate these amounts. Credits arising from the activities of an estate or trust are generally allowable at the estate or trust level, unless the provisions of a particular credit allocate some or all of that credit to the beneficiaries. See, for example, § 29 (the nonconventional source fuels credit) or § 42 (the low-income housing credit). However, § 31 does not allocate any portion of the credit to estate or trust beneficiaries and therefore the credit usually will not be available to beneficiaries, with two major exceptions provided below.

First, § 671 provides that where it is specified in subpart E (grantors and others treated as substantial owners) that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 (normal taxes and surtaxes) in computing taxable income or credits against the tax of an individual the grantor or another person shall be treated as the owner of any portion of a trust. Common powers that may result in the grantor or another person being treated as the owner of a portion or all of a trust include the grantor's power to revoke the trust (§ 676) or the power of a person other than the grantor to withdraw the trust property (§ 678). If the § 31 credit is allocable to a trust or portion of a trust treated as owned by the grantor or another person under subpart E, then the credit should generally appear on that person's Form 1040.

Second, § 691(a)(1) provides that the amount of all items of gross income in respect of a decedent (IRD) which are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all

items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right. If a person other than the estate of a decedent has the right to receive amounts of IRD by reason of the decedent's death (under § 691(a)(1)(B)) from which withholding has taken place or has acquired that right by bequest, devise, or inheritance after a distribution by the estate (under § 691(a)(1)(C)), then that person would be the recipient of the income and would be entitled to any § 31 credit associated with that income. In the case where a person other than the estate has the right to receive amounts of IRD, the IRD and credit should never appear on the estate's Form 1041, U.S. Income Tax Return for Estates and Trusts.

All amounts earned but unpaid at an employee's death received by an estate or beneficiary of a deceased employee should be reported on Forms 1099 and 1096 as nonemployee compensation, rather than in Box 1 of Form W-2. See Rev. Rul. 86-109, 1986-2 C.B. 196. Thus amounts earned but unpaid prior to the employee's death should not have been subjected to income tax withholding in the first place. Instead, the employer should have issued a Form 1099 to the beneficiary.

In addition, reporting on Form W-2 of the Medicare wages and social security wages related to a payment after death is required if the payment is made in the same calendar year as the death of the employee. If the payments are made in the same calendar year as the death of the employee, the payments are generally subject to Federal Insurance Contributions Act (FICA) taxes and should also be reported in Box 3, Social security wages, Box 4, Social security tax withheld, Box 5, Medicare wages, Box 6, Medicare tax withheld, on Form W-2 issued in the name of the employee and with the social security number of the employee. Nothing should be reflected in Box 1 or Box 2 of Form W-2 with respect to a payment of compensation made after death. (It is reported on Form 1099 as noted above.)

If the payment is made after the calendar year of the death of the employee, the payment is not subject to FICA taxes and the payment should not be reported as social security wages or Medicare wages on the employee's final Form W-2. See § 3121(a)(14) of the Internal Revenue Code.

Forms W-2 should be issued to employees, not estates. If a Payor has indicated the estate rather than the beneficiary as the recipient on Form W-2, the estate or the beneficiary should request that the Payor issue a corrected Form W-2 with appropriate reporting in the name of the employee with the employee's social security number. Any

Forms W-2 issued in the name of estates should be corrected by reflecting zero entries in each box and new Forms W-2 should be issued to the employees of the compensation erroneously reported on the estate's Form W-2.

Section 643(d) provides rules for allocating between an estate or trust and its beneficiaries any credit under § 31(c) for amounts subject to backup withholding under § 3406. Section 643(g) provides that certain estimated tax payments made by a trust or estate may be treated as paid by its beneficiaries. This allocation is made by filing Form 1041-T, Allocation of Estimated Tax Payments to Beneficiaries. Neither § 643(d) nor § 643(g) is relevant to the treatment of the withholding credit under § 31(a), and neither Form 1041-T nor any other form or schedule can be used to allocate this credit except as described elsewhere in this memorandum.

### Partnerships

Section 702(a)(7) provides that in determining a partner's income tax, each partner shall take into account separately that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit, to the extent provided by regulations prescribed by the Secretary. Section 702(b) provides that the character of any item of income, gain, loss, deduction or credit included in a partner's distributive share under § 702(a)(7) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in chapter 1, be determined by the partnership agreement. Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Assuming that the payments are for services performed by the partners as employees of the Payor employer, the partners are the recipients or the income for § 31 purposes, and the withholding credit should appear on the partners' Forms 1040, not on the partnership's Form 1065, U.S. Return of Partnership Income, in accordance with the partners' distributive share of that credit as determined under §§ 702 and 704 (and the regulations thereunder). Forms W-2 should be issued to employees, not partnerships. If a Payor has indicated the partnership as recipient on Form W-2, then the partnership or the partner should request that Payor issue a corrected Form W-2 to the partnership reflecting zero entries in each box, and a new Form W-2 should be issued to the employee/ partner in the name of the employee with the employee's social security number reporting the payments erroneously reported on the partnership's Form W-2.

Additionally, the parties would have to file amended returns to allocate the credit to the proper recipient.

### S Corporations

Section 1366(a)(1)(A) provides that, in general, in determining the tax under chapter 1 of a shareholder of an S corporation for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder.

S corporation shareholders, as § 31 recipients, should be treated in a manner similar to partners as described above. The withholding credit should not appear on the S corporation's Form 1120S, U.S. Income Tax Return for an S Corporation. Similar corrective filings may be necessary if the corporation was treated as recipient by a Payor.

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Please call Brad Poston at \_\_\_\_\_ if you have any further questions.