IRB 2020-12
March 16, 2020

ACTION ON DECISION

Subject: Paychex Business Solutions, LLC, et al., v. United States of America, 2017 WL 2692843 (M.D. Fla. 2017).

Issue: Whether control over the bank account from which wage payments are made is sufficient for an entity to be a section 3401(d)(1)[1] statutory employer.

Discussion: For the years at issue, Paychex Business Solutions, LLC. et al. (Plaintiffs) were professional employer organizations (PEOs) headquartered in Florida and licensed by the State of Florida. Plaintiffs entered into a client service agreement (CSA) with each client company (client) in order to provide employer payroll functions and certain human resource functions. The CSAs provided that Plaintiffs assumed full responsibility for the reporting, collection, and payment of employment taxes[2] to the Internal Revenue Service (IRS) with respect to the clients' employees. With respect to payroll processes, typically, Plaintiffs obtained certain payroll information from clients two days prior to the date on which the clients' employees were paid. The clients would submit the employees' hours and rates of pay to the Plaintiffs for the pay period at issue. Plaintiffs, who had Forms W-4 and knowledge of payroll deductions and garnishments for the employees, calculated the appropriate amount of wages and employment taxes. Thereafter, Plaintiffs would initiate a debit to the clients' bank accounts via automated clearing house (ACH), which would include amounts for the employees' compensation and employment taxes. While the ACH process did not ensure that Plaintiffs received payment from the clients prior to the issuance of payroll checks or direct deposits to the clients' employees, the clients' submission of hour and

[1] Unless otherwise noted, all section references are to the Internal Revenue Code.
[2] "Employment taxes" refers to Federal Insurance Contributions Act (FICA) (consisting of both social security and Medicare taxes), Federal Unemployment Tax Act (FUTA), and Income Tax Withholding (ITW), although references to "withholding" only apply to FICA and ITW.

wage data triggered the process for payment of wages. The clients remained liable for those payments if the funds were insufficient to satisfy the ACH, though Plaintiffs would have to seek payments from the clients through collection actions, which did not guarantee payment from the clients. Also, Plaintiffs required a small percentage of their clients to pay the invoice by wire payment, rather than ACH, because Plaintiffs had concerns about the clients' financial conditions.

The Service and Plaintiffs agreed that Plaintiffs are not the common law employers of the clients' employees. Plaintiffs considered themselves to be the statutory employers of the clients' employees under section 3401(d)(1) and filed Forms 941-X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund,* claiming refunds of the overpayment of the employer's portion of the social security tax due to the restart of the social security tax wage base applicable to wages paid by Plaintiffs. The IRS denied Plaintiffs' claims for refunds, and Plaintiffs filed suit in federal district court.[3]

The court identified the issue before it as "who—Plaintiffs ***or*** the client companies—had control over the payment of wages to the worksite employees" (emphasis added) and concluded that the Plaintiffs were the statutory employers of the clients' employees under section 3401(d)(1) because they "actually controlled the [bank] accounts from which the wage payments were made."

Section 3401(d) defines the term "employer" for federal income tax withholding purposes as "the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that (1) if the person for whom the individual performs or performed the services does not have control of the payment of wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages..."[4] When the exception in paragraph (1) applies, liability for employment taxes due on wages shifts from the common law employer to the person in control of the payment of those wages.

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[3] During the course of the litigation, the parties agreed that Plaintiffs erroneously restarted the social security taxable wage base for the employees. See Pls.' Mot. For Recons. ¶ 2. However, the Service did not concede the Plaintiffs' entitlement to a refund because, among other things, Plaintiffs were not the employer and they had not properly substantiated the refund claim.

[4] FICA does not contain a definition of employer similar to the definition contained in section 3401(d)(1) relating to income tax withholding. However, in Otte v. United States, 419 U.S. 43 (1974), the Supreme Court held that a person who is an employer under section 3401(d)(1), relating to income tax withholding, is also an employer for purposes of withholding the employee's share of FICA under section 3102. The Otte decision has been extended to provide that the person having control of the payment of the wages is also an employer for purposes of section 3111, which imposes the FICA tax on employers, and section 3301 (Federal Unemployment Tax Act (FUTA) tax). See In re Armadillo Corp., 410 F. Supp. 407 (D. Colo. 1976), affd, 561 F.2d 1382 (10th Cir. 1977); In re The Laub Baking Co., 642 F.2d 196, 199 (6th Cir.1981).

The exception consists of a two-part test that must be satisfied in order for a person other than the common law employer to be the "employer": (1) the common law employer must not have control of the payment of wages and (2) the other person must have control of the payment of wages. See Century Indem. Co. v. Riddell, 317 F.2d 681 (9th Cir. 1963).

The court failed to determine that the clients did not have control of the payment of wages, a critical precursor element needed in order for the special rule of section 3401(d)(1) to apply. In Riddell at 691, the court considered a situation in which an employer and surety had joint control stating, "Here, neither has sole control, but neither is the subcontractor without any such control. As stated in the Simpson case, both criteria must be met. Literally, the exception of Section 1621(d)(1) [(the predecessor to section 3401(d)] does not cover such a situation. If construction is called for, then it must be in accordance with the legislative intent above indicated, which calls for a narrow construction of the exception, and broad construction of the general terms covering the common law employer's responsibilities." Before reaching the second question of whether another person has control of the payment of wages, the court must first determine that the common law employer "does not have control of the payment of wages."

For example, if wages, such as certain types of pensions or retirement payments, are contributed to a trust by an employer and subsequently paid by the trust to employees or former employees, but the employer has no legal control over the retirement payments, the trust is the employer under section 3401(d)(1) with respect to those payments. See Treas. Reg. § 31.3401(d)-1(f). Similarly, awards in a class action settlement for back wages are often paid through a fund or by an attorney. In each instance, the fund or the attorney is typically the section 3401(d)(1) employer for employment tax liability purposes, because even though the amounts were initially paid to the fund or the attorney by the common law employer, the common law employer no longer has control of those payments. See e.g., STA of Baltimore -- ILA Container Royalty Fund v. United States, 621 F. Supp. 804 F.2d 296 (4th Cir. 1986); FSA 1996 WL 33321014 (June 21, 1996). The language of the statute also indicates that a determination of the control of the payment of wages is on a payment-by-payment basis; a third party payor might have legal control over one payment of wages but not with regard to other payments.

Congress specifically addressed the exception to section 1621(d) in the legislative history. The conference report accompanying The Current Tax Payment Act of 1943 explains that the exception in paragraph (d)(1) was enacted "to cover certain special cases, such as the . . . case of the person making payment of wages in situations where the wage payments are not under the control of the person for whom the services. . .

were performed." H.R. Rep. No. 78-510 at 31 (1943) (Conf. Rep.) The report further states that this exception is "designed solely to meet unusual situations and not intended as a departure from the basic purpose to centralize responsibility for withholding, returning, and paying the tax and furnishing receipts." Id.[5]

Consistent with the legislative history, the IRS has narrowly construed what it means to be in control of the payment of wages under section 3401(d)(1).[6] Treas. Reg. §31.3401(d)-1(h) explains that the "special definitions of the term 'employer'…are designed solely to meet special or unusual situations. They are not intended as a departure from the basic purpose." The regulations further clarify that the term control means legal control of the payment of wages. *See* Treas. Reg. § 31.3401(d)-1(f). Whether an entity has legal control of the payment of wages is determined by considering the facts and circumstances related to each payment of wages. The IRS will continue to take the position that an entity is not in control of the payment of wages if the payment of wages is contingent upon, or proximately related to, the entity having received funds from the common law employer.

The narrow scope of "control" in section 3401(d)(1), and most importantly the need for the common law employer to have no control over the payment of wages in order to trigger the application of section 3401(d)(1) is further evidenced by the recent promulgation of regulations under section 3504, a provision of the Code that imposes employment tax liability on a third party payor ("fiduciary, agent or other person") that has "the control, receipt, custody, or disposal of, or pays" wages to an employer's employees, without affecting the continuing liability of the employer. Under those regulations, in situations in which the third party payor does not meet the legal conditions necessary to be a section 3401(d)(1) employer, yet it enters into a service agreement[7] under which it performs the employment tax obligations of the common law

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[5] See also Sen. Rep. No. 78-221 at 19-20 (1943).

[6] Several courts have also interpreted the language of section 3401(d)(1) narrowly. See Century Indem. Co. v. Riddell, 317 F.2d at 691 (The legislative history "indicate[s] an intent on the part of Congress to impose a narrow construction upon" the exception of section 1621(d)(1).) United States v. Garami, 184 B.R. 834 (M.D. Fla. 1995) (finding that when a third party received funds from its client prior to paying payroll to the client's employees, the contractual agreement to pay the client's employment taxes did not relieve the client of the obligation to pay those taxes); In re Professional Security Services, 162 B.R. 901 (Bankr. M.D. Fla. 1993) (finding that the client company was still in control of the payment of wages because the leasing company did not issue checks to pay wages unless it first received payment from the client company).

[7] A service agreement is an agreement pursuant to which the payor: (A) Asserts it is the employer (or "co-employer") of the individual(s) performing services for the client; (B) Pays wages or compensation to the individual(s) for services the individual(s) perform for the client; and (C) Assumes responsibility to collect, report, and pay, or assumes liability for, any taxes applicable under subtitle C of the Code with respect to the wages or compensation paid by the payor to the individual(s) performing services for the client. Treas. Reg. § 31.3504-2(b)(2).

employer with regard to wages it pays to individuals performing services for the common law employer, the third party payor is "designated to perform the acts required of an employer with respect to the wages…paid" and is liable (along with the common law employer) for employment taxes on such wages. Treas. Reg. § 31.3504-2(a) and (d)(3).

In explaining the need for those regulations, the IRS stated the following in the preamble to the proposed regulations:

> In certain instances, an employer may mistakenly believe it is relieved of employment tax liabilities merely because it has entered into an agreement with a third-party payor (for example, a PEO or employee leasing company) for assistance in fulfilling its employment tax obligations. However, an employer remains liable for employment taxes irrespective of any agreement it may enter into that purports to place the employment tax obligations and liabilities with the payor, except in the limited circumstances when the payor satisfies the conditions to be liable under section 3401(d)(1). In this regard, status as the employer of the worker is determined based on all the facts and circumstances under the common law test (or under other specific Code provisions related to particular types of employees, such as corporate officers). Neither claims by a payor that it is the employer (or "co-employer") of the worker for federal employment tax or other purposes nor the fact that the payor may file employment tax returns under its own EIN are determinative under the Code for purposes of identifying the employer liable for employment taxes.

The regulations demonstrate that the requirements to trigger their application to a third party payor--including payment of wages and entering into a service agreement pursuant to which the third party payor assumes responsibility for employment taxes—establish concurrent liability for the third party payor but are not enough to trigger a transfer of sole liability under section 3401(d)(1). In promulgating the regulations, the Department of the Treasury and the IRS explained that a third party payor (typically a PEO) may not use a service agreement to transfer liability; such a contract generally will not relieve the common law employer of its control over the payment of wages so as to trigger the application of section 3401(d)(1).[8]

The IRS disagrees with the court's conclusions and its characterization that whether a person is a section 3401(d)(1) employer turns on whether that person has exclusive control over the bank account from which wages are paid.

[8]Subsequent to issuance of these regulations, Congress enacted legislation in this area to specifically provide conditions that must be met to transfer liability through a services agreement. See section 3511, Treas. Reg. § 31.3511, section 7705, and Treas. Reg. § 301.7705.

The IRS also disagrees with the court's citation to the cases[9] used in support of its position that the person or entity that controls the bank account from which wages are paid is the section 3401(d)(1) statutory employer. Those cases are all distinguishable from Paychex, as none of them involved situations in which a third party served merely as a conduit. Rather, the cases cited by the court involved third-parties who paid the employees of their clients with their own funds or involved other distinguishing facts such as related entities paying wages from a pooled account.

Plaintiffs were merely acting as conduits through which wages and taxes were paid since, in almost all instances, Plaintiffs received the funds from their clients before issuing paychecks to the clients' employees. Consistent with the IRS's longstanding position, absent statutory authority, an employer may not simply delegate or contract away its taxing responsibilities. See Earthmovers, Inc. v. U.S., 199 B.R. 62, 68 (Bankr M.D. Fla 1996); United States v. Garami, 184 B.R. at 838. See also Treas. Regs. § 31.3504-2, § 31.3401(d)-1(h), and § 31.3401(d)-1(f)

Recommendation: Nonacquiescence

The court failed to apply the language of the underlying statute and disregarded Congressional intent and case law by expanding the scope of section 3401(d)(1) beyond it's intended narrow purpose.[10] As a threshold matter, a statutory employer may exist only when the common law employer does not have control over the payment of wages. In this case the clients and not the Plaintiffs had control over the payment of the wages as in almost all instances the Plaintiffs received the funds from their clients before issuing paychecks to the clients' employees and the clients remained liable for the amount of the payments if the funds were insufficient to satisfy the ACH. Moreover, the court did not apply the correct standard in determining the type of control necessary to trigger the exception under section 3401(d)(1). The focus should have been on control of the payment of wages, not control of the bank account used in the process. The IRS' position is that an entity is not in control of the payment of wages within the meaning of section 3401(d)(1) if the payment of wages is contingent upon, or proximately related to, the entity having first received funds from the common law employer. The IRS will continue to litigate this issue in this court and in other courts.

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[9] See, e.g., Winstead v. United States, 109 F.3d 989 (4th Cir. 1997); Consolidated Flooring Services v. United States, 38 Fed. Cl. 450 (Ct. Cl. 1997). See also Southwest Restaurant Systems, Inc. v. IRS, 607 F.2d 1237 (9th Cir. 1979).

[10] Although we disagree with the decision of the court, we did not appeal due to other considerations.

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