

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

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to:

from: Michael A. Swim  
Senior Technician Reviewer  
Employment Tax Branch 1  
Office of Division Counsel/Associate Chief Counsel  
(Tax Exempt and Government Entities)

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subject:

This Chief Counsel Advice responds to your memorandum dated November 10, 2003. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Taxpayer =  
Years at issue =

ISSUE

Whether the Service can assert that each client company of the Taxpayer, a professional employer organization (PEO), is liable in the years at issue for employment taxes that can not be collected from the Taxpayer that are due upon wages paid to workers leased by each client company from the Taxpayer.

CONCLUSION

If each client company is the common law employer of the particular workers leased from the Taxpayer, and the Taxpayer is not a section 3401(d)(1) employer, the Service could assert that each such client company is liable in the years at issue for the unpaid employment taxes related to these particular workers that can not be collected from the Taxpayer. Whether the Service chooses to act on this legal conclusion is dependent

upon a decision made by the operating division handling the case. The operating division's decision will include consideration of policy and operational concerns, including resource availability.

## FACTS

The Taxpayer is a professional employer organization (PEO). As a PEO, Taxpayer contracted to provide "employees" to client companies. Each client company was required to complete and sign two documents as part of the contract process - an application and a contract. The "Application for Professional Employer Services" (application) contained information, such as payroll method and frequency, employee benefits, health insurance, and direct debit information, that the Taxpayer needed to perform those services for the client company. The "Client Service Agreement" (contract), which was also signed by the Taxpayer, set forth the terms of the agreement. You have provided copies of an application and contract that are typical of those used by the Taxpayer.

The application provided that the client company agreed that its employees would be "hired" by the Taxpayer, and that the client company would then "lease" back these employees from the Taxpayer. Further, the application stated that the Taxpayer had no right to interfere with the hiring, termination, direction or control of the "leased employees", and that the client company retained responsibility and liability for the control over the employees.

The contract provided that the Taxpayer was responsible for administrative matters such as payroll administration and tax deposits, human resource record keeping, and benefits administration. Under the contract, the client company retained the ability to recruit, hire, train, discipline, evaluate and terminate the workers.

The contract required the client company to supply the Taxpayer all necessary payroll information, including time slips, before the employees' payday. The parties were to determine what other necessary payroll information would be supplied by the client company prior to payday. The Taxpayer would compile the payroll and report the amount due by the client company, including the Taxpayer's service fee. The client company was required to pay the amount in full to the Taxpayer on the morning of the client company's regular payday. To achieve this result, the Taxpayer required each client company to authorize the Taxpayer to electronically transfer the gross payroll (wage and tax) amounts, as well as the Taxpayer's fee, directly from an account owned by the client company to the Taxpayer's account. The funds were withdrawn from the client company's account and deposited to the Taxpayer's account before the client company's payroll was issued.

The contract further provided that the Taxpayer could terminate the contract for any material breach of the agreement by the client company. The application provided that non-payment of the Taxpayer's invoice was grounds for immediate termination of the contract between the Taxpayer and the client company. Your office had several client

companies indicate that they timely paid all wage and tax amounts to the Taxpayer as required by the contract for each quarter of the years at issue.

Payroll and tax payments were made from the Taxpayer's account. The Taxpayer commingled funds from each client company in its account. There is no subsidiary ledger which showed the amounts in the account which were attributable to any particular client company.

The Taxpayer filed for Chapter 7 bankruptcy liquidation on . On the petition date, the Taxpayer handled payroll for over client companies and had significant unpaid employment taxes. The trustee has reconstructed the Taxpayer's payroll records and filed delinquent employment tax returns for the Taxpayer. The United States has assessed employment taxes based on the reconstructed returns and has filed a Proof of Claim (POC) in the bankruptcy proceeding. The POC includes a secured claim of \$ , an unsecured priority claim of \$ , and a general unsecured claim of \$ . Due to subordination of the United States' secured claim to other priority creditors under the provisions of 11 U.S.C. section 724(b)(2), it appears that the Taxpayer's property will not be sufficient to pay in full the United States' secured claim. It appears that none of the United States' priority and general unsecured claims will be paid.

The Commissioner is considering whether to assert that each client company is liable for the unpaid employment taxes attributable to the particular workers leased by each such client company from the Taxpayer. Since the investigation of the client companies will require substantial time and resources, the Commissioner wants some assurance that Counsel will support collection of any assessments against the client companies if the evidence shows that the client companies would be liable as the common law employers.

## LAW AND ANALYSIS

In a suit against a client company, the Service needs to establish that the client company was liable for the employment taxes due on wages paid to the leased employees. Following is a discussion of the legal issues that need to be factually developed to establish the liability of a client company.

### 1. Common Law Employment

The applicable Federal employment taxes consist of taxes under the Federal Insurance Contributions Act (FICA), sections 3101-3128 of the Internal Revenue Code (the Code), Federal Unemployment Tax Act (FUTA), sections 3301-3311 of the Code, and Federal income tax withholding (ITW), sections 3401-3405 of the Code. For Federal employment taxes to apply, an employer-employee relationship must exist. The existence of an employer-employee relationship generally is determined using the common law control test. See, §§ 31.3121(d)-1(c)(1); 31.3306(i)-1(a); and 31.3401(c)-1(a) of the Employment Tax Regulations.

Specifically, the employment tax regulations describe an employer-employee relationship:

Generally such relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer . . . are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services.

Section 31.3121(d)-1(c)(2). See also, §§ 31.3306(i)-1(b) and 31.3401(c)-1(b).

The Service has developed a three-category test analyzing various factors to determine whether a common law employment relationship exists between workers and a particular entity. See, “Independent Contractor or Employee?” Training, 3320-102 (Rev. 10-96). The categories are behavioral control, financial control, and relationship of the parties. Each category contains types of information (facts) that illustrate the right to direct and control – or its absence. There is no magic number of relevant evidentiary facts that is dispositive of the issue. Instead, all the facts must be weighed in evaluating the extent of the right to direct and control.

To determine who is the common law employer of the leased employees, the facts for each relationship must be documented and weighed. We are not presented specific facts sufficient to determine on a case-by-case basis whether any particular leased employees are the common law employees of a particular client company, however, the form contract used by the Taxpayer indicates that each client company retained the ability to recruit, hire, train, discipline, evaluate and terminate the leased employees. In gathering facts, you should determine whether the Taxpayer had any role in the hiring, worksite supervision, evaluation, or termination of the leased employees, or if the Taxpayer relied exclusively on the client company to perform these functions. We suggest you engage a Revenue Agent trained as an employment tax specialist to assist you in gathering facts and making the determination.

## 2. Co-Employment

If a client company was the common law employer of workers it leased from the Taxpayer, the Taxpayer could also be a common law employer under the theory of co-employment. Under the common law doctrine of co-employment, a worker may have

the status of an employee with respect to more than one employer if service to one does not involve abandonment of service to the other. Therefore, two employers may employ a worker simultaneously. See, for example, Rev. Rul. 66-162, 1966-1 C.B. 234.

Rev. Rul 66-162 deals with payments made to sales clerks by a department store and by a concessionaire hired by the department store to run the departments. The salary paid by the department store was wages and was not at issue. The question presented was whether the commission payments made by the concessionaire directly to the sales clerks was wages for purposes of the employment taxes. The ruling holds that the concessionaire controlled the clerks independently of the control exerted by the department store, such that the clerks were the employees of the concessionaire, and that the commissions paid by the concessionaire were wages for employment.

Rev. Rul. 66-162 demonstrates that an employee can have two employers with regard to the same performance of services. However, because only the Taxpayer was making a payment to the employees in this case, Rev. Rul. 66-162 would not be controlling on the liability of any client company if the facts reveal that both the client company and the Taxpayer are common law employers of the leased employees. In that case, we advise you to seek further guidance from this office on the liability of the client company.

[REDACTED] The form contract indicates that the Taxpayer was responsible only for administrative matters with no right to interfere with the direction and control of the employees leased by any client company. Additionally, the form contract used by the Taxpayer is devoid of any claim that the Taxpayer was the "employer" or the "co-employer" of the leased employees. [REDACTED]

### 3. Section 3401(d)(1)

If a person who is not the common law employer has control of the payment of wages, that person will be considered the employer for Federal employment tax purposes. Pursuant to section 3401(d)(1) of the Code, if the common law employer does not have control of the payment of wages, the term employer means the person having control of the payment of wages. The Code imposes Federal income tax withholding obligations upon the section 3401(d)(1) employer. Case law has extended the section 3401(d)(1) employer's obligations to include withholding and payment of FICA and FUTA taxes. See Otte v. United States, 419 U.S. 43 (1974); In re Armadillo Corp. v. United States,

561 F.2d 1362 (10<sup>th</sup> Cir. 1977); The Lane Processing Trust v. United States, 25 F.3d 662 (8<sup>th</sup> Cir. 1994).

The key inquiry to make in determining whether the Taxpayer is a section 3401(d)(1) employer of the employees leased to any client company is to establish whether the Taxpayer was in control of the payment of wages to those employees. Several cases have dealt with the issue of what constitutes “control of the payment of wages” for purposes of determining if a taxpayer is a section 3401(d)(1) employer.

In Winstead v. United States, 109 F.2d 989 (4<sup>th</sup> Cir. 1997) the taxpayer, Winstead, owned land that was farmed by sharecroppers, who were accountable for their hired help. However, the sharecroppers could not pay the hired help until after the crops were sold. Therefore, Winstead paid the help from his checking account, over which the sharecroppers had no authority, then deducted what he paid from the sharecroppers’ share of the crop proceeds. Winstead was held to have control of the payment of wages to the hired help and thus to be the employer under section 3401(d)(1).

In In re Earthmovers, Inc., 199 B.R. 62 (Bankr. M.D. Fla. 1996) the taxpayer, Earthmovers, was a construction company in Chapter 11 bankruptcy. Earthmovers entered into a contract with Sunshine Staff Leasing, Inc. whereby Earthmovers leased all of its employees from Sunshine. Pursuant to the contract, the employees were under the direction and control of Earthmovers, but Sunshine was responsible for the payment of wages to the employees, the collection of the appropriate payroll taxes from the paychecks, the payment of all employee withholding taxes due, and the filing of all necessary Federal tax forms. Because Earthmovers had exclusive control of its workers, the court held it to be the common law employer. Additionally, because Earthmovers submitted the information regarding the hours worked each week by each employee, forwarded the amount owed for payroll (including the tax amounts) to Sunshine, and retained the right to hire and fire the employees, Earthmovers was held to be in control of the payment of wages for purposes of section 3401(d)(1).

In Alexander Drilling Inc. v. United States, 98-1 USTC ¶ 50,225 (W.D. Ark. 1997), the taxpayer, Alexander Drilling, leased its field workers from R & A Leasing Corporation. Under the terms of the leasing arrangement, Alexander Drilling was required to pay R & A sufficient funds to cover payroll (including tax amounts). R & A paid the field workers wages out of its own checking account. There is no mention of which party determined the wage rate or whether R & A would have paid the field workers regardless of whether it received the funds from Alexander Drilling. The jury found that Alexander Drilling did not have control of the payment of wages to field workers leased to it by R & A for purposes of section 3401(d)(1).

Consistent with precedent such as Earthmovers, the Service position is that a taxpayer is not in control of the payment of wages if the payment of wages is contingent upon, or proximately related to, the taxpayer having first received funds from its clients. See, for

example, 1998 FSA LEXIS 259 (April 9, 1998). See also, In re: Professional Security Services, Inc., 162 B.R. 901 (Bankr. M.D. Fla. 1993) (Court holding that because the leasing company did not issue payroll checks unless it first received payment from the client company, the leasing company was not in control of the payment of wages for purposes of section 3401(d)(1) of the Code.)

Based on the provisions in the application and the contract, and anecdotal statements you have obtained from employees of the client companies and the Taxpayer, the indications are that the Taxpayer was not in control of the payment of wages within the meaning of section 3401(d)(1) of the Code. The form contract used by the Taxpayer required each client company to provide payroll information, including time slips, so the Taxpayer could compute the payroll. This fact indicates that the Taxpayer had only a ministerial role in providing payroll. The form application used by the Taxpayer required each client company to authorize the Taxpayer to electronically transfer funds from the client company's account to the Taxpayer's account so that the Taxpayer's invoice could be paid in full on the morning of the client company's regular payday. The application also stated that non-payment of the Taxpayer's invoice could result in immediate termination of the contract. These facts support that the Taxpayer was not obligated to, and indicate that the Taxpayer would not, meet the payroll obligations for a client company without first receiving the funds to make payroll from that client company.

Additionally, conversations that you have had with several client companies and employees of the Taxpayer confirm that the Taxpayer's practice was to withdraw funds from a client company's account and deposit the funds to its own account before payroll was issued to employees leased to that client company. Thus, it appears that the Taxpayer acted merely as a conduit for each client company in making payroll and does not meet the standards established in Winstead or Earthmovers to be considered the section 3401(d)(1) employer.



#### 4. Section 530

Section 530 of the Revenue Act of 1978, H.R. 13511, Pub. L. 95-600, 92 Stat. 2763, 2885 (1978) provides businesses with relief from Federal employment tax obligations if certain requirements are met. It is not necessary for a taxpayer to claim relief under section 530 for it to be applicable. Pursuant to section 530(e)(1), before or at the commencement of any audit inquiry related to the employment status of one or more individuals who performs services for the taxpayer, the Service must provide the taxpayer with a written notice of the provisions of section 530. The Service has developed Publication 1976, *Independent Contractor or Employee?*, for this purpose.

Section 530 was enacted to provide relief for businesses in controversies between the business and the Service about whether individuals treated as independent contractors should be reclassified as employees. See S. Rep. 95-1263, at 210 (1978). A business may qualify for relief under section 530 if the business filed all required Forms 1099 (reporting consistency), treated all workers in similar positions the same (substantive consistency) and had a reasonable basis for treating the workers whose status is in question as independent contractors.

Section 530 did not contemplate situations where a business used workers leased from a third-party that treated the workers as employees. The application of section 530 in this situation has not been addressed by a Court or by published guidance.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call [REDACTED] at [REDACTED] if you have any further questions.