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INTERNAL REVENUE SERVICE  
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The Honorable Trent Lott  
United States Senate  
Washington, DC 205110

Dear Senator Lott:

I apologize for the delay in responding to your inquiry of July 29, 2004, on behalf of

[REDACTED]. He wrote about IRS audits of state governments in which the Service may be asserting that state agencies are responsible for withholding, depositing, and reporting employment taxes for informal (in-home) child care providers.

[REDACTED] is concerned that the determination that the state agency is responsible for employment taxes as the "control" employer, under section 3401(d)(1) of the Internal Revenue Code (the Code), will have far reaching financial consequences for state funded programs. He said that this position conflicts with recently issued proposed guidance, which states that state governments may voluntarily serve as withholding agents for disabled individuals and other welfare recipients who employ home-care service providers to assist them in their homes [Notice 2003-70 43 I.R.B. 916].

[REDACTED] suggested that we should publicly state our position and describe the standards used to determine whether a state is the "control" employer of in-home child care providers.

For federal income tax withholding purposes, an employer is the person for whom an individual performs any service as an employee of such person [Code section 3401(d)]. However, if the person for whom the individual performs the services does not have control of the payment of wages for such services, the employer is the person having control of the payment of such wages [Code Section 3401(d)(1)]. Federal courts have extended Code section 3401(d)(1) to apply to the Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax [See e.g., *Otte v. United States*, 419 U.S. 43 (1974)]. The employer is responsible for withholding, depositing, and reporting income tax, FICA tax (both the employer's and employee's shares) and FUTA tax.

When determining whether a person has control of the payment of wages, the focus is on the “legal control” of the payment of wages [Section 31.3401(d)-1(f) of the Employment Tax Regulations]. Courts have defined legal control as “the legal power to control the actual payment of the wages” [e.g., *See Bellus V. U.S.* 198 B.R.782 Bankr. N.D.Cal. 1995); *aff’d in part, rev’d in part on other issues*, 125 F.3d 821 (9<sup>th</sup> Cir. 1997)]. Case law considers the facts and circumstances of a particular situation to determine whether a person has legal control of the payment of wages.

Whether a state agency must withhold, deposit and report employment taxes under Code section 3401(d)(1) on payments to in-home child care providers depends on the facts and circumstances. Given the factual variations among state programs and practices, we have not issued guidance of general applicability on the effect of Code section 3401(d)(1) for state and local government agencies that play a role in paying in-home child care providers. Further, Code section 3401(d)(1) applies for federal employment tax purposes, and has no impact on the determination of employer status for other purposes.

A Proposed Revenue Procedure in Notice 2003-70 updates guidance for state and local government agencies serving as agents, under Code section 3504, for disabled individuals and other welfare recipients who employ in-home domestic service providers to assist them in their homes. The Notice applies to service recipients who are the common law employers of the home-care service providers and allows each service recipient to designate the state or local government agency as its agent under Code section 3504 for certain federal employment tax responsibilities. Notice 2003-70 updates prior guidance in Rev. Proc. 80-4, 1980-1 C.B. 581, in part to provide that the special procedures that allow a state or local government agency to act as an agent when the state or local government agency furnishes home-care providers now also apply when the service recipient directly hires the home-care service provider.

Notice 2003-70 does not address whether a state or state agency can be an employer under Code section 3401(d)(1). Rather, it provides a procedure that service recipients can use to make it easier to report and pay employment taxes. We continue to invite comments on Notice 2003-70, particularly regarding ways to minimize the burden on the service recipients and the states while ensuring the employment taxes are paid. We are very interested in [REDACTED] specific views on the application of Code section 3401(d)(1) to states and state agencies that make payments to domestic workers, and will take them into consideration.

I hope this information is helpful. If you have further questions, please call me at (202) 622-6010 or [REDACTED] (Identification [REDACTED]) at (202) 622-6040.

Sincerely,

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(Exempt Organizations/Employment tax/  
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