

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

**Number: 200526018**

**Release Date: 7/1/2005**

CC:TEGE:EOEG:ET2:DEBoeskin  
PRESSP-109147-03

UILC: 3401.02-00

Date: January 30, 2004

To: ANDREW E. ZUCKERMAN  
(DIRECTOR, FEDERAL, STATE & LOCAL GOVERNMENT)

From: MARIE CASHMAN, SENIOR TECHNICIAN REVIEWER  
(CC:TEGE:EOEG:ET2)

---

Subject **PRISON WORKERS**

LEGEND

Project A:

Regulation D:

X Workers:

This memorandum is in response to your February 13, 2003, request for guidance regarding the proper employment tax treatment and reporting requirements for payments made to X Workers under the Justice Department's (DOJ) Project A.<sup>1</sup> This advice may not be used or cited as precedent.

---

<sup>1</sup> Applicable federal employment taxes are the Federal Insurance Contributions Act tax, the Federal Unemployment Tax Act tax, and the Collection of Income Tax at Source on Wages.

## ISSUES

1. Are payments to X Workers subject to employment taxes?
2. What reporting requirements apply to payments made to X Workers?
3. Are Project A employers eligible for relief under Section 530 of the Revenue Act of 1978 (section 530)?

## CONCLUSIONS

1.
  - A. Whether payments made to X Workers are subject to FICA tax depends upon whether the X Worker is employed by a State, political subdivision or a wholly owned instrumentality, or by a private employer. If the X Worker is employed by a State, political subdivision or a wholly owned instrumentality, the payments are not subject to the Federal Insurance Contributions Act (FICA) tax. If the X Worker is employed by a private employer, the payments are subject to FICA.
  - B. Payments made to X Workers are excepted from the Federal Unemployment Tax Act (FUTA) tax.
  - C. Payments made to X Workers are subject to Collection of Income Tax at Source (income tax withholding).
2. Project A employers must report the payment of wages on Form W-2, unless the employer is eligible for section 530 relief, then the payments may be reported on Form 1099.
3. Section 530 relief is available to Project A employers that relied on Rev. Rul. 75-325 as a reasonable basis for not treating the X Workers as employees, provided the employer also satisfies the reporting and substantive consistency rules.

## BACKGROUND

This memorandum answers the general question raised in your request concerning the reporting requirements applicable to payments made to X Workers. It does not consider a Project A program operated by a specific taxpayer. Our response is based upon our review of the Project A Guidelines (hereinafter Regulation D).

. Prior to publication of Regulation D this office provided comments to DOJ that were incorporated in Regulation D. The Project A is codified by the Justice System Improvement Act of 1979, as amended (the Act).

Project A is intended to create as realistic a working environment as possible within the prison walls, while enabling X Workers to become more self-sufficient to the benefit of themselves, the prison system, and the taxpayer. Under Project A, X Workers perform services for which they receive remuneration for entities described in the Regulation D

as a "Cost Accounting Center" (CAC). There are two types of CACs: a customer model and an employer model.

Under the customer model, the private sector is engaged in a CAC enterprise only to the extent that it purchases all or a significant portion of the output of a prison-based business. A customer model private sector partner assumes no major role in industry operations, does not direct production and has no control over X Workers. These functions are performed by a department of corrections. Thus, under the customer model, the X Worker is performing services for a governmental entity.

Under the employer model, a private sector entity owns and operates the CAC. It controls the hiring, firing, training, supervision, and payment of the X Workers. The department of corrections assumes no major role in industry operations, does not direct production, and exercises minimal control over X Workers. These functions are performed by the private sector. Thus, under the employer model the X Workers perform services for a private entity.

Regulation D provides that X Workers cannot be required to perform services and must participate in Project A on a voluntary basis. X Workers must be paid the locally prevailing wage for the type of work performed. Deductions can be made from the X Workers' wages for taxes, room and board, family support and victims' compensation. The X Workers must agree to any deductions.

### LAW AND ANALYSIS

Code § 6051(a) imposes a requirement on employers to furnish to each employee with respect to the remuneration paid by such person to such employee during the calendar year a written statement showing: (1) the total amount of wages as defined in Code § 3401(a); (2) the total amount deducted and withheld as tax under Code § 3402 (i.e., income tax withholding); (3) the total amount of wages as defined in Code § 3121(a); and 4) the total amount deducted and withheld as tax under Code § 3101 (i.e., FICA taxes). Code § 6051(a) also requires reporting of other items not relevant to this discussion.

Code § 6041(a) provides, with exceptions not applicable here, that any person engaged in a trade or business must file an information return with respect to certain payments made in the course of that trade or business to another person aggregating \$600 or more in the calendar year. This filing requirement applies to payments (whether made in cash or property) of salaries, wages, commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profit, or income. Thus, determining whether payments made to X Workers must be reported on Form 1099 or Form W-2 requires first analyzing whether the X Workers are employees.

The first issue to resolve is whether, under the applicable common law rules, the legal relationship of employer and employee exists between the Project A entity for which the

services are provided and the X Worker. The second issue is whether existing guidance, Revenue Ruling 75-325, 1975-2 C.B. 415, which holds that certain prison work programs are not included within the employer-employee relationship, applies to the X Workers.

For employment tax purposes, an employee is “any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.” Code §§ 3121(d)(2) and 3306(i). 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. Employment Tax Regulations §§ 31.3121(d)-1(c), 31.3306(i)-1 and 31.3401(c)-1. Examining the relationship between the CACs and the X Workers indicates that under the common law rules X workers are employees of the CACs.

However, Rev. Rul. 75-325, considers whether prison inmate workers performing services for Federal Prison Industries, Inc. (FPI) were its employees for purposes of income tax withholding.<sup>2</sup> FPI was created by Executive Order No. 6917, on December 11, 1934. Under the applicable statute as it existed in 1975, Directors of FPI were expected to provide employment for all physically fit inmate workers in the United States penal and correctional institutions. Inmate workers who worked for FPI were paid an hourly rate that was less than the minimum wage rate prescribed by the Fair Labor Standards Act. Inmate workers were subject to disciplinary sanctions by correctional authorities for refusing to work, encouraging others to refuse to work, malingering, and failing to perform work as instructed by a supervisor.

Rev. Rul. 75-325 states that the relationship between the inmate workers and FPI arises from the incarceration of the inmate workers on one hand and from the legal duty of the FPI to provide rehabilitative labor on the other. The ruling concludes that the relationship is not the legal relationship of employer and employee, and holds that the inmate workers performing services for FPI are not its employees for income tax withholding purposes.

Although there are some similarities between the services of the X Worker and the FPI worker, the X Worker is distinguishable from the FPI worker. Providing inmate workers with work experience and training is a purpose of both Project A and the FPI. However, there are additional aspects of the X Workers’ relationship with the CACs that must be considered. First, X Workers participate on a voluntary basis and voluntarily agree to the financial arrangements of their participation. In contrast, FPI workers were required to work by the penal authorities. Thus, the relationship between the X Worker and the CAC is a voluntary relationship entered into by the parties and does not arise solely

---

<sup>2</sup> In 1975, FICA tax did not apply to any government employees. Thus, the revenue ruling did not need to address the FICA tax.

from an obligation to provide employment to all physically fit inmates. Second, X Workers must receive the prevailing wage rate in the locality, whereas FPI workers were paid below the minimum wage. The legislative history of the Act and Regulation D explain that a major purpose of Project A is to prevent the "exploitation of prison labor." Third, the Project A entities are intended to provide as realistic a working environment as possible within a prison and to benefit the taxpayer, the prison system and the X Worker. Fourth, under the employer model, Project A contemplates private businesses assuming responsibility for the direction and control of X Workers on the job.

Finally, the language of the Act contemplates that an employment relationship will be created with respect to the X Worker's services and that withholding will occur from the remuneration paid to the X Worker. The Act provides that Project A must demonstrate that X Workers are not deprived, solely by their status as offenders, of the right to participate in benefits made available by the federal or state government to other individuals on the basis of their employment, such as workmen's compensation (with the specific exception of unemployment compensation). Thus, applying the rationale in Rev. Rul. 75-325, which is based on the incarcerated status of the FPI inmate workers, to the X Workers would, in effect, contradict the language of the Act.

In light of these distinctions, the relationship between the CAC and the X Worker does not arise solely from the incarceration of the X Worker but is more similar to the traditional employer-employee relationship in the non-prison environment. Thus, Rev. Rul. 75-325 is inapplicable to X Workers. Accordingly, we conclude that the X Workers are employees for purposes of the FICA, the FUTA, and federal income tax withholding.

Although the X Workers are employees under the common law, it is necessary to examine the various exceptions under the statutes (FICA, FUTA, and income tax withholding) to determine whether the payments are subject to tax under those provisions.

## **FICA**

FICA taxes (social security and Medicare taxes) are imposed on "wages" as defined in the Code. Code § 3121(a) defines wages as all remuneration for employment, unless specifically excepted. There is no specific exception under Code § 3121(a) that excludes amounts paid to X Workers from wages.

Code § 3121(b) defines "employment" as any service, of whatever nature, performed by an employee for the person employing him unless a specific exception applies. Code § 3121(b)(7) excepts from employment service performed in the employ of a State, a political subdivision, or a wholly owned instrumentality. However, there are several exceptions to the Code § 3121(b)(7) exception, that in effect result in the inclusion of services within the definition of employment. See Code § 3121(b)(7)(A) through (F).<sup>3</sup>

---

<sup>3</sup> Code § 3121(b)(7)(E), in effect, includes within FICA employment services provided under an agreement entered into pursuant to section 218 of the Social Security Act.

Code § 3121(b)(7)(F) includes within employment service performed in the employ of a State, a political subdivision of the State, or a wholly owned instrumentality thereof by an individual who is not a member of a retirement system of such State, political subdivision, or instrumentality. However, this provision is not applicable to service performed in a hospital, home, or other institution by a patient or inmate thereof. See Code § 3121(b)(7)(F)(ii). Thus, services performed in an institution by an inmate in the employ of a State, a political subdivision, or a wholly owned instrumentality are excepted from the term "employment," and therefore, the social security tax, by Code § 3121(b)(7)(F). Code § 3121(u)(2)(B)(ii)(II) also specifically provides that such services are not subject to the Medicare tax.

This exception does not apply, however, if the inmate is performing services in the employ of a non-governmental entity (for example, a private corporation operating a prison or a private corporation operating under the Project A employer model). Thus, whether amounts paid to an X Worker are subject to FICA depends upon whether the X Worker is employed by a government or a private employer.

## **FUTA**

The FUTA tax, at Code §§ 3301 through 3311, imposes an employer tax on wages (as defined in Code § 3306(b)) paid by an employer with respect to employment (as defined in Code § 3306(c)). Code § 3306(c)(21) excepts from employment "service performed by a person committed to a penal institution." Thus, FUTA taxes will not apply with respect to wages paid to X Workers, regardless of whether services are being performed under a customer model CAC or an employer model CAC.

## **INCOME TAX WITHHOLDING**

Income tax withholding applies to "wages" as defined in Code § 3401(a). Code § 3401(a) provides that the term wages means all remuneration for services performed by an employee for his employer unless a specific exception applies. Although Code § 3401(a) provides various exceptions from withholding none apply to X Workers. Further, there is no general exception from gross income for amounts paid to X Workers.<sup>4</sup> Thus, wages paid to an X Worker are subject to federal income tax withholding.

---

These "section 218 [of the Social Security Act] agreements" are under the jurisdiction of the Social Security Administration (SSA). The SSA advises that service performed in a hospital, home, or other institution by a patient or inmate thereof are not covered under section 218 agreements. See 42 U.S.C. § 418(c)(6)(B).

<sup>4</sup> As a general matter, no statutory provision exempts the amounts paid to the X Workers from gross income. However, this advice does not address a particular case and does not opine on whether, based on particular facts and circumstances, certain amounts paid to an X Worker under Project A would be excluded from gross income.

## REPORTING REQUIREMENTS

The requirement to deduct and withhold employment taxes creates reporting obligations. Under Code § 6051, every person required to deduct and withhold employment taxes from an employee's wages shall furnish the employee a written statement showing the amount of wages and amounts withheld. Employment Tax Regulations § 31.6051-1(a)(1) requires this information to be provided on Form W-2. Accordingly, we conclude that wages paid to X Workers must be reported on Form W-2.

## SECTION 530 OF THE REVENUE ACT OF 1978

Notwithstanding the above conclusions, Project A employers may be eligible for relief from employment tax liabilities pursuant to Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, as amended. Section 530 provides businesses and other entities, including state and local governments, with relief from federal employment tax liability (including taxes imposed under the FICA, the FUTA, and income tax withholding) if certain requirements are met.<sup>5</sup> For any period after December 31, 1978, section 530 relief only applies if (1) the taxpayer did not treat an individual as an employee for any period (substantive consistency requirements); (2) all federal returns (including information returns) required to be filed by the taxpayer with respect to the individual for the periods are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee (reporting consistency requirement); and (3) the taxpayer has a reasonable basis for not treating the individual as an employee.

Section 530 sets forth three safe havens which must be considered in determining whether a business had a reasonable basis for not treating the workers as employees. To establish that a business had a reasonable basis, the business must show that it reasonably relied on one of the following: (a) the judicial precedent safe haven; (b) the past audit safe haven; (c) the industry practice safe haven; or (d) some other reasonable basis. The legislative history indicates that "reasonable basis" should be construed liberally in favor of the taxpayer. H.R. Rep. No. 1748.

In this case, the question is whether reliance by a business on Rev. Rul. 75-325 would constitute a reasonable basis under section 530 for not treating an X Worker as an employee. Although we stated above that the FPI inmate workers in Rev. Rul. 75-325 are distinguishable from the X Workers, there are enough similarities to provide a

---

<sup>5</sup> An employment tax examination that involves worker classification begins with a determination of whether section 530 applies to the taxpayer. If the taxpayer is entitled to section 530 relief, the issue of worker classification is discontinued. See IRM 4.23.5.2.1. Additionally, "*Independent Contractor or Employee?*" Training 3320-102 (Rev. 10-96) TPDS 84238I, provides a comprehensive guide to section 530 and worker classification.

reasonable basis under section 530 for relying on that ruling given that liberal construction of the reasonable basis test is required by the legislative history. Thus, we conclude that reliance on Rev. Rul. 75-325 would be a reasonable basis under section 530 for not treating an X Worker as an employee.

To satisfy the reporting consistency test, the business must have timely filed all required Forms 1099 with respect to the worker for the period, on a basis consistent with the business's treatment of the worker as not being an employee. The provision only applies "for the period." That is, if a business in a subsequent year filed all required returns on a basis consistent with the treatment of the worker as not being an employee, then the business may qualify for section 530 relief for the subsequent period. If the business is not required to file Form 1099 (for example, because the worker was paid less than \$600), relief will not be denied on the basis that the return was not filed.

Under the substantive consistency rule, Section 530 relief does not apply if the business or a predecessor treated the worker, or any worker holding a substantially similar position, as an employee at any time after December 31, 1977. In other words, treatment of the class of workers must be consistent with the business's belief that they were not employees. A substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities are substantially similar.

In determining whether a business has "treated" a worker as an employee for purposes of section 530, the following guidelines apply. Withholding of FICA or income tax from an individual's wages is treatment of the individual as an employee. Also, generally, the filing of a federal employment tax return (including Form 940, Employer's Annual Federal Unemployment Tax Return, Form 941, Employer's Quarterly Federal Tax Return, and Form W-2, Wage and Tax Statement) for a period with respect to an individual constitutes treatment of the worker as an employee for that period. However, filing of a delinquent return or amended employment tax return for a particular tax period with respect to an individual as a result of Service compliance procedures is not treatment of the individual as an employee for that period. See Rev. Proc. 85-18, 1985-1 C.B. 518, § 3.03. If section 530 relief is available, it generally continues to apply if the business meets the substantive consistency and reporting consistency rule.

If a business entitled to section 530 relief, nevertheless decides to start treating its workers as employees for federal employment tax purposes, the business would not lose its entitlement to section 530 relief for periods prior to the beginning of its treatment of the workers as being employees. With respect to a business that has treated its workers as employees, section 530 relief would not be available for any period after the beginning of its treatment of the workers as employees because the business could not satisfy the substantive consistency rule.

The applicability of section 530 relief is determined based on the fact and circumstances of a particular case. Although this advice does not address particular facts, we

conclude that section 530 relief would be available to a business that could establish that it relied on Rev. Rul. 75-325 in not treating the X Workers as employees provided the business also satisfied the reporting consistency and substantive consistency rules.

### **Reporting Requirements**

As noted above, Code § 6041(a) requires that a person engaged in a trade or business who makes payments in the course of the trade or business to another person of \$600 or more in any taxable year must report these payment. Based on the foregoing analysis, we conclude that employers who are entitled to section 530 relief that provided X Workers with remuneration in excess \$600 in a tax year may continue to report these amounts on Form 1099.

If you have further questions, please call me or Dan Boeskin at (202) 622-6040.