

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

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subject: Application of Section 530 of the Revenue Act of 1978

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether a third party that Taxpayer contracted with to perform its employment tax obligations is the “statutory employer” under Internal Revenue Code section 3401(d)(1)¹ with the result that Taxpayer is relieved of federal employment taxes, including taxes under the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Federal income tax withholding (ITW) (collectively, employment taxes).
2. Is Taxpayer entitled to relief treatment under Section 530 of the Revenue Act of 1978 (Section 530)?²

¹ All references to “section” are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

² Section 530 has never been codified in Title 26 of the U.S. Code, but many publishers of the Internal Revenue Code include the text of section 530 in the notes following Code section 3401(a).

CONCLUSIONS

1. The third party is not a “statutory employer” under section 3401(d)(1) and Taxpayer is not relieved of the employment taxes at issue.
2. Taxpayer is not entitled to relief under Section 530, because Section 530 is not applicable to the present dispute.

FACTS

Taxpayer is an S Corporation which operates a _____ business. In conducting its operations during the years in issue, Taxpayer hired workers to perform services in various capacities including accounting, administrative, marketing, _____. Taxpayer filed Form 1120S, U.S. Income Tax Return for an S Corporation, for the years in issue and did not claim any deductions for officer compensation or salaries and wages. Instead, Taxpayer claimed deductions for “Employee Leasing” for its entire workforce.

Prior to the years in issue Taxpayer entered into a contract entitled “PEO SERVICES AGREEMENT” with a third party.³ Under the contract: 1) Taxpayer assumes “the responsibility for the day-to-day supervision and control of the individuals who the PEO retains to work at Taxpayer’s location” and the PEO “does not and shall not have any liability, obligation or responsibility therefore whatsoever”; 2) Taxpayer must pay “at least one (1) business day before each payroll date, an amount equal to all wages, salaries and any all other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer’s location”; 3) Taxpayer must provide a security deposit or procure a letter of credit naming PEO beneficiary in the amount as determined by the PEO to cover wages, salaries, contributions, premiums and any and all other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer’s location; and 4) PEO may terminate the contract, immediately without notice, upon the occurrence of the Taxpayer’s failure to pay any invoice in full in the amount and at the time specified when due or any breach or default of the contract by Taxpayer. In the event of termination for any reason whatsoever, the contract provides that Taxpayer is “responsible for payment of all wages, salaries and employment related taxes.”

The duties of the PEO under the contract include: 1) administering Taxpayer payroll, designated benefits, and personnel policies and procedures related to the individuals who the PEO retains to work at Taxpayer’s location; 2) providing human resource administration and payroll administration; 3) furnishing and keeping workers compensation insurance covering the individuals who the PEO retains to work at

³ The third party was part of an industry that, among other things, markets its ability to assist employers with ministerial tasks associated with the reporting and payment of employment taxes. A professional employer organization (PEO) is the name commonly used to reference entities in this industry and we will reference the third party as such for the duration of this memo.

Taxpayer's location in force; 4) processing and paying wages from its own accounts to the individuals who the PEO retains to work at Taxpayer's location based on the hours reported by the Taxpayer; and 5) filing all employment tax returns (i.e., Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return,) with the Government and furnishing information returns (i.e., Forms W-2, Wage and Tax Statement) to the individuals who the PEO retains to work at Taxpayer's location.

Although the contract generally refers to the individuals who the PEO retains to work at Taxpayer's location as "Co-Employees," Taxpayer does not dispute that at all times during the years at issue it was the common law employer of the "Co-Employees" and had the right to direct and control all aspects of the employment relationship between itself and these individuals.⁴

Taxpayer did not file any Forms 940 or Forms 941, or issue or file Forms W-2 with respect to any employees for any of the years at issue based on its contract with the PEO and took no steps to verify that the PEO filed and paid the employment taxes due or filed the appropriate returns. Taxpayer learned on audit that the PEO failed to remit applicable employment taxes to the Government, and now asserts that it paid the amount in question in full to the PEO and is not liable for the unpaid employment taxes that the PEO failed to remit to the Government.

LAW AND ANALYSIS

ISSUE I

For 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.

In the present case, Taxpayer does not dispute it was the common law employer of the workers at issue. Thus, there is no question about the employment status of the workers. Taxpayer also acknowledges that the common law employer has the responsibility to pay the underlying tax liabilities on wages it pays to employees. Taxpayer alleges, however, that it paid the requisite amount of wages, the employer share of FICA and the proper amount of FUTA taxes to the PEO, and that a PEO is "obligated by statute" under section 3401(d)(1) to withhold employment taxes from those wages, and pay such taxes over to the government, making the PEO solely responsible for the payment of the employment taxes at issue.

Pursuant to section 3401(d)(1), 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

⁴ The individuals referenced as "Co-employees" in the contract are referred to as employees or workers for the duration of this memo.

of wages. Although the Code imposes only 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 (10th Cir. 1977); The Lane Processing Trust v. United States, 25 F.3d 662 (8th Cir. 1994).

The key inquiry to make in determining whether the PEO is a section 3401(d)(1) employer of the Taxpayer's employees is to establish whether the PEO was in control of the payment of wages to those employees. When determining whether a person has control of the payment of wages, the focus is on the "legal control" of the payment of such wages. See §31.3401(d)-1(f) of the Employment Tax Regulations. 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 (4th 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, who was not the common law employer, 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, a construction company in Chapter 11 bankruptcy, contracted with a leasing company that operated similarly to the PEO in this case. Pursuant to the terms of the contract, Earthmovers leased all of its employees from Sunshine Staff Leasing. 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. The court also found that 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, Sunshine was not in control of the payment of wages for purposes of section 3401(d)(1). Thus, the court held, Earthmovers bore ultimate responsibility for payment of taxes.

Other cases have also held a taxpayer to not be a section 3401(d)(1) employer if the taxpayer received payroll information and funds from its client prior to the delivery of payroll to the client employees. See, United States v. Garami, 184 B.R. 834 (D.C. Fla. 1995) (leasing company not the section 3401 (d)(1) employer of cleaners because it generated payroll checks based on information submitted to it by the common law

employer and no evidence that leasing company would pay wages without first receiving funds to do so from common law employer); In re Professional Security Services, Inc., 162 B.R. 901 (Bankr. M.D.Fla. 1993) (leasing company not the section 3401(d)(1) employer of security guards because leasing company did not issue checks to the guards unless it received payment from the client company).⁵ Our office has also issued memorandums based on similar facts advising 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.⁶

Based on the provisions contained in the contract, the PEO is not considered to be in control of the payment of wages within the meaning of section 3401(d)(1) because the PEO did not assume legal responsibility for payment of the wages to the employees. Under the terms of the contract, Taxpayer must pay the PEO an amount equal to the wages and salaries with respect to the workers in advance of the next payroll date. To ensure that the PEO will not be responsible for payment of wages to these workers, Taxpayer must provide a security deposit or letter of credit naming the PEO as beneficiary in the amount as determined by the PEO to cover the wages and salaries. Additionally, the PEO may terminate the contract immediately without notice and Taxpayer is “responsible for payment of all wages, salaries and employment related taxes.”

Thus, the PEO acted merely as a conduit for Taxpayer in making payroll and does not meet the standards in section 3401(d)(1) and the regulations thereunder.

ISSUE 2

Section 530 provides that if certain requirements (discussed below) are met, workers shall be deemed not to be employees of a taxpayer for employment taxes, unless the taxpayer had no reasonable basis for treating the worker as other than an employee. As explained more fully below, Section 530 is not applicable in this case because the Taxpayer’s liability for the employment taxes does not involve a question of whether the workers are employees or nonemployees. Rather, the issue is solely whether the Taxpayer remains liable for employment taxes on wages paid to common law employees which the PEO failed to pay over to the government.

There are three requirements for a taxpayer to obtain section 530 relief from employment taxes. First, the taxpayer did not treat an individual, or any worker holding a substantially similar position, as an employee for any period for purposes of employment taxes. Second, the taxpayer must have filed all required Federal returns (including information returns) on a basis consistent with the taxpayer’s “treatment of

⁵ By contrast, in United States v. Total Employment Company, 305 B.R. 333 (M.D. Fla. 2004), the court held that an employee leasing company was, in fact, a section 3401(d)(1) employer because it advanced payroll on behalf of its client. Notwithstanding, the court held both the leasing company and the common law employer equally responsible to the IRS for employment taxes.

⁶ See, for example, FSA 1998-14, CCA 200415008, TAM 201347020.

such individual” as not being an employee. Third, the taxpayer must have had a reasonable basis for not “treating the individual as an employee.”

If all the requirements are met, the flush language of section 530(a)(1) provides that for purposes of applying employment taxes for a particular tax period with respect to the taxpayer, “the individual shall be deemed not to be an employee.” If the worker is deemed not to be an employee, then the taxpayer has no employment tax liability with respect to remuneration paid to that worker for that period.

Section 530(a) focuses on the taxpayer’s treatment of the worker as an employee and not the taxpayer’s treatment of certain payments or services, the taxpayer’s payment of its liability, or the determination of which party is liable for employment taxes on payments made to the taxpayer’s employees.

Congressional intent that Section 530 apply only to employee or nonemployee status determinations is reflected in the language found in section 530(a)(1)(A) that the taxpayer “did not treat an individual as an employee” for purposes of employment taxes.” Further, Section 530(b) prohibits the Service from publishing regulations or revenue rulings clarifying the “employment status” of individuals for purposes of employment taxes prior to the effective date of any law clarifying the same.

Similarly, the legislative history of Section 530 shows that Congress was providing a relief provision limited to controversies regarding whether a worker was or was not an employee of a service recipient. It explains that in the late 1960s the Service increased its enforcement of the employment tax laws, causing significant controversies between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees. H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 3-7 (1978), 1978-3 C.B. 629, 631-632. See also S. Rep. No. 95-1263, 95th Cong., 2d Sess. 209-211 (1978), 1978-3 C.B. 315, 507-508. Until Congress had adequate time to study the matter, it provided relief for taxpayers who were involved in controversies with the Service “involving whether certain individuals are employees for purposes of the employment taxes.” Joint Committee on Taxation Staff, General Explanation of the Revenue Act of 1978, 95 Cong., at 301 (1979).

Neither the statute nor the legislative history indicates that Congress intended Section 530 to apply to disputes regarding whether a common law employer remains liable for employment taxes that were never paid over to the government by a conduit payroll processor. Rather, the legislative history reflects Congressional intent to limit the application of Section 530 relief to only controversies regarding whether an individual should be reclassified from independent contractor status (or other nonemployee status such as partner) to employee status. S. Rept. No. 95-1263, at 210.

In the current examination, there is no question regarding the proper classification status of the workers as Taxpayer’s employees. In fact, the contractual arrangement between the Taxpayer and the PEO is predicated upon the treatment of the Taxpayer’s

workers as Taxpayer's employees for employment tax purposes. Specifically, under the terms of the contractual agreement Taxpayer entered into with the PEO, Taxpayer was required to remit an amount equal to the wages paid to employees, along with the employer's share of FICA and the requisite amount of FUTA taxes prior to the end of the payroll period, so that the PEO could meet the payroll requirements and pay the workers while withholding the corresponding amount of employment taxes. Thereafter, the PEO would issue Forms W-2 to the workers and report and pay employment tax on the appropriate tax returns.

Although Taxpayer did not directly pay the wages to its employees, withhold taxes from the wages paid to its employees or file Federal employment and information returns reporting the amount of wages and taxes to its employees, Taxpayer specifically contracted with a third party for purposes of fulfilling these obligations with respect to the treatment of the workers as its employees.⁷ Thus, the contractual arrangement, in and of itself, demonstrates that no underlying issue of employment tax classification status exists regarding those who received wage payments. Rather, since Taxpayer treated all of these workers as employees for purposes of taxes imposed by subtitle C, but contracted with a third party for purposes of fulfilling its payroll obligations, the dispute is unrelated to the proper employment tax classification of the workers. Rather, the dispute is limited to whether Taxpayer, as the common law employer, remains ultimately liable for the unpaid employment taxes at issue. As such, Section 530 is not applicable to the present dispute.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

⁷ Rev. Proc. 85-18, 1985-1 C.B. 518 provides some guidelines in determining whether a taxpayer did not "treat" an individual as an employee, but does not provide an exhaustive list. See section 3.03.

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