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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ELIZABETH HENN
DEPUTY AREA COUNSEL, BALTIMORE
CC:TEGE:NEMA:BAL

FROM: Will E. McLeod
Assistant Chief, Employment Tax Branch 1
CC:TEGE:EOEG:ET1

SUBJECT: Employment Tax of Residence Employees

This Field Service Advice responds to your memorandum dated October 11, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

X =

Y =

Country A =

Regulations =

Program =

Date =

Individual =

ISSUES

1. Whether the personal cook, an United States citizen, who executed an employment contract with X in Country A, for domestic services and is paid with funds of Y, is the employee of X or Y?

2. If X is the employer of the personal cook, whether X is required to withhold and pay taxes under the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA")?

CONCLUSIONS

1. The personal cook who is hired to perform domestic services for X is the common law employee of X.

2. For the period of time that X meets the definition of "American employer" under I.R.C. §§ 3121(h) and 3306(j)(3), X is liable for FICA and FUTA taxes, respectively.

FACTS

X, an employee of Y in Country A, is given an allowance to hire personal household employees for X's residence in Country A. X has a personal cook who is a U.S. citizen.

The Regulations provide that under the Program, funds may be paid directly to the service provider or reimbursed to the individual designated to receive Program funds for residence expenses, such as domestic staff.

We assume that X in Country A is a Program-designated individual and the expense for the cook is payable from Program funds.

The Regulations state that domestic servants who work as domestic staff for Y employees assigned overseas are not Y employees. They are employees of the individual in whose home they work. The Regulations also state that the lack of direct employee/employer relationship with Y should be clearly understood by all administrative staff members who deal with the domestic staff, both when they enter on duty and periodically during their employment.

The Regulations explicitly state that it is the responsibility of the individuals to provide comparable wages, fringe benefits, terms of employment, and working conditions for domestic staff in accordance with local custom.
It is also our understanding that Y's policy is that Y personnel such as X should treat their domestic staff fairly and provide them the benefits, such as social security and health insurance, that are afforded other U.S. citizens in the course of employment.

LAW AND ANALYSIS

1. Is the cook an employee of X or Y?

An "employee" for purposes of FICA and FUTA taxes is any individual who is an employee under the common law rules applicable in determining the employer-employee relationship as provided in sections 3121(d)(2) and 3306(i), respectively. Under the common law principles, an employer-employee relationship is established by the existence of control by one party over the other.

The cook is hired to provide domestic services for X. We assume the cook is working only for X and not for other persons or residences. The fact that X has discretion over hiring the individual and that X directs the daily activities of the cook are indicative of employer-employee relationship. For example, X has control over what the cook serves, as well as when and how it is served. Despite the fact that the cook may have some discretion as to the preparation of meals, X controls the cook's activity.

Domestic servants like the cook are employees of X rather than Y, not because of the Regulations, but because of the common law rules applicable to employer-employee relationships. See Nationwide Mutual Insurance Co. v. Darden, 503 U.S.

318 (1992).

Even if Y pays the cook directly, X remains the common law employer while Y is considered a section 3401(d)(1) employer.

2. If X is the employer, is X liable for FICA and FUTA?

Remuneration for services performed outside the United States is not subject to FICA and FUTA unless the services are performed as an employee for an "American employer." See I.R.C. §§ 3121(b); 3306(c). Consequently, X's liability for FICA and FUTA is contingent upon whether or not X qualifies as an "American employer" under the respective Code sections.

Under sections 3121(h)(2) and 3306(j)(3)(A), the term "American employer" includes "an individual who is a "resident" of the United States." There is no specific definition of "resident" for this purpose. However, regulations under section 7701(b) provide that, unless the context indicates otherwise, the section 7701(b) regulations apply for purposes of determining whether an United States citizen is also a resident of the United States. Treas. Reg. § 301.7701(b)-1(a).

An individual is a resident of the United States if the requirements of the "substantial presence test" are satisfied. I.R.C. § 7701(b)(1)(A)(ii); Treas. Reg. § 301.7701(b)-1(c). The requirements of the substantial presence test are satisfied if (i) the individual is present in the United States on 31 days during the current calendar year and (ii) the sum of the number of days on which the individual was present in the United States during the current calendar year and the two preceding calendar years (when multiplied by the applicable multiplier) equals or exceeds 183 days. I.R.C. § 7701(b)(3)(A); Treas. Reg. § 301.7701(b)-1(c). The applicable multiplier for the current calendar year is 1, and the applicable multipliers for the first and second preceding calendar years are 1/3 and 1/6, respectively. I.R.C. § 7701(b)(3)(A); Treas. Reg. § 301.7701(b)-1(c).

Even if an individual satisfies the substantial presence test for a calendar year, the individual will not be treated as an United States resident if the individual satisfies the "closer connection exception." The closer connection exception is satisfied if (i) the individual is present in the United States on fewer than 183 days during the calendar year and (ii) the individual establishes that the individual has a tax home in a foreign country and a closer connection to such foreign country than to the United States. I.R.C. § 7701(b)(3)(B); Treas. Reg. § 301.7701(b)-2(a)(1) and (2). For this purpose, the term "tax home" has the same meaning that it has for purposes of section 162(a)(2) (relating to travel expenses while away from home).

Treas. Reg. § 301.7701(b)-2(c). Thus, the individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. Id. An individual generally has a closer connection during the current year to a single foreign country in which the individual maintains a tax home than to the United States. Treas. Reg. § 301.7701(b)-2(a)(3). An individual who claims the closer connection exception must file a fully completed Form 8840 to explain the basis of the claim. Treas. Reg. § 301.7701(b)-8(a)(1) and -8(b)(1)(i).

It is possible X might satisfy the substantial presence test for one or more calendar years, if X is physically present in the United States for a sufficient number of days. However, we think it is likely that even if X satisfies the substantial presence test for a particular calendar year, (i) X would have been present in the United States on fewer than 183 days during that calendar year and (ii) X would have a tax home in Country A and a closer connection to Country A than to the United States, because X's regular or principal place of business would be in Country A. Therefore, we think it is likely the closer connection exception would apply and X would not be a resident of the United States or an American employer, provided X files a fully completed Form 8840.

In our view, the years when X is most susceptible to being treated as an American employer are the first and last years of X's tour of duty, when the X might be physically present in the United States before the tour of duty commences or after the tour of duty concludes.

The "residency termination date" for an individual who meets the substantial presence test is the last day during the calendar year on which the individual is physically present in the United States if the individual establishes that, for the remainder of the calendar year, the individual's tax home was in a foreign country and he or she maintained a closer connection to that foreign country than to the United States. Treas. Reg. § 301.7701(b)-4(b)(2). Thus, during the first calendar year of X's tour of duty in Country A, it is likely X would cease to be a resident of the United States on the last day X is physically present in the United States. If X is not a resident of the United States for the remainder of the calendar year, X also will not be an American employer for the remainder of the calendar year.

The "residency starting date" for an individual meeting the substantial presence test for the current calendar year is the first day during such calendar year on which the individual is physically present in the United States. Code § 7701(b)(2)(A)(iii); Treas. Reg. § 301.7701(b)-4(a). Thus, during the last calendar year of X's employment in Country A, it is likely X would not become an United States resident before the first day X is physically present in the United States. If X is not a resident of the United States for the first part of the calendar year, X also will not be an American employer for the first part of the calendar year.

Therefore, if X qualifies as an United States resident and hence meets the definition of an “American employer” as provided by the Code and regulations, X is liable for FICA and FUTA taxes. If Y controls the payment of wages, it is the section 3401(d)(1) employer. Whereas, if X does not meet the definition of an “American employer,” X is not liable for FICA and FUTA, nor is Y the section 3401(d)(1) employer.

We have enclosed for your information a copy of a letter we sent to Y on Date which discussed substantially the same question raised here. If you have any questions, please contact me or Kyle Orsini at (202) 622-6040.

WILL E. MCLEOD