Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

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subject: Refund Claim

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

LEGEND

Taxpayer

State

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ISSUE

Whether the Internal Revenue Service (Service) should approve the Federal Unemployment Tax (FUTA) tax refund claim filed by the Taxpayer, a staffing company , for FUTA taxes it paid with respect to wages paid to workers performing services for the Taxpayer's clients?

CONCLUSION

No, the Service should not approve Taxpayer's refund claim. The FUTA exemption in Internal Revenue Code (the Code) section 3306(c) applies to service performed in the employ of an . The fact that under State law the employees are considered to perform services for Taxpayer for State unemployment insurance purposes has no effect on whether they are in the employ of Taxpayer or Taxpayer's clients for FUTA purposes. Similarly, even if Taxpayer is the statutory employer of its clients' employees within the meaning of section 3401(d), the FUTA liability, including the exception from FUTA provided under section 3306(c) when wages are paid for service performed in the employ of an , is determined by reference to the common law employer and not the section 3401(d)(1) employer. Taxpayer has staked its argument on its status for State unemployment insurance purposes and, alternatively, its status under section 3401(d)(1). During the course of the examination, Taxpayer has not claimed to be the common law employer of its clients' workers. The facts provided with respect to how Taxpayer initiates its relationship with clients, the range of businesses conducted by the clients, and the geographic dispersion of the clients, weigh against viewing Taxpayer as the common law employer. Absent compelling factual information to support a conclusion that Taxpayer is the common law employer of its clients' workers, Taxpayer's refund claims should be denied.

FACTS

The Taxpayer was established by the in . Taxpayer describes its business as a "staffing company." However, Taxpayer operates in a like manner to businesses commonly called employee leasing companies or professional employer organizations. Taxpayer offers client businesses multiple employee benefit and payroll services including withholding, depositing and reporting all applicable employment related taxes, both state and federal. Generally, clients authorize Taxpayer to perform

payroll and other administrative functions on their behalf for employees performing services for the clients. Typically, clients pay Taxpayer a monthly rate equal to total payroll plus a specified percentage of payroll. The percentage varies based upon the services the client purchases from Taxpayer. The clients are mainly . Taxpayer aggregates all of its clients and files Forms 941, Employer's Quarterly Federal Tax Return and Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return reporting wages, income tax withholding, FICA and FUTA for all of its clients on an aggregate basis under Taxpayer's name and employer identification number.

For and , Taxpayer paid FUTA with respect to the wages paid on behalf of its clients. Taxpayer claimed a credit against FUTA based on its payments into the State unemployment insurance system.

Determination of Taxpayer's Employer Status for Purposes of State Unemployment Insurance

On Taxpayer registered with the State and

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for which services are performed that do constitute employment under section d" may finance its liability using any of the methods provided under f.

Initially, the State granted the application. Subsequently, the State reversed its position, concluding that Taxpayer's employees were not performing services directly for the

. In turn the State assessed Taxpayer for several quarters of SUI contributions from . Taxpayer filed a petition for a reassessment. Following a hearing, a State administrative law judge provided a written decision on concluding that under the State Unemployment Insurance Code, Taxpayer was entitled to pay its SUI taxes

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The judge analyzed whether the workers being paid by Taxpayer were performing services for Taxpayer that constituted employment under section d. In reaching the conclusion that the workers were indeed performing services for Taxpayer that constituted employment, the opinion relied on the conclusion that the workers were employees of Taxpayer under section i. Section i provides that if an entity contracts to supply an employee to perform services for a client, and the entity is a leasing employer or a temporary services employer, the entity is the employer of the employee who performs the services. Section i is an exception to the general rule under section g for determining who is an employer. The general rule follows the common law standard.

Section h defines a “temporary services employer” and a “leasing employer,” as an employing unit that contracts with clients or customers to supply workers to perform services for the client or customers and performs all of the following functions:

The judge concluded that Taxpayer met the criteria to be considered a leasing company or temporary services company, and consequently, was the employer of its clients’ workers for purposes of State unemployment insurance law. Specifically, the judge wrote:

In other words, because Taxpayer was the employer pursuant to section i, all services performed were performed for Taxpayer, regardless of whether the services were conducted under Taxpayer’s direction and control or whether the services had any effect on Taxpayer. Thus, the opinion ruled in Taxpayer’s favor, granting Taxpayer’s request to pay SUI for the years and going forward.

Refund Claim

On , the Taxpayer filed claims for refund for FUTA taxes paid for and . Taxpayer asserts that it does not owe FUTA taxes because it is eligible for the exemption from FUTA provided by section 3306(c) . The amount of the refund claim is $ for the tax year and $ for the tax year.

examined the claims for refund. Although the refund claims do not provide a detailed explanation of the basis for the claims, subsequent examination of the claim indicates that Taxpayer takes the position that its clients' employees were in the employ of Taxpayer for purposes of the FUTA exemption because Taxpayer was held to be the employer of the workers for purposes of State unemployment insurance requirements. Also, Taxpayer's representative has submitted a memorandum claiming that Taxpayer's clients' employees were in the employ of Taxpayer for purposes of the FUTA exemption because Taxpayer was the statutory employer of those workers under section 3401(d)(1) of the Code.

Factual Assumptions for Purposes of This Memorandum

For purposes of providing this legal advice, we have assumed that

[1] Based on the facts we have, we also believe it is a fair assumption that Taxpayer is not the common law employer of the individuals performing services for Taxpayer's clients. A common law employer/employee relationship exists between an entity and individuals when the entity has the right to direct and control the performance of services by the individuals. Factors considered in determining whether an entity has an employer/employee relationship with workers include the nature and degree of financial control and behavioral control the entity has, and the relationship of the parties, including the relationship the parties believe they are creating. Taxpayer operates in form not uncommon for employee leasing companies. When a business hires the Taxpayer, it fires its employees one day, and the next day leases those same employees from Taxpayer. From the affected employees' perspective there is no change in their relationship with the client company. The client company continues to control the daily performance of its workers' duties.[2] Taxpayer does not provide employees with any specific instructions as to when, where or how the work will be done. Taxpayer has hundreds of clients spread across multiple states. A review of Taxpayer's client list shows that its clients are not limited to a particular industry and include small and large employers engaged in a range of businesses including retail,

[1] This assumption is based on a review of Taxpayer's and client lists.
[2] In response to an inquiry from the Service, a client of Taxpayer stated that it fired all of its workers who were then hired by Taxpayer. However, after Taxpayer "hired" the workers, the client continued to assign specific duties to the workers, provide the necessary training for the workers, set work hours for the workers and determine the workers' rate of pay.

service businesses, and restaurants. Taxpayer has expertise and capacity to provide payroll, benefits and human resource functions, but there is no indication it has the capacity to direct and control workers in such diverse workplaces that are so geographically dispersed. Thus, absent additional information on the nature of Taxpayer's interaction with the workers and the clients, it is most likely that Taxpayer is not the common law employer of the workers performing services for client companies.

LAW AND ANALYSIS

Section 3301 of the Code imposes a tax under FUTA on every employer equal to a certain percentage of the wages paid by it with respect to employment. Section 3306(b) provides that, for purposes of FUTA, the term "wages" means all remuneration for employment, with certain specified exceptions. Section 3306(c) defines employment, in relevant part, as any service of whatever nature performed by an employee for the person employing him. Therefore, unless amounts paid are excepted from "wages," or the services performed are excepted from "employment," FUTA tax will apply.

For FUTA purposes, the term employer is generally defined in section 3306(a)(1) as any person who (A) during any calendar quarter in the calendar year or the preceding calendar year paid wages of $1,500 or more, or (B) on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least one individual in employment for some portion of the day.[3]

Employment tax regulation section 31.3306(i)-1 provides that an individual is an employee if the relationship between him and the person for whom he performs services is the legal relationship of employer and employee. The regulation provides that such a relationship exists if the person for whom the services are performed has the right to direct and control the individual who performs the services. Thus, the test applied is the same as the test applied under the common law. The regulation further provides that whether the relationship of employer and employee exists is determined upon an examination of the particular facts of each case.

[3] This definition of "employer" was enacted as an amendment to section 3306(a)(1) in 1970 by the Employment Security Amendments of 1970, Pub. L. No. 91-373. This amended language, however, does not alter the legal principle that the employer for purposes of computing FUTA liability is the common-law employer. The legislative history of section 3306(a)(1)(A) indicates that section 3306(a)(1)(A) was intended merely to extend FUTA liability to any employer with a payroll of a certain amount. There is no indication that it was intended to substitute a third party handling of payroll for the common law employer for purposes of determining FUTA liability.

Section 3401(d)(1) provides, that for purposes of income tax withholding, the term employer means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person except that if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of the definition of wages) means the person having control of the payment of such wages.

Neither the FICA nor the FUTA contains a definition of employer similar to the definition contained in section 3401(d)(1), relating to income tax withholding. However, Otte v. United States, 419 U.S. 43 (1974), holds that a person who is an employer under section 3401(d)(1), relating to income tax withholding, is also an employer for purposes of FICA withholding under section 3102. Otte involved a trustee in bankruptcy who was an employer under section 3401(d)(1) by virtue of having control over the payment of wages owed by the bankrupt. The Court stated:

> The fact that the FICA withholding provisions of the Code do not define "employer" is of no significance, for that term is not to be given a narrower

> construction for FICA withholding than for income tax withholding. (419 U.S. at 51)

The Otte decision has been extended to provide that the person having control of the payment of wages is also an employer for purposes of section 3111, which imposes a FICA excise tax on employers, and for purposes of section 3301, which imposes the FUTA tax on employers. It has been further extended to apply equally to the employer's FICA tax and to FUTA tax. In re Armadillo Corp., 410 F. Supp. 407 (D. Col. 1976), aff'd, 561 F.2d 1382 (10th Cir. 1977. In re Laub Baking Co., 642 F.2d 196 (6th Cir. 1981), and STA of Baltimore --ILA Container Royalty Fund v. United States, 621 F. Supp. 1567 (D.C. Md. 1985), aff'd, 804 F.2d 296 (4th Cir. 1986) reached similar conclusions.

Rev. Rul. 54-471, 1954-2 C.B. 348, sets forth the Service's position that the common law relationship of the parties determines whether an employment tax liability exists, even when a third party is involved in the payment of wages. In Rev. Rul. 54-471, the Service considered the application of employment taxes to individuals who performed demonstrations on citrus products on behalf of a state commission. The individuals were paid by a third party advertising agency. The revenue ruling concludes that the agency controlled the payment of wages under the income tax withholding provisions but further held that the state commission was the common-law employer of the individuals, and the determination of FICA and FUTA tax liability is made with respect to the common-law employment relationship. Also see, Rev. Rul. 57-145, 1957-1 C.B. 332, concluding that although architectural firms controlled the payment of wages and were therefore liable for withholding, reporting and paying over federal income taxes, other corporations were found to remain the common law employers. The determination of FICA and FUTA tax liabilities was determined with respect to the corporation's employment relationship. The same conclusion was reached in Rev. Rul. 57-315, 1957-2 C.B. 626.

Taxpayer's counsel takes the position that Taxpayer is a section 3401(d)(1) employer, and as such is the employer eligible for the FUTA exception in section 3306(c)

The determination of whether amounts are "wages" under section 3306(b), the determination of whether services performed are "employment" for purposes of section 3306(c), and the determination of whether workers are employees under section 3306(i), in sum, the determination of whether a FUTA liability exists, is made with reference to the common law employer. The common law test which is the standard for finding an employer/ employee relationship is applied to determine which entity is the common law employer. Cencast Services, L.P. v. United States, 62 Fed. Cl. 159 (2004). The same common law standard applies for determining what is wages and what is employment for purposes of income tax withholding and FICA.

Although section 3401(d)(1) provides an exception to the common law rule for purposes of assigning liability for income tax withholding, the parenthetical in section 3401(d)(1) provides that the person who is in control of the payment of wages is the employer "except for purposes of subsection (a)", which is the subsection containing the definition of wages for income tax withholding purposes. Thus, for purposes of determining whether payments are wages, and whether exceptions apply that depend on the identity of the employer, the employer is the common law employer, not the section 3401(d)(1) statutory employer.

The Court of Claims agreed with the Service's interpretation of how section 3401(d)(1) applies when determining wages under section 3306(b) in its recent decision in Cencast. In Cencast the court considered whether a section 3401(d)(1) employer, paying wages to employees performing services for various common law employers, was entitled to use the same wage base for purposes of the FUTA as the common law employers. In Cencast the government argued that when defining the term "wages" under section 3306, the only employer to be considered is the person for whom the individual performs or performed any services. Thus, the government argued that while Otte and the cases that followed Otte have incorporated the section 3401(d) definition of employer into FICA and FUTA, this definition has been incorporated only for purposes "of (1) withholding with respect to the employees' share of FICA and (2) accounting for, reporting, and paying FICA and FUTA taxes." The court in Cencast agreed and held that the section 3401(d)(1) employer could not be considered the "employer" for purposes of calculating FICA and FUTA taxable wage bases under sections 3121(a) and 3306(b) and thus, the statutory employer could not aggregate the wages paid to employees by all the common law employers for which they performed services for purposes of such calculations, notwithstanding the payor's status as a section 3401(d)(1) employer. [4]

If, under Cencast and its underlying rationale, a section 3401(d)(1) employer is not the employer for purposes of the definition of wages, then a section 3401(d)(1) employer is also not the employer for purposes of the definition of employment. Wages are defined as remuneration for employment. Otte and its progeny extend the definition of "employer" contained in section 3401(d)(1) to FICA and FUTA. Cencast demonstrates that the parenthetical exception contained in section 3401(d)(1) signals that the statutory employer is the employer solely for purposes of withholding, reporting, and payment and that the common law employer remains the employer for purposes of determining whether there is a liability for employment tax, and if so, how much tax is owed. There is nothing in the statute or legislative history to suggest that the exception to employment provided in section 3306(c) should be read contrary to this general principle. To hold otherwise would permit taxpayers to manipulate application of exceptions intended to favor entities that create employment opportunities or direct and

[4] When considering whether the determination of "wages" should be made at the common law or section 3401(d)(1) level the Court in Cencast thoroughly reviewed and considered legislative history, beginning with the Social Security Act of 1935, IRS pronouncements, and the applicable Court cases, including Otte, Armadillo, and In re Laub Baking Co.

control the performance of certain services. If the Taxpayer's argument were accepted, then any employer could receive an exemption from FUTA simply by running its payroll through in a fashion that would allow to claim it was a section 3401(d)(1) statutory employer.

The fact that the State treated Taxpayer as the employer for SUI purposes has no bearing on the application of the Code to this case. The decision was based on language in State Unemployment Insurance Code that treats temporary services employers or leasing employers as employers of individuals who are common law employees of a third party for purposes of State unemployment insurance coverage.

Taxpayer contends that its status as an , and a section 3401(d)(1) employer, allows it to use the exemption under section 3306(c) . Taxpayer's representative cites several private letter rulings (PLRs) and a technical advice memorandum (TAM) to support its theory that the FUTA exemption "can be pegged" to the section 3401(d)(1) employer. Private letter rulings and TAMs are not precedential and may be relied upon only by the parties to which they were issued. A taxpayer may not rely on a letter ruling issued to another taxpayer. See section 6110(k)(3) and section 11 of Revenue Procedure 2008-1.

The PLRs Taxpayer cites[5] were issued in response to Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding requests submitted by individuals. The rulings address factual situations involving three parties and conclude that one party is the common law employer of the worker and without any analysis conclude that the other is a section 3401(d)(1) statutory employer. The rulings also conclude that the section 3401(d)(1) employer is responsible for the federal employment taxes. None of the rulings, are directly on point as they do not address or analyze the issue of whether a section 3401(d)(1) employer is the employer for purposes of determining whether an employment tax liability exists.

Taxpayers also cite TAM 86-03-004 (Sept. 20, 1985), which addressed whether an engineer custodian, a public school employee, was the employer of helpers engaged by him to perform maintenance services for the school. The pivotal question in the TAM was whether the engineer was serving the school as both an employee and an independent contractor. The TAM concluded that the engineer custodian was an employee of the school for all purposes. It further concluded that the helpers were

[5] LTR 92-370-23 (June 15, 1992); LTR 92-38-031 (June 22, 1992); LTR 92-38-035 (June 23, 1992); LTR 92-380-38 (June 23, 1992); LTR 92-38-039 (June 22, 1992); and PLR 94-23-017 (March 10, 1994).

employees of the school and that the school was "the party that had legal control of the payment of wages to the helpers." There is no legal analysis to support the conclusion that the school was both the common law and statutory employer with respect to the helpers. The conclusion ensured that federal income tax was withheld from the helpers' wages. There was no analysis of how FICA or FUTA would be calculated because the school was a government entity exempt from those taxes. Thus, the TAM does not answer the question raised by the refund claim.

Consistent with the position set forth in Rev. Rul. 54-471 and supported by the Cencast court, whether there is employment that gives rise to wages under section 3306(b), which in turn give rise to a liability for FUTA depends upon the existence of a common law employment relationship.

Assuming Taxpayer is a section 3401(d)(1) employer it is required to pay the FUTA tax liability existing with respect to its clients for and . Based on the facts as we have them, it appears the Code section 3306(c) exception does not apply because the workers in question do not appear to be the common law employees of the Taxpayer. Accordingly, in the absence of additional facts demonstrating that a common law employment relationship does exist between the Taxpayer and the workers, the Service should deny the refund claims.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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[redacted]

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

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