OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR CHIEF, EXEMPT ORGANIZATIONS CP:E:EO:T-1
TECHNICAL BRANCH 1
Attn: Rick Kaiser

FROM: Chief, Branch 2 CC:EBEO:2
Office of Associate Chief Counsel
(Employee Benefits and Exempt Organizations)

SUBJECT: Request for assistance regarding employment status in connection with technical advice memorandum

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved: and following

LEGEND:

Institution =
Taxpayer =
TAM =
State =
Professional =
Professional Type 2 =
Year 1 =
$w = $
$x = $
$y = $
$z = $
Plan =

ISSUE:

Whether employees working in institutions leased by Taxpayer are common law employees of Taxpayer, rather than employees of the institution owners.

CONCLUSION:

Employees working in the institutions leased by Taxpayer are common law employees of Taxpayer, not employees of the institution owners. Thus, Taxpayer is the employer of the employees for purposes of employment taxes.[1] Further, Taxpayer is the employer of the employees for purposes of coverage under the Plan and the health plan Taxpayer maintains for its employees.

FACTS:

Background

You have asked us to determine whether employees working in the leased institutions are employees of the respective institutions or employees of Taxpayer. This issue was raised in connection with a request for technical advice that resulted in the issuance of the TAM.

Taxpayer has contracts with the boards of trustees of many public institutions in State. The contracts are of three types. The first type is the lease, under which Taxpayer leases an institution and its grounds, along with all permanent equipment, and takes responsibility for operating the institution, including day-to-day operations and all administrative functions. These institutions are referred to as the leased institutions. The second type is the management agreement, under which Taxpayer agrees to provide management services with respect to the institution. These institutions are referred to as the managed institutions. The third type is the service agreement, under which Taxpayer provides specific services for institutions (for which it does not have a lease or management agreement).

This memorandum addresses the issue of which entity is the employer of the employees who work in the leased institutions. The memorandum addresses only the leased institutions; it does not apply to any other institution. Further, this

[1] This memorandum collectively refers to the following as employment taxes: (1) the taxes imposed on employees and employers by the Federal Insurance Contributions Act (FICA), sections 3101 and 3111 of the Internal Revenue Code; (2) the tax imposed on employers by the Federal Unemployment Tax Act (FUTA), section 3301 of the Code; and (3) the requirement for collection of income tax at source on wages, section 3402 of the Code.

memorandum will use the word “institution” to refer to the building and the term “institution owner” to refer to the county or community that owns the building leased to Taxpayer.

The materials submitted with the request for technical advice indicate that the Service and Taxpayer agree that within the managed institutions, only the institution administrator is an employee of Taxpayer. All the other employees are employed by the owner of the managed institution. However, within the leased institutions, Taxpayer views all the employees as its own, while the Service states that the employees at the leased institutions are employed by the institution owner, not Taxpayer.

The TAM contains a recital in the facts section that Taxpayer does not employ Professionals or Professionals Type 2. It states that Professionals and Professionals Type 2 are hired and paid by the individual institutions with which Taxpayer has lease, management, and other agreements. Although these statements appear to resolve the issue whether employees working in the leased institutions are employees of the respective institutions or employees of Taxpayer (at least with respect to Professionals and Professionals Type 2), because you have asked us to determine who is the employer, we make our determination without regard to these statements in the TAM. Since we conclude that the employees are employed by Taxpayer, you may wish to revise the facts section of the TAM to avoid the appearance of a contrary conclusion.

We note that each lease provides that any licensed Professional graduated from an accredited school is permitted to practice in the institution. A Professional who is engaged in his or her own private practice is generally not an employee. Employment Tax Regulations § 31.3121(d)-1(c)(2). Thus, it may be that some or all of the Professionals who work at the institutions are not employees at all. This memorandum does not make a determination whether the Professionals are employees.

Taxpayer’s Stated Purpose

Taxpayer's articles of incorporation include the following purpose:

> to manage under contract, lease, purchase, erect, or acquire property necessary for the operation, maintenance and management of [institutions] . . . and to perform charitable acts as part of the provision of such management, leasing or other services in the operation of such institutions . . . .

Taxpayer's bylaws provide that the chief executive officer is responsible for selection, employment, control, and discharge of employees and for development and maintenance of personnel policies for the leased institutions.

Lease Arrangements

In Year 1, Taxpayer had leases with eleven institution owners through each institution's board of directors or board of trustees. All eleven leases are nearly identical. All the leases state that the lessor is the owner of the institution, and has, by resolution, declared that it is in the best interest of the institution to rent, lease or let the institution to some person, persons, corporation or society for the purpose of maintaining and operating the institution.

Under each lease, Taxpayer pays $1 to the institution owner, and Taxpayer receives use of the institution and grounds, as well as permanent equipment and fixtures. The institution owner agrees to levy a tax to provide funds to run the institution in accordance with an annual budget prepared by the institution owner and Taxpayer. Funds from the levy are to be placed in the hands of the trustees for the use of the institution. The institution owner pays certain insurance and other expenses. The remainder of the funds from the levy is to be paid to Taxpayer from time to time as necessary to establish and maintain an operating fund. Each lease sets forth a minimum amount to be maintained in the operating fund. These amounts range from $w to $x. One lease recites that the operating funds are necessary to meet the institution's obligations to pay all expenses, including payroll. Bank signature cards for the operating accounts indicate that only certain Taxpayer employees are authorized to sign checks on these accounts. No member of an institution's board has authority over these accounts.

Taxpayer is to be paid an operating fee for its institution administration services provided from its corporate offices in addition to all other expenses incurred in the operation of the institution. The amount of this fee ranges from about $y to about $z, with an annual increase specified in the lease. Taxpayer is required to keep books to show expenses, income, liabilities, and accounts receivable. The leases vary in the length of their terms; four are for 15-year terms, two are for 10-year terms, two are for 5-year terms, and three are for 3-year terms.

The lease provides for Taxpayer to maintain all equipment and supplies and replace worn out items, with the cost being considered an operating expense. Taxpayer is to carry liability, worker's compensation, and professional liability insurance. The institution owner is to furnish new items of equipment and make major repairs to buildings, built-in equipment, and heating and air conditioning systems.

The lease provides that as long as Taxpayer is in possession of the institution, Taxpayer will continuously operate and maintain a duly accredited institution and that fees and charges to the public will be comparable to the fees and charges of other accredited and licensed institutions of comparable size in the area.

The institution owner, through its board of directors or board of trustees, agrees to act as an advisory committee to Taxpayer in matters of public relations or any other matters at the request of Taxpayer. The lease provides, however, that it is understood that Taxpayer, being in charge of the operation of the institution, shall have full responsibility for its operation under the terms of the lease without interference by the institution owner.

The lease provides generally that either party may terminate the lease on 60 days' written notice. The lease also specifically provides that if differences arise between the parties which are irreconcilable and irremediable and which wholly thwart and destroy the legitimate aims and purposes of the agreement, then either party may terminate the lease on 60 days' written notice. Each of the leases recites that it is expressly understood that such day to day management decisions as, but not limited to, institution personnel management shall not for purposes of the lease be considered to "wholly thwart and destroy the legitimate aims and purposes" and the same shall be deemed only to refer to either county or trustees level differences.

Any Professional graduated from an accredited school and licensed to practice in the state is permitted to practice in the institution, and shall constitute the institution Professional staff, provided that Taxpayer may for good cause deny any Professional the right to practice in the institution who is not competent in professional ability and worthy in character and in matters of professional ethics.

Taxpayer maintains a corporate and a financial office from which centralized core services for the institutions are provided. Regional Vice-Presidents each serve a number of institutions and provide routine monthly visits which include meeting with the institution administrator, board of trustees, and Professional staff as well as participation in various employee and community meetings.

One of the institution owners terminated its lease with Taxpayer. Taxpayer's president and CEO sent a letter to the interim administrator of the institution, requesting that the interim administrator notify Taxpayer's employees that they would no longer be employees of Taxpayer effective as of a specified date. Taxpayer submitted this letter to illustrate its belief that employees working at the institutions are employees of Taxpayer during the lease term.

The TAM states in the facts section that Taxpayer has the power to lease equipment, give and seek grants, enter into compensation agreements (including Professionals), hire and fire all employees including Professionals, settle claims and litigation for the institutions, and purchase certain kinds of insurance. Although the power to enter into compensation agreements and to hire and fire employees is not specified in the leases, we find that this statement in the facts section of the TAM is generally supported by the text of the leases and is confirmed by the submissions made on behalf of Taxpayer.

Employee Benefits

Taxpayer maintains a health plan for its employees. It also maintains an employee retirement plan, the Plan. The Plan provisions are set forth in a single plan document containing (1) plan provisions for a deferred annuity plan intended to meet the requirements of section 403(b) of the Code and (2) plan provisions for a defined contribution money purchase pension plan intended to meet the requirements of section 401(a) of the Code. The employees who perform services at the institutions participate in these plans. The institution owners have not adopted the Plan. Taxpayer files a separate Form 5500 with respect to the Plan relating to the employees performing services at Taxpayer's offices and the employees at each institution. That is, Taxpayer files twelve Forms 5500 each year. The Plan tests contributions for compliance with section 401(m)(2) considering all employees in the Plan as employees of one employer.

Federal Employment Tax Reporting

Taxpayer files Form 941 under its own EIN covering the corporate office employees. It files a separate Form 941 under an EIN obtained for each institution covering the employees who work at that particular institution. Some of the EINs were obtained in the name of the institution followed by either the words "operated by" or simply a dash and Taxpayer's name. Taxpayer offered the explanation, supported by representative correspondence, that there has always been some confusion about payroll reporting, that it attempted to comply with the law, that the relationship between Taxpayer and the institutions has been made known to the Service, and that Taxpayer has sought guidance from the Service in the past as to how to comply.

LAW AND ANALYSIS:

For employment tax purposes, "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. Section 3121(d)(2) of the Code.[2]

"Employee" is defined further in the regulations under sections 3401 and 3121 of the Code. Both sections 31.3401(c)-1(b) and 31.3121(d)-1(c)(2) provide that, generally, the relationship of employer and employee exists when the person for whom the 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.

The analysis of whether an employment relationship exists typically arises in the context of determining whether an individual is an employee or an independent contractor. However, the determination of which of two potential employers is treated as the employer for employment tax purposes is made using the same standard. Bartels v. Birmingham, 332 U.S. 126 (1947); Professional & Executive Leasing, Inc. v. Commissioner, 89 T.C. 225, 232 (1987), aff'd, 862 F.2d 751 (9th Cir. 1988).

For purposes of the Employee Retirement Income Security Act of 1974, the Supreme Court adopted a common law test for determining who qualifies as an "employee." Nationwide Mutual Insurance Co. v. Darden, 503 U.S. 318, 323 (1992). The Supreme Court summarized the common law test as follows:

> In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the

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[2] Under section 3401(d)(1) of the Code, if the common law employer does not have control of the payment of wages, the person that has control of the payment of wages is the employer. Because we find that Taxpayer is the common law employer and Taxpayer has control of the payment of wages, section 3401(d)(1) does not apply in this case. Kittlaus v. United States, 41 F.3d 327 (7th Cir. 1994), involved similar facts. In that case, a management company had complete responsibility for hiring, discharging, promoting, and supervising the executive staff and the other operating and service employees of a motel under a management agreement. The motel owner had very limited access to funds used to pay employees. The court found that the management company controlled the payment of wages, and the motel owner was not liable for unpaid employment taxes. The court based its decision on section 3401(d)(1), without addressing which entity was the common law employer.

> source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.

Nationwide, at 323-324, quoting Community for Creative Non-Violence v. Reid, 490 U.S. 730 (1989). The Court added:

> Since the common-law test contains "no shorthand formula or magic phrase that can be applied to find the answer, . . . all of the incidents of the relationship must be assessed and weighed with no one factor being decisive." NLRB v. United Ins. Co. of America, 390 U.S. [254], at 258 [1968].

Nationwide at 324.

In applying the Supreme Court's test to the inquiry of which entity is the employer, the factors must be considered in terms of whether Taxpayer or the institution owner has the right to control the employees.

Taxpayer, not the institution owner, has the right to control the manner and means by which the employees accomplish the work product. It is Taxpayer's vice presidents who make monthly visits to supervise the employees. No one from the institution owner or the institution board of trustees supervises the employees. All employees at the institutions ultimately report to the institution administrator, who is an employee of Taxpayer. The leases all include a declaration that the institution owner expects Taxpayer to operate the institution. Taxpayer has authority under its articles of incorporation to manage institutions, including employing the requisite staff. Taxpayer's chief executive officer has responsibility under its bylaws to hire, fire, and control employees for the institutions.

Taxpayer, not the institution owner, is the source of the equipment and tools the employees use in their work. The institution owner owns the building, but Taxpayer leases it along with all the equipment. Taxpayer also provides all the supplies needed to operate the institution.

The institution owner has no right to assign work to employees, determine employees' work schedules, or hire and pay assistants. Under the terms of the lease, Taxpayer is responsible for operation of the institution, including personnel management, and the institution owner may not interfere. Part of the regular business of Taxpayer is operating an institution, and it hires and pays the employees. Taxpayer provides the employees with benefits--participation in an employee health plan and a retirement plan. Taxpayer treats the employees as its own for tax purposes, providing them with Forms W-2 and paying employment taxes.

We note that Taxpayer's filing a separate Form 941 for each institution tends to indicate that Taxpayer views the employees at the institutions as employees of the institution owners. However, we do not find this fact determinative, especially in light of Taxpayer's explanation that it was confused about how these forms were to be filed, as well as other facts evidencing that it treated the employees as its own.

The remaining factors enumerated by the Supreme Court may have little bearing on the determination of who is the employer. Method of payment, in the context of determining whether a worker is an employee or an independent contractor, usually refers to payment as an hourly wage as opposed to a flat fee for services. In the context of this case, the important fact is that Taxpayer, not the institution owners, pays the employees. Both the skill required of the employees and the location of the work are the same for the institution workers, no matter which entity is the employer. The duration of the relationship between the employees and Taxpayer is not known. However, for the duration of the lease, from 3 to 15 years, Taxpayer is responsible for operating the institution, including controlling and paying the employees.

In sum, the factors cited by the Supreme Court in Nationwide (with the possible exception of the manner of employment tax reporting) all point to the conclusion that Taxpayer is the employer of the employees working at the institutions, and the institution owners are not.

In cases where courts have determined which of two parties is the employer, the courts look to which party has control over the workers. See Professional & Executive Leasing and Packard v. Commissioner, 63 T.C. 621 (1975), discussed below.

In Professional & Executive Leasing, the petitioner leasing company (PEL) furnished medical, legal, and management personnel to recipient companies and treated the workers as its own employees. PEL covered the workers in pension, profit-sharing, and fringe benefit plans. It also issued paychecks, paid employment taxes, and provided workers' compensation coverage. By contract, PEL had the right to terminate or reassign a worker. The recipient companies provided equipment, tools, office space, and malpractice insurance for the workers. Almost all the leased workers had a pre-existing ownership or equity interest in the recipient to which they were leased.

Among the factors considered by the courts in Professional & Executive Leasing were the degree of control over the details of the work; investment in the work facilities; withholding of taxes; payment of workers' compensation and unemployment insurance funds; right to discharge; permanency of the relationship; and the relationship the parties think they are creating. Citing Bartels v. Birmingham, the Tax Court noted that a contract purporting to create an employer-employee relationship will not control where the common law factors (as applied to the facts and circumstances) establish that the relationship does not exist.

The Ninth Circuit found that an employment relationship did not exist between PEL and the workers because PEL exercised minimal, if any, control over the workers; rather, each client and the worker controlled the details of the work and the selection of assignments. PEL did not have a genuine right to terminate or reassign the workers. In addition, PEL had no investment in the work facilities; the clients provided office space, tools, and equipment. The court held that the workers were not employees of PEL.

Although the facts in Professional & Executive Leasing are somewhat similar to those here, Taxpayer does not lease employees to the institutions. Taxpayer leases the institutions themselves and bears responsibility for operating them, including hiring and firing workers, as well as doing payroll. The employees at the institutions Taxpayer leases do not have an ownership or equity interest in the institutions. The factors which the Professional & Executive Leasing courts considered indicative of an employer-employee relationship are present in Taxpayer's relationship with the employees. See also Burnetta v. Commissioner, 68 T.C. 387 (1977).

Where a corporation assumed all the obligations of the employer and had the right to control the employees' services, the Tax Court found that the corporation was the employer. Packard v. Commissioner, 63 T.C. 621 (1975). In Packard, the employment of the employees of a dental practice was transferred to a separate corporation owned by the dentist-partners of the practice. After the transfer, the employees continued to be supervised by the general manager, who was in turn supervised by the dentists, now as officers of the corporation. The Service argued that the transferred employees remained the common law employees of the partnership for purposes of qualified plan participation because the partners continued to have supervisory powers over the employees after the transfer. However, the court honored the structure of the arrangement and accepted the fact that the employees were supervised by the dentists as corporate officers. In addition, it noted that the corporation paid the salaries, the employment taxes, liability insurance, workers' compensation, and unemployment insurance. Thus, the court found that the corporation, not the partnership, was the employer.

In this case, under the terms of the lease, Taxpayer is in charge of the operation of the institution and has full responsibility for its operation without interference by the institution owner. The leases make it clear that Taxpayer will make day to day management decisions, including institution personnel management.

The Service's statement that the employees at the leased institutions are employed by the institution owner and not Taxpayer has some support. In particular, the fact that a separate Form 941 is filed for the employees at each leased institution creates the appearance that there are separate employers and that these separate employers are the individual institutions. However, we do not find the confusion surrounding the proper method of reporting on Form 941 to be determinative of which entity is the employer. (We do expect that Taxpayer will begin to properly report all its employees on a single Form 941.) Taxpayer's contention that it is the common law employer is supported by the authorities discussed above.

Accordingly, we conclude that employees working in the institutions leased by Taxpayer are common law employees of Taxpayer, not employees of the institution owners. Thus, Taxpayer is the employer of the employees for purposes of employment taxes and for purposes of coverage under the Plan and the health plan Taxpayer maintains for its employees.

CAVEAT

No opinion is expressed regarding any other Code section. In particular, no opinion is expressed regarding the qualification of the Plan. Further, no opinion is expressed regarding whether the Professionals are employees.

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Jerry E. Holmes
Chief, Branch 2
Office of Associate Chief Counsel
(Employee Benefits and
Exempt Organizations)

cc: Chief, Employee Plans CP:E:EP:T
Attn: Robert Architect

District Counsel
Internal Revenue Service

Separate cover:
Enclosures: Materials sent with request for technical assistance