

Office of Chief Counsel
Internal Revenue Service
memorandum

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to:

Newark, NJ 07102
(Appeals, Area , Team)

From: Linda P. Azmon
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(Tax Exempt & Government Entities Division Counsel)

subject:

This memorandum concerns information regarding the above taxpayer. This advice may not be used or cited as precedent in other cases. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

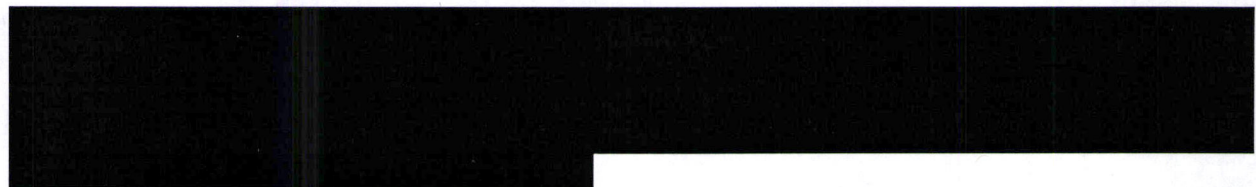
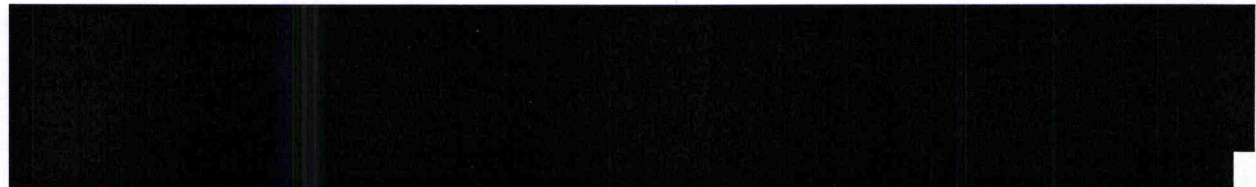
1. Whether _____ is liable for the employment taxes proposed by the Examination Division for the taxable periods included in the _____ and _____ taxable years, as well as the taxable years ending December 31, _____ and _____?
2. Is _____ entitled to relief treatment under Section 530 of the Revenue Act of 1978?
3. Whether the amount of proposed employment taxes should be calculated using the rates provided for in I.R.C. § 3509?¹

¹ All references to "section" are to the Internal Revenue Code of 1986, as amended, unless otherwise noted, except that references to "section 530" are to the Revenue Act of 1978. Section 530 has never been codified in Title 26 of the U.S. Code, but many publishers of the Internal Revenue Code include the

4. Whether _____ would be entitled to an interest-free adjustment pursuant to I.R.C. § 6205?
5. Whether a Notice of Determination of Worker Classification should be issued to the _____ in the event your office is unable to resolve the present dispute.

SUMMARY CONCLUSIONS

1. As the common law employer of the workers at issue, _____ is liable for the employment taxes proposed by the Examination Division.
2. _____ would not be entitled to relief treatment under section 530 of the Revenue Act of 1978 ("section 530"), as section 530 is not applicable to the present dispute.
3. The rates provided for in I.R.C. § 3509 are not applicable to the present dispute.
4. _____ could be entitled to an interest-free adjustment of the FICA and ITW pursuant to I.R.C. § 6205 if they execute a Form 2504-WC, and tender payment to Service prior to the issuance of a Notice of Determination of Worker Classification.
5. Since the present case does not involve an issue regarding the proper employment status of workers, and since the Taxpayer has not alleged that it is entitled to relief treatment pursuant to section 530, the taxes may properly be assessed without the issuance of a Notice of Determination of Worker Classification.



FACTS

text of section 530 in the notes following Code section 3401(a).

During the taxable quarters included in the taxable years ending December 31, through December 31, as well as the taxable years ending December 31, and December 31, (“taxable periods and years at issue”),

(“the Taxpayer”) operated a limousine transportation business. In conducting its operations, the Taxpayer employed workers to perform services in the accounting department, administrative department, marketing department and sales department. The Taxpayer also employed reservationists, fleet technicians, dispatchers, meeting and conference personnel, and chauffeurs.

The Taxpayer filed Forms 1120S (U.S. Income Tax Return for an S Corporation) for the taxable years ending December 31, and December 31. On such Forms 1120S, the Taxpayer did not claim any deductions for officer compensation or salaries and wages. Instead, the Taxpayer claimed deductions for “Employee Leasing” for its entire workforce.

In October, the Taxpayer entered into a contract entitled “PEO SERVICES AGREEMENT” with. Subsequent to entering into this contract, in or about January became known as. On April 2, the Taxpayer entered into another contractual agreement with. Although the administrative file contains only the contract entered into with, there is no dispute between the parties that the terms of the contracts remained substantially the same throughout October through December 31, and that each of these entities provided the same type of services to the Taxpayer based on substantially similar contractual language.

Article II of the October contract with describes the relationship between the Taxpayer and the PEO as follows:

“Subject to the terms and conditions of this Agreement, shall retain the individuals who work at CLIENT’S location (the “Co-Employees”). is a “professional employer organization” and an “employer” under the Internal Revenue Code Section 3401(b). Nonetheless, the Parties shall share the responsibilities of being the employer of the Co-Employees as provided in this Agreement.

Without limiting the generality of the foregoing and the Representations and Warranties and Covenants of CLIENT as set forth herein assigns and delegates to CLIENT, the responsibility for the day-to-day supervision and control of the Co-Employees does not and shall not have any liability, obligation or responsibility therefore whatsoever.”²

² I.R.C. § 3401 contains a variety of definitions and does not appear to be applicable in the context

Although the contract refers to the workers as "Co-Employees", the Taxpayer does not appear to dispute that at all times during the taxable periods and 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 the workers.

Paragraph III of the contract sets forth the duties and rights of which basically were to: 1) "administer CLIENT payroll, designated benefits, and personnel policies and procedures related to the Co-Employees"; 2) provide "Human Resource Administration and Payroll Administration"; 3) furnish and keep workers' compensation insurance covering the "Co-Employees" in force; 4) and process and pay "Co-Employee" wages from its own accounts based on the hours reported by the Taxpayer.

In terms of funding for payroll and benefit administration, paragraph VI.A. of the contract requires that the Taxpayer 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 to or with respect to the Co-Employees on the next payroll date." Thus, this contractual provision requires the Taxpayer to remit all salary and wages to _____ for use in payment of the wages and salaries of the employees prior to actual payment of such wages and salaries by _____ to the common law employees of the Taxpayer.

To ensure that _____ would not be responsible for payment of wages to the Taxpayer's common law employees, paragraph VI.E. of the contract requires that the Taxpayer provide a security deposit or procure a letter of credit _____ beneficiary in the amount as determined by _____ to cover wages, salaries, contributions, premiums and any and all other charges or payment to be paid to or with respect to the Co-Employees on any given payroll date.

Additionally, paragraph VII of the contract provides that _____ could 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 the Taxpayer. Upon termination of the contract for any reason whatsoever, the contract provides that the Taxpayer is "responsible for payment of all wages, salaries and employment related taxes."

Although the Taxpayer entered into contractual agreements with the aforementioned entities, during the taxable periods and years at issue, employment tax returns (Forms 940 and Forms 941) as well as information returns (Forms W-2) were

contained in the agreement. I.R.C. § 3401(b) provides: "For purposes of this chapter, the term "payroll period" means a period for which a payment of wages is ordinarily made to the employee by his employer, and the term "miscellaneous payroll period" means a payroll period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual payroll period."

apparently filed by reporting the wages and salaries of the Taxpayer's common law employees during the taxable periods and years at issue. The Taxpayer did not file any Forms 940, Forms 941 or issue or file Forms W-2 with respect to any employees for any taxable periods and years at issue. Although the Taxpayer took no steps to verify the filing and payment of employment taxes, the Taxpayer states that "it paid the amount in question in full to all three PEOs and asserts that it is not liable for any unpaid tax that was failed to be remitted to the Service by the PEOs". The Examination Division has taken the position that, as the common law employer, the Taxpayer remains liable for the payment of the taxes at issue, and that Section 530 of the Revenue Act of 1978 is not applicable to the present dispute.

LAW AND ANALYSIS

Issue 1 – Whether is liable for the employment taxes
proposed by the Examination Division?

The applicable Federal employment taxes at issue consist of taxes under the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and Federal income tax withholding (ITW). For any of these Federal 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. Specifically, the employment tax regulations describe an employer-employee relationship:

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. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer . . . are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services.

Treas. Reg. §§ 31.3121(d)-1(c)(2), 31.3306(i)-1(b) and 31.3401(c)-1(b).

In the present case, there is no dispute that the Taxpayer was at all times the common law employer of workers at issue. The 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 PEOs, and that such PEOs are "obligated by statute" to withhold employment taxes from those wages, and pay such taxes over to the government.

In its protest to Appeals the Taxpayer acknowledges that the majority of court cases addressing this issue conclude that the common law employer has "the ultimate responsibility" of paying the underlying tax liabilities even if the client utilized the services of, and paid money to, a PEO. The Taxpayer appears to argue, however, that the PEOs are "equally responsible for the payment of the employment taxes". In support of this position, the Taxpayer cites to a statute governing the licensing of employee leasing agencies, and appears to assert that the PEOs at issue are I.R.C. § 3401(d)(1) employers making such entities solely responsible for the payment of the taxes at issue. We will address each of these arguments separately below.

Statute

state law contains statutory provisions governing the licensing of employee leasing companies located within the state. The Taxpayer alleges that this statute requires every employee leasing company to "assume responsibility for the payment of wages to each covered employee without regard to payments by the client company". The Taxpayer also alleges that this statute requires an employee leasing company to "assume responsibility for the payment of payroll taxes and collection of taxes from payroll on each covered employee". The Taxpayer argues that "the plain reading of the statute "is that the licensed PEO is required to pay over to the taxing authorities both taxes collected from each employee's wages and the employer's portion of payroll taxes." Finally, the Taxpayer argues that the requires all employee leasing companies to file a "Certification of Timely Payment of Applicable Federal and State Payroll Taxes By an Employee Leasing Company." Although the Taxpayer has provided a sample of such certification, the Taxpayer has not provided a copy of the actual certification, if any, for the PEO's at issue, nor any evidence that it ever attempted to obtain a copy of such certifications.³

First, state law governing the licensing of employee leasing does not supersede the Internal Revenue Code and, with the exception for rules related to state employment, the Internal Revenue Code does not determine employment tax liability based on state law. Thus, to the extent that state law allows a person to contractually assume responsibility for the payment of employment taxes related to its clients' employees with respect to state tax liabilities, state law cannot relieve the actual employer of the obligation to pay taxes for which it is liable under the Internal Revenue Code.

³ Paragraph X of the contract provides that the agreement will be interpreted under the laws of the

Even if _____ state law had any import on the present dispute, the PEOs at issue would not be considered employee leasing companies under the

statute, nor would they be relieved of the obligation to pay any employment related payroll taxes. Notably, the Taxpayer cites to both the requirement under _____ state law that the employee leasing company must assume responsibility for the payment of wages **without regard to payments by the client company** and also **assume responsibility for the payment of payroll taxes and collection of taxes of payroll for covered employees.**

In the present case, however, the PEOs utilized by the Taxpayer assumed neither responsibility. In fact, the contract entered into by the Taxpayer specifically: 1) states that the Taxpayer assumes “the responsibility for the day-to-day supervision and control of the Co-Employees” and that the PEO “does not and shall not have any liability, obligation or responsibility therefore whatsoever”; 2) requires that the Taxpayer 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 to or with respect to the Co-Employees on the next payroll date.”; 3) requires the Taxpayer provide a security deposit or procure a letter of credit naming _____ beneficiary in the amount as determined by _____ to cover wages, salaries, contributions, premiums and any and all other charges or payment to be paid to or with respect to the Co-Employees on any given payroll date; and 4) allows for termination by the PEO, 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 the Taxpayer. In the event of termination for any reason whatsoever, the contract provides that the Taxpayer is “responsible for payment of all wages, salaries and employment related taxes.” As such, even assuming, *arguendo*, that _____ state law has any bearing on the tax liabilities at issue, the PEOs utilized by the Taxpayer would not be considered licensed PEOs under state law. Nor has the Taxpayer even demonstrated or presented any evidence that such PEOs were, in fact, licensed employee leasing agencies under _____ state law.

Section 3401(d)(1)

The Taxpayer also argues that it should be relieved of the liabilities at issue because the PEOs they utilized qualified as the “statutory employer” under section 3401(d)(1). Pursuant to section 3401(d)(1) of the Code, 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 of wages. Although the Internal Revenue 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 Taxpayer is a section 3401(d)(1) employer of the employees leased to any client company is to establish whether the Taxpayer was in control of the payment of wages to those employees. 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 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, was a construction company in Chapter 11 bankruptcy. Earthmovers entered into a contract with Sunshine Staff Leasing, Inc. whereby Earthmovers leased all of its employees from Sunshine. Pursuant to the contract, 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. Additionally, 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, Earthmovers was held to be in control of the payment of wages for purposes of section 3401(d)(1).

In Alexander Drilling Inc. v. United States, 98-1 USTC ¶ 50,225 (W.D. Ark. 1997), the taxpayer, Alexander Drilling, leased its field workers from R & A Leasing Corporation. Under the terms of the leasing arrangement, Alexander Drilling was required to pay R & A sufficient funds to cover payroll (including tax amounts). R & A paid the field workers wages out of its own checking account. There is no mention of which party determined the wage rate or whether R & A would have paid the field workers regardless of whether it received the funds from Alexander Drilling. The jury found that Alexander Drilling did not have control of the payment of wages to field workers leased to it by R & A for purposes of section 3401(d)(1).

Other cases have also held the leasing company to not be a section 3401 (d)(1) employer when the leasing company received payroll information and funds from its client prior to the delivery of payroll to the client employees. See, U.S. 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).⁴

Based on the provisions contained in the contract and the Taxpayer's own admissions that at all times it remained the common law employer, the PEOs utilized by the Taxpayer would not be considered to be in control of the payment of wages within the meaning of section 3401(d)(1) of the Code. As previously stated, the PEOs utilized by the Taxpayer assumed neither full nor complete responsibility for payment of the wages to the leased employees. In fact, the contracts entered into by the Taxpayer specifically: 1) require that the Taxpayer 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 to or with respect to the Co-Employees on the next payroll date."; 2) require the Taxpayer provide a security deposit or procure a letter of credit naming beneficiary in the amount as determined by to cover wages, salaries, contributions, premiums and any and all other charges or payment to be paid to or with respect to the Co-Employees on any given payroll date; and 3) allows for termination by the PEO, 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 the Taxpayer. In the event of termination for any reason whatsoever, the contract provides that the Taxpayer is "responsible for payment of all wages, salaries and employment related taxes." Thus, it appears that the PEOs acted merely as a conduit for each client company in making payroll and do not meet the standards established in Winstead or Earthmovers such that the PEOs utilized by the Taxpayer would be considered the section 3401(d)(1) employer.

The Taxpayer also asserts that it should be relieved of any employment tax liabilities since the PEO's would be liable for such taxes pursuant to I.R.C. § 3505(a). As set forth below, the Taxpayer's claims in this regard are without merit. The PEOs would not be considered lenders, sureties or other persons, liable for the unpaid taxes pursuant section 3505(a). Nor does section 3505(a) relieve a common law employer of liability for unpaid employment taxes. See: Rev. Proc. 78-13, 1978-1 C.B. 591.

Section 3505(a) of the Code provides, in part, that for purposes of sections 3102, 3402, and 3403, any person, who is not an employer under such sections with respect to an employee or group of employees, pays wages to the employee or group of employees, shall be liable for a sum equal to the taxes (together with interest)

⁴ By contrast, in U.S. v. Total Employment Company, 305 B.R. 333 (USDC M.D. Florida, 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 that both the leasing company and the common law employer and leasing company are both equally responsible to the IRS for the withholding requirements on employee income and for the collection and payment of payroll taxes.

required to be deducted and withheld from such wages by the employer. In essence, section 3505 extends liability to lenders, sureties or other persons who directly pay wages to employees, or who supply funds to the employer for wage payments.⁵

As discussed above, the Taxpayer does not dispute that it is the common law employer of the workers whose wages underlie the present employment tax liabilities. As the common law employer, the Taxpayer remains ultimately liable for the unpaid employment taxes at issue even if the Service were to pursue collection of unpaid taxes pursuant to section 3505(a). See: Rev. Proc. Rev. Proc. 78-13.

Nor would the PEOs utilized by the Taxpayer in the present case be considered "a lender, surety, or other person" liable for the unpaid taxes pursuant to section 3505(a), because the PEOs did not use their own funds to pay wages, and acted only in a ministerial capacity in paying the wages to the Taxpayer's common law employees. *U.S. v. Total Employment Company*, 305 B.R. 333 (USDC M.D. Florida, 2004).⁶ As set forth above, the Taxpayer paid the PEOs the funds to be used to pay wages to the workers, and also remitted the requisite amount of employment taxes required to be remitted by an employer to the PEOs. However, rather than paying the employment tax liabilities to the government, the PEOs failed to use the money provided by the Taxpayer in satisfaction of their contractual obligations with the Taxpayer. These contractual obligations, however, are solely between the PEO and the Taxpayer and have no effect upon the government's ability to collect the taxes at issue from the Taxpayer. Any recourse the Taxpayer may have with respect to recovery of such funds from the PEOs would be through a civil action between the parties to the contract.

Issue 2 - entitled to relief treatment under Section 530 of the Revenue Act of 1978?

Section 530 of the Revenue Act of 1978, as amended, provides that if three prerequisites (discussed below) are met, workers shall not be deemed to be employees

⁵ The Taxpayer's position with respect to section 3505 is in direct contradiction with its assertion that the PEOs are section 3401(d)(1) employers. If the PEOs are in fact section 3401(d)(1) employers (which they are not), the PEOs would not be liable pursuant to section 3505(a).

⁶ Liability pursuant to section 3505(a) has been found in cases where the payor advances, lends or makes direct wage payments to employees. *United States v. Kennedy Const. Co. of NSB, Inc.*, 572 F.2d 492 (5th Cir. 1978) (holding contractor liable for trust fund taxes, where contractor entered into agreement with subcontractor whereby contractor, at end of each pay period, made advances of funds for purpose of paying net wages to specific employees of subcontractor, funds were advanced only after verification by contractor, that sums proposed to be paid were being paid to employees for work on contractor's job, payment was made from agreed upon checking account into which funds provided by contractor had been deposited, and payment to subcontractor's employees was made by checks which were signed by contractor. Substance of transaction was a direct payment by contractor to subcontractor's employees.); *Abrams v. United States*, 333 F. Supp. 1134 (S.D.W.Va. 1971) (holding corporation liable where it entered into labor contracts with an employer whereby the employees of such employer were to sew garments for such corporation and which allegedly paid or provided for the wages of such employees).

of a taxpayer for Federal employment taxes, unless the taxpayer (defined as the service recipient) had no reasonable basis for treating the worker as other than an employee. But, as set forth more fully below, section 530 is not available as a relief provision to the Taxpayer with respect to its liability for the employment taxes at issue, because the Taxpayer's liability for these taxes does not involve any questions of employment status or the proper classification of workers. Rather, the issue is solely whether the Taxpayer (who entered into a contractual agreement with third party PEOs for payroll processing purposes) remains liable for employment taxes which the PEOs failed to pay over to the government.

There are three requirements for a taxpayer to obtain section 530 relief from employment taxes. First, section 530 only applies when the taxpayer "did not treat an individual as an employee for any period" for purposes of employment taxes. Section 530(a)(1)(A)). Second, the taxpayer must have filed all required Federal returns (including information returns) on a basis consistent with the taxpayer's "treatment of such individual" as not being an employee. Section 530(a)(1)(B). Third, the taxpayer must have had a reasonable basis for not "treating the individual as an employee". Section 530(a)(1)(flush language).

If all three 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 a 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. It is important to note that section 530(a) does not specifically state that "the payment will not be subject to employment tax." Rather, the statute focused on the issue of whether the worker was an employee. This statutory language shows that it is applicable only to controversies involving employment status, and not questions of who remains liable when a third party payroll processing company fails to remit funds to the government on behalf of the common law employer.

The legislative history of section 530 also shows that Congress was providing a relief provision limited to employment status controversies regarding whether a worker was or was not an employee of the 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 IRS 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. So 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).

Other statutory language also shows that Section 530 is limited to employment status controversies. Section 530(b) prohibits Treasury from issuing regulations and revenue rulings on "employment status." See Section 530(c)(2) (explicitly defining employment status as: the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee)).

As outlined above, nothing in the Act or the legislative history indicates that Congress intended section 530 to apply to disputes regarding whether a common law employer remains liable for taxes for its common law employees that were never paid over to the government by a conduit PEO payroll processor. Rather, the legislative history clearly reflects Congressional intent to limit the application of section 530 relief only to "employment status" controversies regarding whether an "individual" should have been "treated" as an employee, not to whether a common law employer remains ultimately liable for employment tax liabilities that were never paid by a PEO on its behalf.

In the current examination, there is no question regarding the proper classification or employment status of any workers. In fact, the contractual arrangement between the Taxpayer and the PEOs is predicated solely upon the treatment of the Taxpayer's workers as employees for Federal employment tax purposes.

Specifically, under the terms of the contractual agreement the Taxpayer entered into with _____, the Taxpayer was required to determine and advise the PEO of the amount of hours worked by each employee, as well as the amount of wages to be paid to each employee at least one day prior to the end of the payroll period. The Taxpayer was also 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 PEOs would also issue Forms W-2 to the Taxpayer's common law employees, and report and pay employment tax relating to them on the Form 941 (Employer's Quarterly Federal Return) and Form 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return).

Although Taxpayer did not directly pay the wages to its common law employees, withhold from the wages paid to its common law employees or file Federal employment and information returns reporting the amount of wages paid to its employees, the Taxpayer specifically contracted with a third party for purposes of fulfilling its obligations with respect to the treatment of workers as employees. Thus, the contractual arrangement, in and of itself, demonstrates that there is no underlying issue of employment status regarding those who received wage payments. Rather, since the Taxpayer treated all of these workers as employees for purposes of subtitle C, but contracted with a third party payroll processor for purposes of fulfilling its federal employee payroll obligations, the dispute is unrelated to proper classification of workers.

Rather, the dispute is limited to whether the 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.

Issue 3. Whether the amount of proposed employment taxes should be calculated using the rates provided for in I.R.C. § 3509?

Section 3509 is another example of an employment tax provision that applies only to employment status controversies. Section 3509 was enacted to relieve the "serious retroactive tax burdens that may arise when a worker who has been treated as an independent contractor is reclassified as an employee." S. Rep. No. 97-494, at 370 (1982) (this statutory mechanism is a substantial simplification of present procedures to reduce the burdens on employers "whose workers are reclassified"). Consistent with the legislative history of section 530, the legislative history of section 3509 shows that Congress limits 3509 rates only to disputes over the proper classification of workers, and not to questions of whether a common law employer remains ultimately liable for remains ultimately liable for employment tax liabilities that were never paid by a PEO on its behalf.

Section 3509 provides reduced rates for taxpayers who fail to deduct and withhold certain employment taxes "by reason of treating such employee as not being an employee" for purposes of those taxes. It reduces an employer's liability for income tax withholding ("ITW") and the employee portion of the Federal Insurance Contribution Act ("FICA") taxes when the employer fails to deduct and withhold those taxes because it has treated the employee as not being an employee. Section 3509(a).

Similar to the requirements of section 530, an employer must meet several requirements to be eligible for section 3509 rates. The employer must have treated the worker as not being an employee for purposes of both ITW and FICA tax. Section 3509(a). The employer must also have treated the worker as not being an employee for purposes of information reporting. Section 3509(b)(1). Further, if the employer intentionally disregarded the deduction and withholding requirements, the reduced rates do not apply, and the employer is liable for the full taxes that should have been withheld. Section 3509(c).

Courts have treated 3509 rates as only available in worker reclassification contexts. See, e.g., Consolidated Flooring Services v. United States, 42 Fed. Cl. 878 (Fed. Cl. 1999)(although it claimed it treated its workers as independent contractors, because the employer withheld income taxes from its payments to those workers, it treated them as employees and was not entitled to section 3509 rates); Flamingo Fishing Corp. v. United States, 32 Fed. Cl. 377 (Fed. Cl. 1994)(taxpayer did not treat the workers as non-employees; instead, taxpayer mistakenly believed the services did not constitute "employment" under section 3121(b)(20); as a result, 3509 rates do not apply).

In the present case, there is no question regarding the proper classification of any workers. In fact, the contractual arrangement between the Taxpayer and the PEOs is predicated on the treatment of workers as employees for Federal employment tax purposes. Specifically, under the terms of the contractual agreement the Taxpayer entered into with _____, the Taxpayer was required to determine and advise the PEO of the amount of hours worked by each employee, as well as the amount of wages to be paid to each employee at least one day prior to the end of the payroll period. The Taxpayer was also 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 PEOs would also issue Forms W-2 to the Taxpayer's common law employees, and report and pay employment tax relating to them on the Form 941 (Employer's Quarterly Federal Return) and Form 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return).

Although Taxpayer did not directly pay the wages to its common law employees, withhold from the wages paid to its common law employees or file Federal employment and information returns reporting the amount of wages paid to its employees, the Taxpayer specifically contracted with a third party for purposes of fulfilling its obligations with respect to the treatment of workers as employees. Thus, the contractual arrangement, in and of itself, demonstrates that there is no underlying issue of employment status regarding those who received wage payments. As such, section 3509 is not available to the Taxpayer with respect to the present dispute.

Issue 4 - Whether _____ would be entitled to an interest-free adjustment pursuant to I.R.C. § 6205?

Section 6205(a)(1) provides that if less than the correct amount of tax imposed by §§ 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment of wages or compensation, proper adjustments, with respect to both the tax and the amount to be deducted, shall be made, without interest, in such manner and at such times as the Secretary may by regulations prescribe.

Section 31.6205-1(a)(1) of the Employment Tax Regulations provides that an employer who makes, or has made, an undercollection or underpayment of employee tax under § 3101, employer tax under § 3111, employee tax under § 3201, employer tax under § 3221, or income tax required under § 3402 to be withheld, with respect to any payment of wages or compensation, shall correct such error as provided in this section and that such correction shall constitute an interest-free adjustment to the extent provided in (b) or (c) of this section.

Section 31.6205-1(a)(4) provides that an error is ascertained when the employer has sufficient knowledge of the error to be able to correct it.

Section 31.6205-1(a)(6) provides that an interest-free adjustment may not be made after the earlier of receipt of notice and demand for payment based on an assessment or receipt of a Notice of Determination of Worker Classification under section 7436.

Revenue Ruling 75-464, 1975-2 CB 474, addresses interest-free adjustments in the context of an audit. The ruling provides that since an error may not be discovered until an audit is made of the employer's tax returns by the Internal Revenue Service, if a Form 2504, Agreement to Assessment and Collection of Additional Tax, is signed at the conclusion of such audit, the agreement form will be considered to satisfy the interest-free adjustment requirements under § 31.6205-1(b) and/or (c). The ruling goes on to provide that the Service will not allow interest-free adjustments in cases in which the taxpayer's returns for prior years were audited and additional tax found to be due with respect of the same issue involved in the current audit, nor in cases in which the taxpayer, after having been informed of his tax status as an employer, knowingly underreports his employment tax liability in subsequent years.

Neither the interest-free adjustment rules under § 6205 nor the accompanying regulations define the term "error" for purposes of determining when an interest-free adjustment may be made. The Merriam-Webster dictionary defines "error" as an act or condition of ignorant or imprudent deviation from a code of behavior, an act involving an unintentional deviation from truth or accuracy, or an act that through ignorance, deficiency, or accident departs from or fails to achieve what should be done. There is no statutory or regulatory provision linking the meaning of an "error" for purposes of § 6205 with the standard for imposing the accuracy-related penalty under § 6662(b)(1). As a practical matter, the same facts that indicate that the penalty is warranted may also indicate that there was no error for purposes of § 6205 or that the employer knowingly underreported its liability so that no interest-free adjustment is available. However, an interest-free adjustment should not be denied solely because the accuracy-related penalty is imposed.

In the present case, since the Taxpayer's reliance on a PEO to fulfill its employment tax obligations was in error, if the Taxpayer would be amenable to a binding resolution through the execution of agreed reports, we believe an offer of an interest free adjustment with respect to the employment taxes would be a proper way to resolve this case.

The amount of interest that is compromised as a result of an interest-free adjustment is significant, and often serves as an enticement to resolution prior to issuance of an NDWC. Once a demand for payment of employment taxes is made subsequent to assessment or a NDWC is issued, taxpayer's are no longer entitled to an interest-free adjustment. As such, we recommend that you explain the monetary benefits of agreeing to enter into a full resolution of this case at the Appeals level which would entitle the Taxpayer to an interest-free adjustment.

Issue 6. Whether a Notice of Determination of Worker Classification should be issued.

I.R.C. § 7436(a) - PROCEEDINGS FOR DETERMINATION OF EMPLOYMENT STATUS - provides the Tax Court with limited jurisdiction to review the following employment tax determinations by the Service: (1) that individuals are employees for purposes of employment taxes under subtitle C of the Code; (2) that the person for whom services are performed is not entitled to treatment under section 530; and (3) the proper amount of tax under such determination(s). Ewens and Miller, Inc. v. Commissioner, 117 T.C. 263 (2001); Charlotte's Office Boutique, Inc. v. Commissioner, T.C. Memo. 2004-43, aff'd, 425 F.3d 1203 (9th Cir. 2005). In two recent Tax Court decisions, the Tax Court has held that in order for the Court to assert jurisdiction with respect to an employment status controversy, there must be:

- (1) an examination in connection with the audit "of any person;"
- (2) a determination by the Secretary that "one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or such person is not entitled to the treatment under subsection (a) of section 530 of the Revenue Act of 1978 with respect to such individual;"
- (3) an "actual controversy" involving the determination as part of an examination; and
- (4) the filing of an appropriate pleading in the Tax Court.

American Airlines, Inc. v. Commissioner, 144 T.C. 24 at 32 (2015). See also, SECC Corp. v. Commissioner, 142 T.C. 225 (2014).

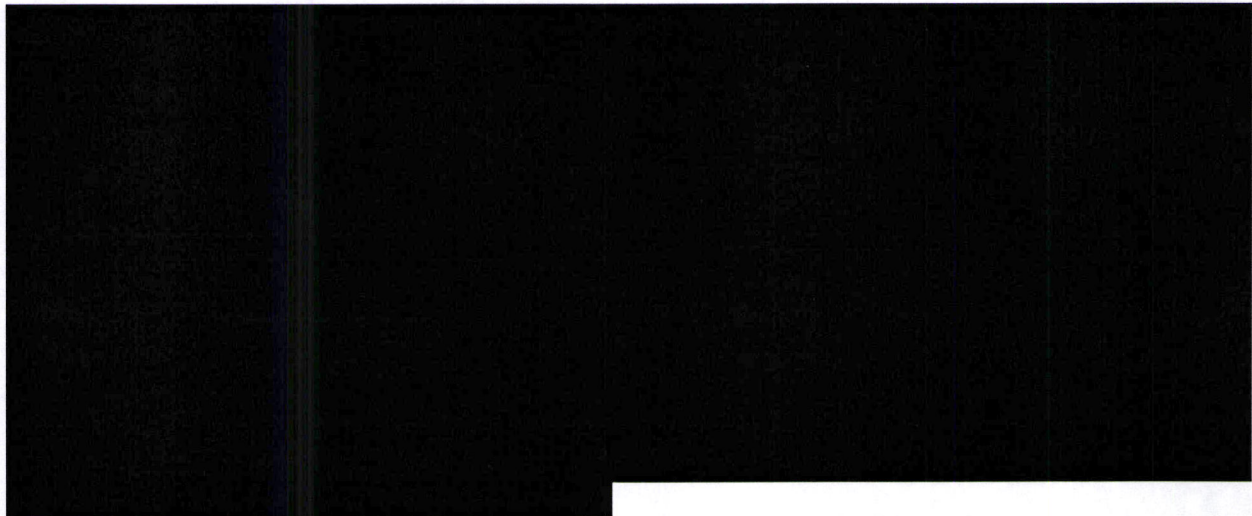
In the present case, there is no dispute that the first prong of section 7436 has been met. An examination in connection with an audit of the Taxpayer has, in fact, occurred.

However, with respect to the second prong of the test, the Examination Division did not make any determinations regarding the proper employment status or the proper classification of workers. As stated earlier, the Taxpayer agrees that the workers governed by the contracts between the Taxpayer and the PEOs were properly classified as employees for purposes of subtitle C. In fact, the Taxpayer's entire argument that the PEOs are liable for the employment taxes at issue is foundationally premised upon the workers being properly classified as employees for purposes of subtitle C.

The examination of the Taxpayer did, however, involve a determination that the Taxpayer is not entitled to section 530 relief. The Form 886A issued to the Taxpayer states that "the Service does not believe Section 530 is applicable because the legal issue is not that the workers were treated as non-employees". Based upon the statement contained in the 886A, we believe the Tax Court would hold that the Service made a determination that the Taxpayer is not entitled to section 530 relief. See: American Airlines, 144 T.C. No. 2.

However, there does not appear to be any "actual controversy" regarding either: 1) a determination by the Secretary that "one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or 2) such person is not entitled to the treatment under subsection (a) of section 530 of the Revenue Act of 1978..." which would require the issuance of a Notice of Determination of Worker Classification. Specifically, assuming, arguendo, the Service even made a determination regarding the proper employment status of any workers, the Taxpayer has not disputed that the workers are their common law employees. Nor has the Taxpayer disputed that the workers should be classified as employees for purposes of subtitle C. As such, there is no actual controversy regarding whether or not one or more individuals are employees of the Taxpayer for purposes of subtitle C.

Moreover, although the 886A contains a statement that section 530 is not applicable to the present dispute, the administrative file contains no evidence the Taxpayer ever claimed entitlement to section 530 relief or disputes the Examination Division's determination that section 530 is not applicable to the present case. As such, at this time we do not believe it necessary for your office to issue a Notice of Determination of Worker Classification should your office be unable to reach agreement with the Taxpayer. If no agreement is reached, at the present time, we believe the taxes may properly be assessed without the issuance of a Notice of Determination of Worker Classification.



Please call (516) 688-1734 if you have any further questions.

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Attachment (1)