INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 14, 2006

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-147262-05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

State =
Department =
Agency =
Administration =
Program =
State Code =
State Code § =
State Case Law =

$X =
$Y =
$Z =

ISSUE:

Whether the State is an employer pursuant to § 3401(d)(1) of the Internal Revenue Code (the Code).

CONCLUSION:

The State is not an employer pursuant to Code § 3401(d)(1) when it makes payments jointly to a common law employer and employee via a two-party check.

FACTS:

The Agency administers the Program on behalf of the Department.[1] The Agency has implemented the Program in accordance with the Child Care and Development Block Grant Act of 1990 (the Act), as amended and codified at 42 U.S.C. Chapter 105 (2000). The Act offers federal funding to provide low-income families with the financial resources necessary to afford quality child care. The Department is the lead agency for the State with respect to grants awarded under the Act, is responsible for complying with the requirements of the Act, and is accountable for the use of funds provided thereunder.

Pursuant to § 9858c(c)(2)(A) of the Act a child care certificate must be available to any parent offered child care services under the Program. See § 98.30(a) of the implementing regulations at 45 C.F.R. Part 98 (2000). Pursuant to § 9858n(2) of the Act "[t]he term 'child care certificate' means a certificate (that may be a check or other disbursement) that is issued by a State or local government . . . directly to a parent who may use such certificate only as payment for child care services or as a deposit for child care services if such a deposit is required of other children being cared for by the provider." See 45 C.F.R. § 98.2 (2000). A two-party check enables the lead agency to ensure that the parent pays a child care provider who meets the Act's health and safety requirements. Conversely, a single-party check payable exclusively to the parent may compromise the lead agency's ability to monitor the child care provider and to ensure compliance with the Act.[2]

Under the Program a day care aide is a common law employee of the parent who provides care in the home where the child lives.[3] The parent and the day care aide are

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[1] During the years under examination the Agency was named the Administration.

[2] While the preamble to the regulations implementing the Act "strongly discourage[s] a cash system" (i.e., single-party checks payable exclusively to the parent), a lead agency nonetheless "retains the flexibility to use it." See 63 Fed. Reg. 39936, 39949 (July 24, 1998). Accordingly, the Agency began issuing single-party checks to the parents beginning in 2003.

[3] Pursuant to the Fair Labor Standards Act of 1938 (FLSA), 29 U.S.C. § 206(f) (2000) employers must generally pay wages to employees employed in domestic service at a rate not less than the applicable

responsible for negotiating the method of payment, the hours of care, and the rate of compensation. However, to participate in the Program the day care aide must keep complete and accurate records of daily attendance showing the daily care “begin time” and the daily care “end time” for each funded child. Additionally, both the parent and the day care aide must sign an attendance record and must certify that the attendance record is true and correct.

Day care aides set their own rates for child care, and parents are responsible for paying all child care expenses.[4] The Agency sends a payment directly to the parent based on the care authorized by the Agency and the reporting information provided by the day care aide. The Agency pays up to the maximum hourly rate for the lesser of the number of hours authorized or the number of hours reported. The Agency bases the maximum hourly rate on the area in which the care is provided and the age of the child. For the years at issue the maximum hourly rate paid per child ranged from $X to $Y per hour.[5] The Agency does not pay any child care charges above the maximum rate.

In conformity with the Act the Agency issued child care certificates directly to the parent in the form of two-party checks payable jointly to the parent and the day care aide. The two-party checks were mailed to the parent at the parent’s home address. The Agency was not responsible for resolving disputes regarding payments between parents and their day care aides. In the event of non-payment the Agency advised day care aides to resolve disputes with the parents through small claims court.

The Agency neither furnished nor filed any Forms 1099 or Forms W-2 reporting the amounts paid to the day care aides for the years at issue. Additionally, the Agency never treated day care aides as employees of the State for any purpose.

LAW:

Chapter 24 of the Code (collection of income tax at source on wages) requires every employer making payment of wages to deduct and withhold from the wages a tax that is subsequently allowed as a credit against the income tax liability of the employee receiving the wages.

For income tax withholding purposes the term “employer” means the person for whom an individual performs any service, of whatever nature, as the employee of such person.

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minimum wage. See Application of the Fair Labor Standards Act to Domestic Service, 29 C.F.R. Part 552 (2000). The Agency maintains that day care aides are common law employees of the parents and are subject to the FLSA.

[4] Under the Program the day care aide may not charge higher rates for an Agency funded child than the day care aide charges the general public.

[5] Day care aides who had completed 16 hours of training in basic child care skills received an infant/toddler incentive payment of $Z per hour.

See Code § 3401(d). However, if the person for whom the individual performs the services does not have control of the payment of the wages for such services, the term "employer" means the person having control of the payment of such wages. See Code § 3401(d)(1). For example, where wages, such as certain types of pensions or retired pay, are paid by a trust and the person for whom the services were performed has no legal control over the payment of the wages, the trust is the employer. See Treas. Reg. § 31.3401(d)-1(f).

A basic purpose of the income tax withholding provisions is to centralize in the employer the responsibility for withholding, returning, and paying the tax. As a matter of business administration, certain of the mechanical details of the withholding process may be handled by representatives of the employer. Nevertheless, the legal responsibility for withholding, returning, and paying the tax rests with the employer. See Reg. § 31.3402(a)-1(e). Thus, the special definition of the term employer provided in Code § 3401(d)(1) is designed solely to meet special or unusual situations. It is not intended as a departure from the basic purpose. See Reg. § 31.3401(d)-1(h).

The employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition. See Reg. § 31.3402(a)-1(b).

In Westover v. William Simpson Const. Co., 209. F.2d 908 (9th Cir. 1954) a prime contractor advanced funds to a subcontractor sufficient to meet the net take-home pay of the subcontractor's employees. The prime contractor deposited the advances in a payroll trust account opened by the subcontractor. A designated employee of both the prime contractor and the subcontractor had independent signature authority with respect to the account. The government contended that the prime contractor controlled the payment of the wages within the meaning of Code § 3401(d)(1). The court disagreed, stating as follows: "[t]o render the exception applicable two things must be shown: (1) that [the subcontractor] had no control over the payment of the wages, and (2) that [the prime contractor] had. Obviously the requirement was not met. Whatever measure of control [the prime contractor] might have had it was not exclusive, but was shared with [the subcontractor]." 209. F.2d at 911. See Phinney v. Southern Warehouse Corp., 212 F.2d 488 (5th Cir. 1954) ; see also Arthur Venneri Co. v. United States, 340 F.2d 337 (Ct. Cl. 1965) (since third party did not have sole control over the payment of wages, it was not Code § 3401(d)(1) employer).

In Century Indemnity Company v. Riddell, 317 F.2d 681 (9th Cir. 1963) a subcontractor secured a bond from a surety guaranteeing the performance of a subcontract and the payment of all costs associated therewith. The subcontractor opened a trust account over which the surety had joint control. The terms of the account required that an authorized representative of both the subcontractor and the surety sign all checks drawn against the account. Pursuant to the terms of the bond the subcontractor assigned all payments made by the prime contractor to the surety. Accordingly, the prime contractor deposited all payments made under the subcontract into the account. The subcontractor made weekly wage payments to each employee by means of individual checks drawn against the account. In accordance with the terms of the account, an authorized representative of both the subcontractor and the surety signed each check. The government contended that the surety controlled the payment of the wages within the meaning of Code § 3401(d)(1). The court disagreed, stating as follows:

> We agree with both parties and with the Treasury Regulations, that when the statute speaks of "control" over the payment of wages, it means legal control. Further, we hold that legal control means legal power to control the actual payment of the wages rather than merely what actually may have been practiced by voluntary forbearance of the person actually having such legal power.
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> Joint control of a trust account into which all contract payments are required to be deposited, even from the inception of a contract job as in this case, which still leaves the common law employer in control of all the incidents of employment except the requirement of the concurrence of its bonding surety on checks for withdrawals from such account, does not have the dual effect required by [Code § 3401(d)(1)] of establishing (1) that the contractor "does not have control of the payment of the wages", and (2) that the surety, whose concurrence is required, does have such "control of the payment of such wages." Here, neither has sole control, but neither is the subcontractor without any such control. As stated in the Simpson case, both criteria must be met. Literally, the exception of [Code § 3401(d)(1)] does not cover such a situation. If construction is called for, then it must be in accordance with the legislative intent above indicated, which calls for a narrow construction of the exception, and a broad construction of the general terms covering the common law employer's responsibilities.

317 F.2d at 686, 691.

In Matter of Southwest Restaurant Systems, Inc. v. United States, 607 F.2d 1237 (9th Cir. 1979) two individuals owned four separately organized corporations. A single bookkeeper handled the accounting, bookkeeping, and finances for the corporations.

The sales receipts of each corporation were deposited in a general expense bank account maintained by that corporation. However, the bookkeeper paid the wages of the employees of all four corporations from one payroll bank account maintained by Southwest Restaurant Systems, Inc. (the debtor). The bookkeeper funded the payroll account with checks drawn against the general expense accounts of each corporation. The two individual owners and the bookkeeper each had independent signature authority over all of the bank accounts. The debtor subsequently filed for bankruptcy and the government contended that the debtor controlled the payment of the wages within the meaning of Code § 3401(d)(1). The Ninth Circuit agreed, citing Century Indemnity Co. for the proposition that "in order to satisfy the exception under Code § 3401(d)(1) for the supplanting of the common law employer by the person 'having control of the payment' such person must have sole and legal control over such payment of wages." 607 F.2d at 1239-1240. Notwithstanding the owners' and the bookkeeper's signature authority over all of the bank accounts, the Ninth Circuit concluded that "there was no shared control; the debtor alone controlled." 607 F.2d at 1240. See also Winstead v. United States, 109 F.3d 989 (4th Cir. 1997) (third party paying wages directly from his checking account was Code § 3401(d)(1) employer); Consolidated Flooring Services v. United States, 38 Fed. Cl. 450 (1997) (third party controlling the account from which wages were paid was Code § 3401(d)(1) employer); but see Reliance Insurance Co. v. United States, 98-2 USTC ¶ 50,609, 82 AFTR 2d 98-5482 (D. Or. 1998) (third party funding the account from which wages were paid and countersigning checks required to be signed by the common law employer was Code § 3401(d)(1) employer).

In Otte v. United States, 419 U.S. 43 (1974) a corporation filed a bankruptcy petition under Chapter XI of the Bankruptcy Act. Former employees of the corporation filed proofs of claim with the bankruptcy court for unpaid wages earned prior to the filing of the petition. Four years after the arrangement failed and the bankruptcy court adjudicated the corporation a bankrupt, the bankruptcy trustee paid the wage claims. The Supreme Court readily acknowledged that the bankrupt corporation (the common law employer) did not have control of the payment of the wages:

> The withholding taxes are not taxes which became due and owing by the bankrupt. As has been noted above, the taxes did not become due and owing at all until the claims, constituting wages, were paid. This took place after bankruptcy, not before. The situation, thus, differs from that where the bankrupt paid wages prior to bankruptcy, but the taxes withheld were not remitted to the taxing entities by the time of the inception of the bankruptcy proceeding. The latter would be taxes "which became legally due and owing by the bankrupt."

419 U.S. at 56 (citations omitted). Nonetheless, the Supreme Court determined that payments to the wage claimants for services performed by them for their former employer were wages as defined in Code § 3401(a). Additionally, the Supreme Court

determined that either the bankruptcy estate, the trustee, or the referee controlled the payment of the wages within the meaning of Code § 3401(d)(1):

> The fact that in bankruptcy payment of wage claims is effected by one other than the bankrupt former employer does not defeat any withholding requirement. Although § 3402(a) refers to the "employer making payment of wages," § 3401(d) (1), as also has been noted, provides that if the person for whom the services were performed "does not have control of the payment of the wages for such services," the term "employer" then means "the person having control of the payment of such wages." This obviously was intended to place responsibility for withholding at the point of control.

419 U.S. at 50.

Under the State Code if an instrument is payable to two or more persons alternatively, it is payable to any of them and may be negotiated, discharged, or enforced by any or all of them in possession of the instrument. Conversely, if an instrument is payable to two or more persons not alternatively, it is payable to all of them and may be negotiated, discharged, or enforced only by all of them. See State Code §. Thus, if an instrument is payable to X and Y, neither X nor Y acting alone is the person to whom the instrument is payable. Neither person, acting alone, can be the holder of the instrument or the person entitled to enforce or negotiate the instrument because neither, acting alone, is the identified person stated in the instrument. See State Case Law (instrument made payable to two or more persons not alternatively is payable to all of them and may be negotiated, discharged, or enforced only by all of them).

ANALYSIS:

Pursuant to Code § 3401(d)(1) if the person for whom services are performed does not have legal control of the payment of the wages, the term "employer" means the person having such control. The primary approach of the income tax withholding provisions is to impose responsibility for withholding, returning, and paying employment taxes on the common law employer. Thus, this exception to the general definition of the term employer is designed solely to meet special or unusual situations. As explained by the court in Century Indemnity, the legislative history to Code § 3401(d)(1) "calls for a narrow construction of the exception, and a broad construction of the general terms covering the common law employer's responsibilities." 317 F.2d at 691.

In William Simpson, Century Indemnity, and Southwest Restaurant the courts consistently emphasized two requirements for the application of Code § 3401(d)(1): first, the common law employer must not have legal control of the payment of the wages, and second, a third party must have "sole and legal control" of the payment of the wages. If the common law employer has legal control of the payment—

notwithstanding a third party's joint control of the payment—the common law employer rather than the third party is the employer for income tax withholding purposes. However, if the common law employer does not have legal control of the payment of the wages, Code § 3401(d)(1) "was intended to place responsibility for withholding at the point of control." Otte v. United States, 419 U.S. at 50. Additionally, while legal control does not necessarily reside with the person closest in the chain of payment to the employee, to constitute payment the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made.

The Agency administers the Program in accordance with the Act and is responsible for complying with the requirements of the Act and for the use of funds provided thereunder. Pursuant to the Act, the Agency must issue child care certificates relating to day care aides directly to the parent. While the Act permits the use of single-party checks payable to the parent, two-party checks are encouraged to ensure compliance with the Act's health and safety requirements. In conformity with the Act, the Agency issued child care certificates directly to the parent in the form of two-party checks payable jointly to the parent and the day care aide. The Agency mailed the two-party checks to the parent at the parent's home address. The issuance of two-party checks directly to the parent fully discharged the Agency's obligations to the parent and the day care aide. A parent's failure to pay the negotiated compensation to the day care aide was a legal matter between the parent and the day care aide.

Under the State Code an instrument made payable to two or more persons not alternatively (e.g., a two-party check) is payable to all of them and may be negotiated, discharged, or enforced only by all of them. Thus, unless endorsed by the parent, a two-party check was a restricted payment that constituted neither the actual nor the constructive receipt of wages by the day care aide. Similarly, the payments were neither set apart for the day care aide without any substantial limitation or restriction nor within the day care aides' own control and disposition. The parent had a legal right to control disbursement of the proceeds of the check.

Code § 3401(d)(1) does not apply if the common law employer has legal control of the payment of the wages. Accordingly, the State is not an employer pursuant to Code § 3401(d)(1) when it makes payments jointly to a common law employer and employee via a two-party check.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.