INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-128149-12

TEGE Area Counsel
Dallas, TX

Taxpayer's Name:

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

LEGEND:

X =

Z =

Tax Years =

ISSUE

Whether X, a professional employer organization ("PEO"), was eligible to claim the income tax credit under section 45B of the Internal Revenue Code ("Code") for Tax Years for employer Federal Insurance Contributions Act ("FICA") tax paid on tips received by its clients' employees in connection with the providing, delivering, or serving of food or beverages for consumption.

CONCLUSION:

X was not entitled to claim the section 45B credit for Tax Years. The language of section 45B(a) provides that the person entitled to the section 45B credit is the taxpayer who incurs the tax imposed by section 3111 (the employer portion of the FICA tax). Generally, the taxpayer who incurs the employer portion of FICA tax is the common law employer.[1] Even if another entity could be a section 3401(d)(1) employer with regard to the employer FICA tax on the tips, under the facts and circumstances presented, we conclude X was not the section 3401(d)(1) employer of its' clients employees. Thus, because X was neither the common law employer nor the section 3401(d)(1) employer of its clients' employees for Tax Years, X did not incur the employer portion of the FICA tax under section 3111 with regard to the tips received by those employees and was not entitled to claim the section 45B credit.

FACTS:

The IRS Examination Division ("Exam") conducted an income tax examination of X for Tax Years. As part of the examination, X contended that it was a section 3401(d)(1) employer responsible for payment of FICA tax on tips received by its clients' employees in connection with the providing, delivering, or serving of food or beverages for consumption, and was thus entitled to the section 45B credit with respect to those tips. Exam took the position that X was not the section 3401(d)(1) employer. X asserted its right to appeal. The Appeals Division ("IRS Appeals") and X requested this technical advice memorandum (TAM). For purposes of this TAM, X agreed that it was not the common law employer of the workers performing services for X's clients. The analysis and conclusions reached in this TAM are therefore based on the assumption that the workers are the common law employees of X's clients for whom they performed services. Thus, the workers are referred to in this TAM as the "clients' employees."

During Tax Years, X was licensed as a PEO[2] in Florida and had as many as clients, with approximately client employees located in . The clients were primarily small and medium-sized businesses in a wide variety of industries, including approximately food and beverage establishments. .

[1] For purposes of seeking this technical advice, X agreed that it was not the common law employer of its clients' employees.

[2] There is no definition of PEO for Internal Revenue Code purposes. According to the National Association of Professional Employer Organizations (NAPEO), PEOs provide human resource services to their small business clients, pay wages and taxes, and assume responsibility for compliance with other state and federal laws and regulations. In addition, PEOs may provide workers with access to health and welfare benefits not typically provided by small businesses. See www.napeo.org.

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X's described X's business activity as providing certain HR related activities under what it called a "co-employment" arrangement.[3] Under this arrangement, X purported to assume certain human resource and employment-related responsibilities of its client. The stated that the "co-employment" arrangement allowed X to become an "employer of record", allowing X to relieve the client of administrative burdens for matters such as employment tax and insurance-related paperwork.
With regard to its claimed "co-employment" arrangement, X's

) stated in pertinent part:

> [X] provides certain HR-related services and functions for clients under what is referred to as a co-employment arrangement. Under the co-employment arrangement, [X] assumes certain HR/employment-related responsibilities, as provided for by a professional services agreement ("PSA") and as may be required under certain state laws. The co-employment relationship allows the PEO to become an employer of record and administrator for matters such as employment tax and insurance-related paperwork as well as relieving the client of these time-consuming administrative burdens. Because a PEO can aggregate a number of small clients into a larger pool, the PEO is able to create economies of scale—enabling smaller businesses to get competitively priced benefits.

Pursuant to a contractual agreement termed a , X offered clients payroll processing services, employee benefits such as health and welfare programs, life insurance, workers compensation insurance, 401(k) plans, and human resource functions such as background checks, employment testing, and customized employee handbooks.[4]

Under the , X contractually agreed to comply with all laws and regulations governing the reporting, collection, and payment of federal and state payroll taxes on the wages of clients' employees, including taxes imposed by the Code. The also provided that X assumed responsibility to process payroll, pay wages, and report and

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[3] X also referred to itself as the "co-employer" in several sections of the it executed with clients (see, for example, sections 6 and 12.) As discussed more fully in the Analysis section of the TAM, neither "co-employment" nor "co-employer" are recognized concepts for federal employment tax purposes. Thus, these characterizations have no impact on our analysis.

[4] For purposes of the TAM, X provided a copy of a blank "model" as well as a executed with a client. The terms of each are similar. Our references in this TAM to sections of the are made with regard to the model .

pay federal taxes, including Federal income tax withholding, FICA tax, and tax under the Federal Unemployment Tax Act (FUTA), under its own employer identification number (EIN).

Specifically, section of the provided:

Section of the further provided:

Consistent with the terms of the , X filed Forms 941, *Employer's QUARTERLY Federal Tax Return* (FICA taxes and Federal income tax withholding), for all of its approximately clients on an aggregate basis, entering X's name, address, and EIN in the blocks designated on the Form 941 for the name, address, and EIN of the employer. X also furnished to all client employees and filed with the Social Security Administration Forms W-2, *Wage and Tax Statement*. X's name, address, and EIN were entered in the blocks designated as for the employer on the Forms W-2 and Form W-3, *Transmittal of Wage and Tax Statements*.

With regard to X's clients' responsibilities, the provided that the client controlled its worksite and the day-to-day supervision of its employees. Under the , the clients were also responsible for determining and reporting to X how much was to be paid to the employees and for transferring the payroll amounts to X for processing. Specifically, section of the provided:

Section of the contained provisions regarding the clients' obligation to provide payroll information and payment to X prior to X making a payment of wages. It provided in pertinent part:

A memorandum from to IRS Appeals, dated

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(May Memo), explains that through its payroll process, X sought to achieve contemporaneous or same-day payment of wage and tax amounts to X from its clients as the date that X issued payroll and deposited payroll taxes. Specifically, X stated that "[c]lient billings were managed from a cash flow perspective with a goal to achieve a matching between the time that the funds were received from a client to the time that the funds were paid to the client employees and appropriate tax jurisdictions."

The May Memo explained that in order for payroll checks to be produced by X, client payroll information needed to be input into the online payroll reporting application. Thus, upon closure of a payroll period, the client was required to submit payroll and hours to X. Most clients used X's online payroll reporting system to report payroll and hours information. However, for other transmittals (for example, fax transmittals) X's staff would enter the client's information into the online application. Regardless of the method used, X initiated a cut-off date for supplying payroll information, which was generally the next business day following the close of a payroll period.

Once information was entered into the online application (by either the client or X), the payroll totals flowed directly into a billing statement automatically produced from the online application. X would assign a check date for payment of wages, and issue a wage summary/billing statement to the client one day prior to the designated check date. Billing statements included amounts for wages, withholding taxes, employer taxes (FICA, FUTA and state taxes), workers compensation, 401(k), and other benefits provided on behalf of the client's employees. The amounts shown on the billing statement were based on the contracted pricing with the client and client wage and benefit totals.

As discussed above, section of the provided that the totals shown on the billing statement were due from the client upon receipt. The May Memo confirmed that X generally received funding from its clients for payroll just prior to or on the same day the client employees actually received the payroll checks/direct deposits.[5]

Pursuant to section of the , clients could use bank wire transfers, Automatic Clearing House ("ACH") debit transfers, negotiable bank drafts, cashier's checks or any other method acceptable to X. The May Memo stated that most clients used ACH Debit.

Failure to make timely payments of the amounts shown on the billing statement constituted a breach of the by the client and gave rise to X's right to immediately terminate. In this regard, section of the provided:

In addition, section of the provided, in pertinent part:

[5] This is consistent with information provided in the , which addresses X's bad debts attributable to its clients' failure to reimburse it for wages and taxes paid on behalf of employees. The stated:

The May Memo states that X generally had the right to immediately terminate the client relationship for non-payment for the next payroll cycle, but not the current payroll cycle. That is, X considered the lag period between the time services were performed and wages earned (i.e., the current payroll cycle) and the date the wages were paid to present its most significant financial risk because X did not view itself as able to terminate the for the current payroll cycle, notwithstanding the language regarding the right to immediately terminate for nonpayment.

For example, if client employees performed services in week 1, but were not paid for those services until pay date in week 2, the May Memo indicates that X was required under the to complete the delivery of the payroll for week 1 based on payroll information it received from its client even if the related wage and tax payments were not remitted by its client. According to X, this requirement to pay without regard to receipt of payroll amounts from a client is pursuant to law[6], as captured in section of the , which stated:

Thus, as explained in the May Memo, in a non-payment situation as described above, X would likely not be able to terminate the with the client until sometime in week 2 with regard to the payroll for week 2, but not with regard to the payroll for week 1.[7]

The also allowed X to request a deposit by clients if X chose to do so. Section of the provided:

[6] Florida Statute §§ 468.525(4)(b) and (c) require an employee leasing contract to contain a provision that the leasing company assume responsibility for the payment of wages to the leased employees without regard to payments by the client to the leasing company and assume full responsibility for the payment of payroll taxes and collection of taxes from payroll on leased employees.

[7] However, we are uncertain how to reconcile this representation with sections , and of the , which seemingly allowed X to immediately remove from its payroll the client employees for whom client informed X that payment would not be forthcoming when due. These sections do not appear to be qualified by X's receipt, or lack of receipt, of payroll information from the client. In other words, if X received payroll information from the client but was informed it would not receive the payroll amount, sections , and seemingly gave X the right to immediately terminate the .

X stated that it generally did not ask for a deposit.

For federal income tax purposes, X reported the total wage transfers received from clients in its gross receipts on its Form 1120, *U.S. Corporate Income Tax Return*, and took a deduction for payroll as a cost of goods sold.[8]

With respect to amounts paid to employees of its food and beverage establishment clients, X filed a Form 3800, *General Business Credit*, and a Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*, with its Forms 1120 for Tax Years. The Forms 8846 filed by X claimed a section 45B credit in the aggregate for employer FICA tax paid on employee tips with regard to all of X's food and beverage clients.

The did not reference tip wages, tip reporting, or the section 45B credit. X indicated that some of its food and beverage establishment clients were given "rebates" from X on its billing statements, which X stated were attributable to the 45B credit. X submitted records indicating that X "rebated" the 45B credit to some, but not all, of its food and beverage establishment clients, but did not state how it determined which clients received a "rebate". X's representatives stated that X had no knowledge of whether its food and beverage establishment clients also claimed the section 45B credit on their federal income tax returns.

LAW:

Section 38 allows a general business credit against the tax imposed by chapter 1 of the Code for the taxable year. Section 38(b)(11) lists, as a component of the section 38 credit, the employer social security credit determined under section 45B. As a component of section 38, the amount of the section 45B credit is only available as a credit against income tax. It is not available as a credit against employment tax.

Section 45B(a) provides that, for purposes of section 38, the employer social security credit for the taxable year is an amount equal to the excess employer social security tax paid or incurred by the taxpayer during the taxable year. Section 45B(b)(1), in relevant part, defines "excess employer social security tax" as any tax paid by an employer under section 3111 with respect to tips that are deemed under section 3121(q) to have been paid by the employer to an employee.

Section 45B(b)(2) provides that:

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[8] X did not treat amounts received for client payroll as gross receipts in its audited financial statements included in its . X stated this treatment of reporting revenues on a net basis was

> In applying paragraph (1), there shall be taken into account only tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary.

The legislative history of section 45B indicates that the credit is available to "food and beverage establishments". H.R. Rep. No. 103-213, 103rd Cong., 1st Sess. (Aug. 4, 1993), page 736, states:

> The conference agreement provides a business tax credit for food or beverage establishments in an amount equal to the employer's FICA tax obligation (7.65 percent) attributable to reported tips with respect to the food or beverage establishment in excess of those treated as wages for purposes of satisfying the minimum wage provisions of the FSLA. A food or beverage establishment is any trade or business (or portion thereof) which provides food or beverages for consumption on the premises with respect to which the tipping of employees serving food or beverages by customers is customary. No credit is allowed with respect to FICA taxes paid on tips that are not received in connection with the provision of food or beverages on the premises of the establishment.

Sections 3101 and 3111 impose FICA taxes on "wages", as that term is defined in section 3121(a), with respect to "employment," as that term is defined in section 3121(b). FICA taxes consist of the Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on both the employer and employee. Sections 3101(a) and 3101(b) impose the employee portions of the social security tax and the Medicare tax, respectively. Sections 3111(a) and 3111(b) impose the employer portions of the social security tax and the Medicare tax, respectively. Section 3102 imposes on the employer the requirement to deduct the employee portions of the FICA tax from wages the employer pays to the employee.

Section 3121(q) provides that tips received by an employee in the course of his employment shall be considered remuneration for such employment (and deemed to have been paid by the employer for purposes of section 3111 (employer FICA tax)).[9] Section 6053(a) requires an employee to report tips received to his employer. Section 3102(c) provides special rules with regard to the employer's deduction of the employee share of FICA tax on reported tip wages from other wages of the employee that are within the employer's control.

Section 31.3121(d)-2(a) of the Employment Tax Regulations generally provides for FICA purposes that a person who employs one or more employees is an employer. Section 31.3121(d)-1(c)(1) provides that an individual is an employee under the usual

[9] Section 3121(a)(12) provides limited exclusions for tips from wages for FICA tax purposes. Those exclusions are not at issue in this memorandum.

common law rules if the relationship between him and the person for whom he performs services is the legal relationship of employer and employee. Whether the relationship of employer and employee exists under the usual common law rules is determined upon an examination of the particular facts of each case. See section 31.3121(d)-1(c)(3). Thus, generally whether a person is an employer is determined under the common law rules (also referred to as the common law employer).

Section 3401(d)(1) defines the term "employer" for income tax withholding purposes as the person for whom the individual performs or performed any service, of whatever nature, as the employee of such person, except that, if the person for whom the individual performs or performed services does not have control of the payment of wages for such services, the term "employer" means the person having control of the payment of such wages. Under the statutory language, whether the requisite control exists is determined with regard to separate payments of wages, such as payroll period by payroll period.

Section 31.3401(d)-1(f) of the regulations provides that if the person for whom the services are performed does not have legal control of the payment of the wages for such services, the term "employer" means the person having such control. For example, where wages are paid by a trust and the person for whom the services are performed has no legal control over the payment, the trust is the employer.

In Century Indemnity Co. v. Riddell, 317 F.2d 681 (9th Cir. 1963), the court examined the history of the predecessor to section 3401(d)(1) and noted that the House[10] and Senate[11] reports coupled with the Conference Committee[12] report ". . . amply indicate an intent on the part of Congress to impose a narrow construction upon the exceptions of [section 3401(d)(1)]." Thus, the court concluded that joint control of a trust account by a common law employer and a surety, into which all job payments were made, and from which the surety made wage payments, did not give the surety "legal" control of the payment of wages. The court noted that control within the meaning of section 3401(d)(1) requires that the common law employer does not have control, and that the payor does have control. Legal control, the Court held, means "the 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." Supra, at 686.

The FICA does not contain a definition of employer similar to the definition contained in section 3401(d)(1) relating to income tax withholding. However, Otte v. United States, 419 U.S. 43 (1974), holds that a person who is an employer under section 3401(d)(1), relating to income tax withholding, is also an employer for purposes of FICA withholding

[10] H.Rept.No. 401, 78th cong. 1st Sess., April 30, 1943.
[11] S.Rep. No. 221, 78th Cong. 1st Sess., May 10, 1943.
[12] H.Rept.No. 510, 1943, pp. 1351-1353.

under section 3102. The Otte decision has been extended to provide that the person having control of the payment of the wages is also an employer for purposes of section 3111, which imposes the FICA tax on employers, and section 3301 (Federal Unemployment Tax Act (FUTA) tax).[13]

In Winstead v. United States, 109 F.3d 989 (4th Cir. 1997), the taxpayer, Winstead, owned land that was farmed by sharecroppers. The sharecroppers used migrant farm workers as day laborers to assist with the farming, but could not pay the workers until after the crops were sold. Therefore, Winstead paid the help from his own checking account and deducted this amount from the sharecroppers' share of the crop proceeds. Winstead was held to have control of the payment of wages to the workers and thus to be the employer under section 3401(d)(1).

In Consolidated Flooring Services v. U.S., 38 Fed.Cl. 450, (Ct.Fed.Cl. 1997), the general contractor, CFS, contracted with installers for flooring installation. The installers hired helpers. After a job, CFS would elicit from the installers the amount to be paid to the helpers and would deduct that amount from the invoiced amount submitted to CFS by the installers for the job completed. Separate checks would then be distributed directly by CFS to the helpers. The court concluded that CFS controlled the payment of wages to the helpers under section 3401(d)(1).

In Earthmovers, Inc. v. U.S., 199 B.R. 62 (Bkrtcy M.D. Fla 1996), the taxpayer, Earthmovers, entered into a contract with a leasing company whereby Earthmovers leased all of its employees from Sunshine, a leasing company. 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 Earthmovers to be the common law employer. Additionally, the court concluded that Earthmovers was the "employer who directs the employees and who has control over the payment of wages" under section 3401(d)(1) because it submitted the information regarding the hours worked each week by each employee, and forwarded the amount due for payroll (including the tax amounts) to the leasing company for distribution. However, the court went on to state:

> In Florida, where there is a contractual obligation to pay taxes and a statutory requirement to pay payroll and taxes during the contract period, the IRS can look to both Earthmovers and Sunshine . . . . Sunshine and Earthmovers are de facto "co-employers" of these workers.

[13] See, In re Armadillo Corp., 410 F. Supp. 407 (D. Colo. 1976), *aff'd,* 561 F.2d 1382 (10th Cir. 1987); In re The Laub Baking Co., 642 F.2d 196, 199 (6th Cir.1981); Winstead v. United States, 109 F.3d 989 (4th Cir. 1997).

> . . . Under the Florida statute, Sunshine must be responsible for paying the wages and filing the payroll tax returns and paying the taxes. * * * However, in the event that Sunshine defaults on its obligations, the government could still look to Earthmovers for payment of taxes owed on behalf of its employees. Earthmovers bears the ultimate responsibility in making sure that wages and taxes are paid on a timely basis. If Earthmovers wishes to contract out this function, that is acceptable. However, in the event of a default by Sunshine on the contract, Earthmovers must still bear responsibility."

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).

By contrast, in U.S. v. Total Employment Company, 305 B.R. 333 (USDC M.D. Florida, 2004), (TEC) the court held that TEC, an employee leasing company, had control of the payment of wages of its client, AESI. The court acknowledged that the employee leasing arrangement before it was very similar to that in Earthmovers. However, the facts differed from Earthmovers in that TEC advanced payroll for its client, AESI, for several payroll periods in 1999 and for two weeks in January 2000. The 1999 payments were reimbursed by AESI in January 2000. From January 2000 to November 2000, TEC received net payroll from AESI prior to making the wage payments, but did not receive the tax amounts from AESI. TEC continued to timely file employment tax returns under its EIN for all periods reporting the wage and tax amounts, but underpaid the tax amounts due.[14]

Without distinguishing between the periods when TEC advanced payroll for AESI compared to when TEC received payroll from AESI prior to making the wage payments, the court held:

> [U]nder the statutory framework in Florida,[15] the client company in an employee leasing arrangement is the common law employer of the leased employees and the employee leasing company is the statutory employer [under section

[14] The TEC court reversed the Bankruptcy Court's Order in this regard. The Bankruptcy Court held TEC did not control the payment of wages for periods when it did not use its own funds to pay wages and acted only in a ministerial capacity in issuing paychecks to leased employees. See In re: Total Employment Company, Inc. (Bankr. M.D. Fla., Aug. 6, 2003).

[15] See footnote 7 for the relevant provisions of the Florida Statute.

3401(d)(1)]. Both are responsible to the IRS for the withholding requirements on employee income and for the collection and payment of payroll taxes. As between the two, the client company bears ultimate responsibility and is liable to the employee leasing company when, like here, the employee leasing company pays or is held liable to the IRS.

ANALYSIS:

Two questions are relevant to the issue regarding X's entitlement to the section 45B credit. First, does the section 45B credit apply only to taxpayers that are food and beverage establishments? Second, was X an employer entitled to the section 45B credit?

Does the section 45B credit apply only to food and beverage establishments?

Section 45B(a) provides that the amount of the employer social security credit is equal to the excess social security tax paid or incurred by the taxpayer. Subsection (b) defines the "excess social security tax" as tax paid by an employer under section 3111 with respect to tips. Thus, as per the statute, the person entitled to claim the section 45B credit is the employer liable for the employer portion of the FICA tax.

Generally, the employer liable for the employer portion of the FICA tax on wages is the common law employer. In the event that a person other than a common law employer has control of the payment of wages, that person (the section 3401(d)(1) employer) is liable for the employer portion of the FICA tax on such wages and the common law employer is not.

This office has not directly answered whether a person can have control (within the meaning of section 3401(d)(1) and the regulations thereunder) of the payment of tips that are treated as wages and deemed paid by the "employer" under section 3121(q) for purposes of the employer FICA tax.[16] Section 3401(d)(1), long-settled by the courts as applicable to FICA tax, defines the employer for purposes of liability for tax, focusing on which party is in control of the payment of wages. There is no actual payment of tip wages by an employer, only a deemed payment under section 3121(q). Thus, arguably,

[16] We understand the issue was implicitly answered in the affirmative in prior informal advice, but no detailed analysis of the control issue was included. Specifically, CCA 200103070 (November 24, 2000), considered the question of which entity is entitled to the section 45B credit when a restaurant obtains its tipped employees from a leasing organization. The CCA states that section 45B provides that the credit belongs to the employer. While the CCA opines that the restaurant rather than the leasing agency is likely to be the common law employer, it notes the important exception contained in section 3401(d)(1). In the event that a section 3401(d)(1) employer rather than a common law employer has control of the payment of wages, the employer portion of the FICA tax is incurred by the section 3401(d)(1) employer. Thus, the CCA concludes that the section 45B credit should be claimed by the restaurant/common-law employer, unless the leasing company qualifies as the section 3401(d)(1) employer.

neither a common law employer nor a third party can control the payment of tip wages in the same way it controls the payment of non-tip wages.[17]

However, the provision in section 3102(c) that an employer deduct the employee FICA tax attributable to tip wages from non-tip wages under the employer's control indicates that a section 3401(d)(1) employer in control of the payment of the non-tip wages should also be the employer liable for the employee FICA tax on the tip wages. Furthermore, the courts' extension of section 3401(d)(1) to determine liability for FICA and FUTA tax—thus consolidating the employment tax obligations on the section 3401(d)(1) employer—suggests that such employer should also be liable for the employer FICA tax on the tips deemed paid by the employer under section 3121(q).

Although, the legislative history with respect to the enactment of section 45B indicates that the intent was to limit the application of the section 45B credit to "food and beverage establishments", the statutory language of section 45B(a), which authorizes the credit, contains no such limitation. Thus, the fact that the employer liable for the employer FICA tax on the tip wages is not a food or beverage establishment does not itself prevent such employer from entitlement to claim the credit. Although it is possible for a non-food and beverage section 3401(d)(1) employer to be liable for the FICA tax on deemed tip wages and be entitled to claim the 45B credit, as is illustrated by the facts of this case and the discussion below, we believe the occurrence of the requisite fact pattern to be rare.

Was X an employer entitled to the section 45B credit?

The employer liable for the employer FICA tax for purposes of calculating the section 45B credit is generally the common law employer. The determination of whether a person is an employer for employment tax purposes is made by applying the law to the particular facts and circumstances of each case. For purposes of determining whether a person is the common law employer under the common law test, an employment relationship 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. See Regs. §§ 31.3121(d)-1(c), 31.3306(i)-1(b), and 31.3401(c)-1(b). This same test applies for determining which party is the common law employer. *See,* for example, Professional and Executive Leasing, Inc. v. Commissioner, 89 T.C. 225 (1987), *aff'd* 862 F.2d 751 (9th Cir. 1988).

In its , X described its arrangement with its clients as a "co-employment arrangement" and in the X entered into with clients it referred to itself as a "co-employer". There is no definition of "co-employment" or "co-employer" for federal employment tax purposes.

[17] However, we understand that, in some cases, credit card tips may be paid to the employee in connection with the regular paycheck.

Nor does the Code, regulations, other formal guidance, or any binding court precedent recognize "co-employment" or "co-employer" for federal employment tax purposes.[18] Thus, a claim by X that it is the "co-employer" in a "co-employment arrangement" for federal employment tax or other purposes is not relevant under the Code for purposes of identifying the employer liable for employment taxes.[19]

The fact that X filed employment tax returns under its own EIN is not determinative of its status as an employer. The IRS' processing of returns filed and a payment made by X under its EIN is not acceptance by the IRS of a party as the employer.

X has agreed for purposes of this TAM that it is not a common law employer of the employees performing services for its clients during Tax Years. Therefore, a common law employment analysis is not required.

However, as discussed above, if a person other than the common law employer has control of the payment of wages within the meaning of section 3401(d)(1), that person is the employer liable for federal employment taxes--including the employer FICA tax--with regard to such wages. While we have not answered the specific question of whether a section 3401(d)(1) employer with respect to non-tip wages can also be a section 3401(d)(1) employer with respect to liability for the employer FICA tax on tip wages by virtue of section 3121(q), as discussed above, there is statutory support for that position and it is consistent with the desire (as reflected by the courts' extension of section 3401(d)(1) to the other federal employment taxes) to consolidate the employment tax liability on wages with the person who is in control of the payment of the wages.

In any event as discussed below, X is not a section 3401(d)(1) employer with respect to the wages it paid (or possibly was deemed to have paid in the case of tips) to its clients' employees.

The determination of whether a person is a section 3401(d)(1) employer is based on the facts and circumstances in each case. The legislative history of section 3401(d)(1)

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[18] We acknowledge that the Bankruptcy Court in Earthmovers characterized the leasing company as a "co-employer"; however, this language was dicta and the decision is not binding. We disagree with the court's characterization of the relationship as "co-employers" to the extent it relies on the Code. To the extent the premise was more narrowly based on Florida statute, we reserve comment, but point out that the Code does not direct us to state law for determining employment tax liability. See discussion of state law in regards to TEC, below.

[19] In unique circumstances, an individual may be a common law employee of more than one employer (concurrent employment) with regard to the same services. Revenue ruling 66-162, 1966-1 C.B. 234, describes a concurrent employment arrangement where sales clerks are employees of both a store and a concessionaire. Under the facts of the ruling, the store and the concessionaire each independently satisfy the common law direction and control test such that each was a common law employer of the sales clerks. X has agreed for purposes of this TAM that it is not a common law employer, making this Revenue Ruling of no further relevance.

establishes that this Code section was “designed solely to meet unusual situations” and was not intended as a departure from the basic purpose to centralize responsibility for withholding, returning and paying taxes in the common law employer. S.Rep. No. 221, 78th Cong. 1st Sess., May 10, 1943. Consistent with this legislative history, section 31.3401(d)-1(f) of the regulations provides that the control of the payment of wages must be “legal control”. Thus, in recognition that section 3401(d)(1) involves the replacement of the common law employer with the person in control of the payment of wages as the entity that is liable for employment taxes, the IRS has narrowly construed what it means to be in control of the payment of wages under section 3401(d)(1).

Several revenue rulings, which do not involve PEOs, place weight on ownership of the funds used by the third party to pay wages when determining control of the payment of such wages under section 3401(d)(1). In Rev. Rul. 70-267, 1970-1 C.B. 205, the question presented was whether the owner of improved real estate or the management company that hired, fired and paid the individuals engaged in the operation of the property was the employer of the individuals. The ruling concludes that the owner was the common law employer of the individuals and that despite the fact that the property management company paid the workers, it was not in control of the payment of wages within the meaning of section 3401(d)(1). The property management company paid the wages of the employees from funds belonging to the owner that were deposited in a special bank account in the owner's name. The ruling states that, in effect, the wages were paid out of funds belonging solely and exclusively to the owner. It held that under these circumstances, the property management company could not be said to have control of the payment of the wages within the meaning of section 3401(d)(1).

Rev. Rul. 57-145, 1957-1 C.B. 332, involved a situation in which a corporation employed so-called “clerks of the works” to ensure the quality of a building’s construction. An architectural firm, which prepared building plans for the corporation, paid the “clerks” from its funds at the request of the corporation, and subsequently was reimbursed by the corporation for the amounts advanced. The ruling concluded that the architectural firm was in control of the payment of wages under section 3401(d)(1). See also, Rev. Rul. 54-471, 1954-2 C.B. 348, which held that an advertising agency was the section 3401(d)(1) employer where the agency paid employees of a State citrus commission at the request of the commission and then billed the commission for the amounts disbursed. In both revenue rulings, the entity which paid the workers sought reimbursement, at some point in the future, from the workers’ common law employer. However, no facts suggested that the wage payments were contingent upon, or proximately related to, the entities having first received funds from the workers’ common law employers.

The courts have also generally taken a narrow view of when liability is shifted under section 3401(d)(1). Both Winstead and Consolidated Flooring, discussed above, address situations where a third party paid the employees with its own funds, without having received funds from the common law employer in advance and without regard to

the timing of receiving funds from the common law employer. In fact, in those cases the common law employer never had possession of the funds used to pay the wages. The funds were always in the dominion and control of the third party. Only after the third party payor made the payment of wages was it indirectly reimbursed by the common law employer through an offset of funds owed to the common law employer by the third party payor. These cases are analogous to Rev. Ruls. 70-176, 54-471 and 57-145 in that the payor did not require the common law employer to advance the wage and tax amounts prior to payment, but made the wage payments with its own funds and only received reimbursement subsequently.

In contrast to Winstead, Consolidated Flooring, and the above cited revenue rulings, X did not own the funds used to pay wages. X's required the client to make payment immediately upon receipt of the billing statement, which receipt generally occurred before X paid the net payroll to the workers. X stated in the May Memo that it required payment of wages from its clients prior to it making payroll and publicly expressed this policy in its . X merely served as a conduit to deliver payroll funds.[20]

Consistent with the regulations, legislative history, these revenue rulings and cases, the Office of Chief Counsel has consistently stated that a PEO or similar employee leasing company is not in control of the payment of wages if the payment of wages is contingent upon, or proximately related to, the PEO having first received funds from its clients.[21]

As discussed above, a number of cases have also found that a PEO is not the section 3401(d)(1) employer. *See*, Earthmovers, supra, (leasing company not the section 3401(d)(1) employer of construction workers because common law employer forwards the amount owed for payroll to leasing company for distribution); U.S. v. Garami, 184 B.R. 834 (D.C. Fla. 1995) (leasing company not the section 3401(d)(1) employer of cleaners because 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).

Exam relied primarily on Earthmovers to conclude that X is not a section 3401(d)(1) employer. As rebuttal to Exam's reliance on Earthmovers, X notes that, based on the court's analysis of state law requirements under which both X and Earthmover were

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[20] We also note that X also did not claim ownership of the amounts forwarded for payroll, as evidenced by its exclusion of those amounts from gross receipts it reported , even though it reported the amounts as gross receipts offset by costs of good sold for federal income tax purposes.

[21] *See*, for example, 1998 FSA LEXIS 259 (April 9, 1998) and CCA 200415008 (April 9, 2004).

licensed[22], the court determined that the IRS could look to both Earthmovers and Sunshine to pay the taxes. X apparently reads the court's statement that Sunshine and Earthmovers are de-facto "co-employers" of the workers, as a statement that Sunshine was a section 3401(d)(1) employer. Because X is licensed under the same state law, X argues it should also be considered to be a section 3401(d)(1) employer.

As stated by the Riddell court, *supra*, in order for an entity to have control of the payment of wages under section 3401(d)(1), two conditions must exist. First, the common law employer must not have legal control of the payment, and second, the payor must have legal control. Thus, the court's holding that Earthmovers "is the employer who has control over the payment of wages" would foreclose a finding that Sunshine was also in control of the payment of wages. Instead, although not directly stated, it appears that the court's statement that the entities are "co-employers" is derived from the Florida statute that regulates leasing companies in that state. However, as noted, there is no definition of "co-employer" for federal employment tax purposes and the import of the court's meaning as related to the Code is unclear.[23]

X also disputes the precedential value of Earthmovers. X notes that the Earthmovers decision was vacated[24], and that in any case, no deference should be extended to a Bankruptcy court decision that has no jurisdiction in this matter. Instead, X cites U.S. v. Total Employment Company ("TEC"), 305 B.R. 333 (M.D. Florida, 2004), (TEC) as controlling precedent. We are not bound by the holding in TEC[25], however, and we disagree with the holding for several reasons.

First, the TEC court used a flawed analysis of what it means to be in control of the payment of wages for purposes of section 3401(d)(1). In the first instance, the court rejected TEC's argument, which cited to Professional Security Services, supra, that the client company was in control of the payment of wages because it must provide the funds in advance to the employee leasing company before the wages were paid. The TEC court noted, "While Professional Security Service does contain language to that effect, it does not hold that the employee leasing company is not also responsible for the payment of payroll taxes. Its holding is that a common law employer cannot avoid its federal employment tax obligations merely by showing that the responsibility for performing the obligation has been assigned to a third party."

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[22] As noted, the Florida law considered in Earthmovers is identical to the Florida law in effect in Tax Years that required the leasing company to pay wages without regard to payments by the client.

[23] Furthermore, as noted in footnote 16, the court's statement is dicta. Additionally, the opinion is not binding precedent. See footnote 26.

[24] Sunshine Staff Leasing v. Earthmovers, Inc., 242 B.R. 49 (M.D. FLA 1999).

[25] As a matter of law, federal District Court decisions are not binding within the federal district in which they are issued. Only decisions of the U.S. Supreme Court and the Eleventh Circuit Court of Appeals are binding on the District Courts of the Eleventh Circuit. Arriaga v. Florida Pacific Farms, 305 F.3d 1228 (11th Cir. 2002).

The TEC court then cited cases for which it interpreted the holding that the payor controlled the payment of wages as relying on the payor's control of the *bank account* from which the wages were paid.[26] Yet, in equating control of the payment of wages solely to control of the bank account from which payment of wages is made, the TEC court's analysis, if correct, would allow a common law employer to avoid its employment tax obligations by assigning the payment of wages to another party, in direct contravention of the principal for which it cites Professional Security Services.

The TEC court's attempt to counter this result by stating that both a common law employer and a third party in control of the payment of the wages are liable for the federal employment taxes runs counter to the section 3401(d)(1) statute. As discussed, liability for income tax withholding is imposed on the person for whom an individual performs services as an employee (i.e., the common law employer). Section 3401(d)(1) provides that if the common law employer does not have control of the payment of wages, the employer liable for the withholding tax is the entity that does have control. Thus, section 3401(d)(1) contemplates one employer being liable for the tax and does not create joint liability in the case where an entity other than the common law employer controls the payment of wages. The TEC court's statement that the IRS can look to both the common law employer and the employer under section 3401(d)(1) is not tenable under the Code.

Second, to the extent the court's holding in TEC relies on state law for determining federal employment tax liability, such reliance is improper. State law does not supersede the Code and, with the exception for rules related to state employment, the Code does not determine employment tax liability based on state law. Thus, to the extent state law allows a person to contractually assume responsibility for the payment of employment taxes related to its clients' employees, the state law cannot relieve the actual employer of the obligation to pay taxes for which it is liable under the Code. As stated in Professional Security Service, and endorsed in TEC, each taxpayer has a non-delegable duty under the Code to perform its federal employment tax obligations; a contract with a third party, even if allowed by state law, cannot relieve it of its duty to do so.

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[26] See Otte, supra; CFS, supra; Southwest Restaurant Systems, Inc v. IRS, 607 F.2d 1237 (9th Cir. 1979). It is arguable control of the bank account from which wages were paid was a determinative factor for finding control of the payment of wages in these cases. CFS is distinguished above. The Supreme Court, in holding that a bankruptcy trustee was liable to withhold taxes in Otte, did not mention control of the account from which wages were paid. Instead, the Court found control based on the fact that the trustee, and no other party, was legally bound to make the wage payments. Southwest Restaurant does raise control of the account as a factor in holding that Taxpayer was in control of the payment of wages, however, the facts are not aligned with this case. First, it did not involve an employee leasing situation. Second, the payroll account Southwest administered was funded by monies from accounts of corporations related to Southwest and amounts transferred to the payroll account did not relate to wages owed to any particular corporation's employees. Southwest transferred funds from whatever account had money in it to fund payroll for all employees.

Thus, we believe it was error for the court to conclude TEC was a section 3401(d)(1) employer for all periods before it without distinguishing between the periods when TEC advanced payroll on behalf of its clients as compared to when TEC paid wages to its client employees only after receipt of the funds from its client. Under the statutory language, whether the requisite legal control exists must be determined with regard to separate payments of wages, such as on a payroll period by payroll period basis. If a person pays wages without regard to receipt of the wage amounts from a client, as TEC did for periods in 1999 and for two weeks in 2000, that person may have control of the payment of wages for those payments.[27] However, if in the next payroll period the person paid wages after receipt of the wage amounts from the client, as TEC did for the periods from January to November 2000, it would not be in control of the payment of wages for that payroll period.

Thus, under this analysis, X did not have legal control over the payment of wages to the client employees within the meaning of section 3401(d)(1). The client/common law employer had control of the payment of wages. Because X's payments of wages to its clients' employees were contingent upon, or proximately related to, X having first received funds from its clients, the amounts did not come under the control of X and it acted only as a conduit to deliver payroll. Our conclusion is consistent with the regulations, legislative history, revenue rulings, and previously stated IRS informal guidance on this issue, as well as with most case law on the issue.

We place no import for this federal employment tax analysis on that section of the , or of Florida law, which provided that X was required to pay wages without regard to payment by the client, or that X was to assume responsibility for payment of taxes related to those wages. Nor do we find it relevant that X may have been at risk of financial loss due to the inherent time delays between any nonpayment and X's notification of such nonpayment. Financial exposure due to *potential* non-payment or late payment is not a factor in, let alone determinative of, whether an entity is in control of the payment of wages for purposes of section 3401(d)(1). To the extent that X in fact made payment of wages for a clients' payroll period without first receiving the funds to make payroll from its client, X may have been in control of the payment of wages for those periods.[28] However, there is no evidence presented that the instances where that occurred related to payment of wages to the employees of X's food or beverage establishment clients.[29]

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[27] We note that the presence of a security deposit equal to the amount of one payroll may effectively mean the person does not have legal control of this payment of wages either; however, this fact does not appear to be generally present in this case.

[28] This statement assumes X did not in fact have a security deposit to offset any such payment.

[29] To the extent X presents evidence that it did control payment of wages in certain periods to employees of food and beverage establishment clients as a section 3401(d)(1) employer, X might be eligible to claim the section 45B credit with respect to the employer FICA tax paid on the tip wages deemed paid to the same employees for the same periods. As noted above, we have not conclusively answered the question of whether a third party can be a section 3401(d)(1) employer with respect to the deemed payment of tip

Based on the foregoing, we conclude that X did not have legal control over the payment of wages (including any deemed paid tip wages) to its clients' employees in Tax Years, and was therefore not a section 3401(d)(1) employer with respect to those wages. Thus, since X was not an employer with respect to those wages, X was not entitled to claim the section 45B credit for Tax Years.

CAVEAT(S):

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.

wages for purposes of establishing liability for the employer FICA tax and the entitlement to the section 45B credit, but we believe there is support for that position.