**Office of Chief Counsel**
**Internal Revenue Service**
# Memorandum

Number: **201735021**
Release Date: 9/1/2017

CC:TEGE:EOEG:ET1:LPAzmon
POSTN-116084-17

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 3121.10-00, 7436.01-03, 6201.00-00, 3121.04-15

date: May 18, 2017

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subject: Whether an Employment Tax Audit Concerns Worker Classification

This Chief Counsel Advice responds to your request for assistance dated May 18, 2017. This advice may not be used or cited as precedent.

## QUESTIONS

1. Whether the employment tax audit of [redacted] (the Taxpayer) involves worker classification for the taxable periods and taxable years at issue when the Taxpayer used the Services of a professional employer organization (PEO) to pay compensation to its sole corporate officer, and the Service has determined that the Taxpayer is liable for additional employment taxes[1] due to the Service's recharacterization of payments made by the Taxpayer to its corporate officer as wages?

## CONCLUSION

[1] For purposes of this memo, employment taxes means the Federal Insurance Contributions Act (FICA) tax (under I.R.C. §§ 3101-3128), the Federal Unemployment Tax Act (FUTA) tax (under I.R.C. §§ 3301-3311), and the collection of income tax at source on wages (under I.R.C. §§ 3401-3406).

1. The employment tax audit does not involve worker classification for the taxable periods and years at issue because the Taxpayer treated its corporate officer as an employee, either by withholding employment taxes from wages paid to the corporate officer or pursuant to the terms of the contractual agreement between the Taxpayer and the PEO.

## FACTS

The Taxpayer is currently under an employment tax audit for each of the four taxable quarters included in the taxable years, as well as the taxable years ending

On , the Taxpayer entered into a contract entitled "CLIENT SERVICE AGREEMENT" with entire workforce, including its corporate officer (Assigned Employees).[2] Under the terms of the contract, the Taxpayer was required to "supervise all Assigned Employees and set their times, wages, and other terms and conditions of employment". The contract further provides that "control over the day-to-day job duties of Assigned Employees and over the job site at which, or from which, the Assigned Employees perform their duties is solely and exclusively assigned and assumed by" the Taxpayer.

The duties of the PEO under the contract include: 1) administering Taxpayer payroll, designated benefits, and personnel policies and procedures related to the Assigned Employees; 2) providing human resource administration and payroll administration with respect to the Assigned Employees; 3) furnishing and keeping workers compensation insurance covering the Assigned Employees; 4) processing and paying wages from its own accounts to the Assigned Employees based on the hours and wage information reported by the Taxpayer; and 5) filing all employment tax returns (i.e., Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return) with the Government and furnishing information returns to the workers.

The PEO's duties under the contract, however, were limited to only those wages that were reported and verified by the Taxpayer to the PEO for each pay period. In the event the Taxpayer paid wages to the Assigned Employees that were not reported to the PEO, the contract provides that the Taxpayer will be "solely responsible for damages of any nature out of the Client's failure to report payment of unreported wages to any of the Assigned Employees".

[2] The third party was part of an industry that, among other things, markets its ability to assist employers with ministerial tasks associated with the reporting and payment of employment taxes. A professional employer organization (PEO) is the name commonly used to reference entities in this industry and we will reference the third party as such for the duration of this memo.

For the taxable quarters included in the taxable year, as well as the taxable year, the Taxpayer's corporate officer received wage payments through the PEO. These wages were reported on a Form W-2, Wage and Tax Statement, issued by the PEO (under the PEO's EIN) and included on Forms 940 and 941 filed under the PEO's EIN. During this same year, the corporate officer also received distributions directly from the Taxpayer reported on a Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., under the Taxpayer's EIN. The distributions were not reported or verified by the Taxpayer to the PEO as wages so were not included on the employment tax returns filed under the PEO EIN.

For the taxable quarters included in the taxable year, as well as the taxable year, the Taxpayer did not contract with the PEO. Instead, the Taxpayer withheld employment taxes from wages it paid to its common law employees and corporate officer. The Taxpayer reported these wage payments on Forms 940 and 941, and issued Forms W-2 to its common law employees and its corporate officer. During the taxable year, the corporate officer also received distributions directly from the Taxpayer reported on a Schedule K-1 (Form 1120S) under the Taxpayer's EIN.

During the audit, the Service determined that the wages reported for the tax years with respect to its corporate officer are unreasonably low. Thus, the Service is proposing to recharacterize portions of the distributions paid by the Taxpayer directly to the corporate officer as wages, and is proposing to assess additional employment tax liabilities on such wages.

LAW AND ANALYSIS

For employment taxes to apply, an employer-employee relationship must exist. An officer of a corporation who performs more than minor services and receives remuneration for such services is a considered an employee. I.R.C. § 3121(d)(1); Treas. Reg. § 31.3121(d)-1(b), 31.3306(i)-1(e) 31.3401(c)-1(f). See Joseph M. Grey Pub. Accountant, P.C. v. Commissioner, 119 T.C. 121, 126 (2002), aff'd, 93 F. App'x 473 (3d Cir. 2004).

When an employer has provided additional compensation to an employee, but has not subjected that compensation to withholding because it believes an exception from the definition of "wages" or of "employment" applies, the Service will assess employment taxes under Code section 6201 against the portion of the payment that is being recharacterized as wages.

In contrast, a worker classification issue arises when a service recipient (employer) has classified an individual performing service as an independent contractor (or some other non-employee designation) and has not withheld employment taxes from compensation paid to the individual. Code section 7436(a) provides the Tax Court with jurisdiction to review certain employment tax determinations made by the Service in a worker

classification case and the proper amount of employment tax under such determinations.[3]

In the present case, there is no dispute that at all times during the taxable periods and taxable years at issue, the Taxpayer's corporate officer performed more than minor services for the Taxpayer, received compensation for such services, and was an employee of the Taxpayer pursuant to Code section 3121(d)(1).

For , the Taxpayer treated the corporate officer as an employee, evidenced by its issuance of a Form W-2 to the corporate officer reporting wage compensation, as well as inclusion of such wage compensation on the Forms 940 and 941 it filed with the Service. Thus, the audit of the taxable periods and taxable year with respect to the corporate officer is not properly considered worker reclassification.[4] The Service should assess employment taxes for under section 6201 against the portion of the payment that is being recharacterized as wages.

The position taken in this memorandum, i.e. that the audit of the taxable periods and taxable year does not involve worker classification, is consistent with the Tax Court's Orders in Martin S. Azarian. P.A. v. Commissioner, Docket No. 28957-15 (Azarian) and Patricia Arroyo DDS. Corp., Alex Mansilla and Mercedes P. Arroyo v. Commissioner, Docket No. 5874-15 (Arroyo). These cases were dismissed by the Court for lack of jurisdiction on the basis that the Service had not made any determinations for purposes of section 7436 when the corporations treated the officers as employees by issuing them a Form W-2 reporting wages and did not claim entitlement to Section 530 relief. The Court stated that section 7436 only confers jurisdiction on the Court to determine the correct amount of employment tax when the Service makes a worker classification determination or a determination that a taxpayer was not entitled to Section 530 relief, not when the Service concludes that a taxpayer underreported reasonable wage compensation.

For , the corporate officer also received a Form W-2 reporting wages for services rendered to the Taxpayer, and the wages were also reported on Forms 940 and 941, however, the Forms were filed under the PEO's EIN and not the Taxpayer's. The use of a PEO by the Taxpayer as a conduit for paying wages to its corporate officer, however,

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[3] Specifically, the Court has jurisdiction to review determinations that: (1) individuals are employees for purposes of employment taxes under subtitle C of the Code (i.e., requiring reclassification of a nonemployee to employee status), or (2) the person for whom services are performed is not entitled to relief under Section 530 of the Revenue Act of 1978 (Section 530). The Tax Court has held that it has jurisdiction under section 7436 when four required elements are present: (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, 32 (2015). See also, SECC Corp. v. Commissioner, 142 T.C. 225 (2014).

[4] The Taxpayer has not claimed entitlement to Section 530 relief.

does not affect whether the audit for with respect to the distribution made by the Taxpayer to its corporate officer is considered a worker classification audit. The contractual arrangement demonstrates that no underlying issue of employment tax classification status exists because the Taxpayer specifically contracted with the PEO to fulfill its obligations as an employer with respect to the treatment of the corporate officer as its employee. Thus, the dispute is not whether the corporate officer performed more than minor services for the Taxpayer and received compensation for those services, i.e., whether the corporate officer was an employee. Rather, the dispute is limited to the amount of compensation required to be treated as "wages" paid to the corporate officer – including distributions paid directly by the Taxpayer that did not flow through the PEO - for employment tax purposes, i.e. whether the additional payments constitute wages, rather than distributions.

Consistent with the Tax Court's reasoning in Azarian and Arroyo, the Service has not made a worker classification determination for the taxable periods and taxable year with regard to the corporate officer when the Service concludes that the Taxpayer underreported reasonable wage compensation. Therefore, the Service should also assess employment taxes for under section 6201 against the portion of the payment that is being recharacterized as wages.

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Please call (202) 317-6798 if you have any further questions.