OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) (Patricia M. McDermott)

SUBJECT:

This Field Service Advice responds to your memorandum. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Parent =

X =

U. S. Sub =

Foreign Sub =

FC =

M =

r =

s =

t =

v =

Facility =

ISSUES:

(1) Whether the separate existence of Foreign Sub should be respected.

(2) Whether income received by Foreign Sub from U.S. Sub under the t Subcontract constitutes foreign base company services income.

(3) Whether any of the income received by Foreign Sub from U.S. Sub under the t Subcontract will be excluded from Foreign Sub's subpart F income on account of it qualifying as U.S. source effectively connected income.

(4) Whether I.R.C. section 482 requires a reallocation of income from Foreign Sub to U.S. Sub.

(5) What legal theories are relevant in determining whether a United States corporation is liable for the taxes imposed under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) with respect to United States nationals performing services for a foreign subsidiary.

CONCLUSIONS:

(1) The separate taxable existence of Foreign Sub must be recognized in this case.

(2) Income received by Foreign Sub in the year t and the year v under the t Subcontract qualifies as foreign base company services income and thus must be reported by Foreign Sub 's sole United States shareholder, U. S. Sub, on U. S. Sub's t and v income tax returns.

(3) It appears that most or all of Foreign Sub's income is attributable to services performed by its employees and the dual employment employees at Facility in FC and thus is foreign source income. However, to the extent that any of Foreign Sub's income is attributable to services performed by its employees (or those of U.S. Sub or X acting on its behalf) in the United States, such income will qualify as U.S. Source income and may be effectively connected with a United States trade or business.

(4) If it is determined that the U.S. citizens who are performing the services required under the t Subcontract are in substance employees of U.S. Sub and not Foreign Sub, I.R.C. section 482 may require a reallocation of Foreign Sub's income that is attributable to these persons to U.S. Sub.

(5) Determination of liability of a United States corporation could depend on the application of the common law rules in determining which entity is the common law employer and whether section 530 of the Revenue Act of 1978 provides relief to the United States corporation.

FACTS:

Parent is a United States corporation that owns all of the stock of another corporation, X, which in turn owns all the stock of another corporation (U.S. Sub). X and U.S. Sub are both engaged in the business of providing support services to U.S. Government facilities. However, unlike X, which provides these services primarily to U.S. Government facilities located in the United States, U.S. Sub provides these services solely to U.S. Government facilities located on foreign soil.

On date r, U.S. Sub established a wholly-owned subsidiary, Foreign Sub, which was incorporated in M outside the United States. X has explained that U.S. Sub formed Foreign Sub to provide foreign individuals to staff and perform services pursuant to contracts entered into by U.S. Sub. This arrangement was necessary, according to X, to make U.S. Sub more competitive by eliminating costs attributable to employment taxes with respect to those persons that, in the absence of Foreign Sub's services, U.S. Sub would have employed to carry out its obligations under its various contracts.[1]

On date s, U.S. Sub entered into a contract (the "t Contract") with the U.S. Government to provide services at Facility in FC during the years at issue. At a later date, U.S. Sub entered into a contract with Foreign Sub (the "t Subcontract") to furnish individuals to perform the maintenance services required under the t Contract.[2] It appears that these services were performed by two groups of

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[1] Unlike domestic corporations, foreign corporations that employ citizens of the United States generally are not required to pay the taxes imposed under the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) with respect to services of such employees performed outside the United States.

[2]We are assuming that at all times after the t Subcontract was signed, U.S. Sub remained fully obligated and was paid by the U.S. Government for the performance of the services that were the subject of the t Subcontract. We are also assuming that during the years at issue Foreign Sub's only contract to perform services was the t

personnel located in FC: (1) individuals who were treated as employees of Foreign Sub (referred to as "Foreign Sub's employees"), and (2) individuals who were treated as employees of both Foreign Sub and U.S. Sub (referred to as "dual employment employees"). Many employees had been treated as employees of U.S. Sub, but then were transferred to FC and treated as employees of Foreign Sub.

According to X, the dual employment employees included at least three lower-level personnel who directly supervised the daily activities of Foreign Sub's employees. Further, the revenue agent report indicates that some employees of X were empowered with the right to direct, control, hire and fire all of Foreign Sub's employees.

Employees (whether Foreign Sub's employees or dual employment employees) who were U.S. citizens were compensated for their services in the form of two payments, a salary and a foreign area living allowance ("FALA"). These persons received their FALA in local currency drawn on Foreign Sub's local bank account with a bank located in FC. In receiving their salary, however, they had two options. They could receive a check in FC in U.S. dollars drawn on Foreign Sub's account with a bank located in the United States. Alternatively, they could have their salaries deposited directly into their personal U.S. bank accounts in U.S. dollars. In the case of any employee who selected the latter option, Foreign Sub requested X or U.S. Sub to make such payment, since the bank located in FC was unable to provide this service for Foreign Sub. According to X, in each case in which X or U.S. Sub compensated an employee on Foreign Sub's behalf, it was reimbursed via bookkeeping entries among the corporate family's internal accounts.

Employees who were not U.S. citizens were compensated for their services by Foreign Sub in local currency drawn on Foreign Sub's local bank account with a bank located in FC.

A question has arisen as to whether Foreign Sub's employees or the dual employment employees who were U.S. citizens should be treated solely as U.S. Sub's or X's employees. A determination that such persons were employees solely of U.S. Sub or X will result in U.S. Sub or X becoming subject to an additional employment tax liability.

Subcontract.

LAW AND ANALYSIS

1. Whether the separate existence of Foreign Sub should be respected.

The test of whether a corporation will be recognized as a taxable entity was first enunciated in Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). There, the Supreme Court held that a corporation will remain a separate taxable entity so long as it is established for the purpose of carrying on business activity or, following its establishment, it actually carries on real business activity. These alternative requirements of business purpose or business activity have been followed in numerous cases. See generally Hospital Corporation of America v. Commissioner, 81 T.C. 520, 579 fn. 28 (citing cases applying Moline Properties' alternative tests). Only if neither of these requirements are shown will a court agree that the separate existence of the corporate entity should be disregarded. See e.g., Shaw Construction Co. v. Commissioner, 35 T.C. 1102 (1961) (corporations used in the acquisition, development, and sale of land were disregarded since their formation lacked any real business purpose and they had no offices, employees, and income-producing assets), aff'd. 323 F.2d 316 (9th Cir. 1963).

The Hospital Corporation case is instructive on this issue. There, a domestic corporation had established a separate Cayman Islands subsidiary to manage a hospital in Saudi Arabia in order to facilitate assigning responsibility for the success of the project and to keep a separate accounting of the project's profits. According to the court, such a decision reflected valid business considerations. 81 T.C. at 582. Moreover, the court found that following its formation, the Cayman Islands subsidiary engaged in substantive business activity by issuing stock, electing officers and directors, holding regular meetings of the shareholders and directors, maintaining bank accounts for paying expenses and investing funds, and hiring employees. Id. at 584. Based on these facts, the court concluded that the Cayman Islands subsidiary both was organized for a business purpose and in fact carried on substantive business activity. Thus, it was not a sham corporation and was recognized for tax purposes. Id. at 586.

In this case, Foreign Sub was formed for the purpose of employing individuals who would perform services on behalf of U.S. Sub at a lower cost than if U.S. Sub had employed these persons directly. The fact that Foreign Sub's status as a foreign corporation means that it is effectively exempt from any U.S. employment tax liability associated with its employees who are U.S. citizens does not negate this business purpose. See Hospital Corporation, 81 T.C. at 583 (securing a tax benefit is not, by itself, "sufficient reason to disregard the corporate existence" of an entity). Further, Foreign Sub appears to have engaged in

substantive business activity such as hiring employees and compensating them with funds from its own U.S. and foreign bank accounts. Accordingly, we believe that Foreign Sub satisfies both the business purpose and business activity tests established by Moline Properties, and therefore, its separate taxable existence must be recognized in this case.

2. Whether income received by Foreign Sub from U.S. Sub under the t Subcontract constitutes foreign base company services income.

Although we believe Foreign Sub should be recognized as a separate taxable entity, its status as a foreign corporate entity does not mean that its activities lack U.S. tax consequences. Because it is performing services in connection with the contractual obligations of its U.S. parent, Foreign Sub is subject to the current taxation rules of I.R.C. §§ 951 - 964 (collectively referred to as "subpart F").

Determining Whether Foreign Sub is a CFC Subject to the Current Taxation Rules of Subpart F

Under subpart F, a United States shareholder of a foreign corporation that is a controlled foreign corporation ("CFC") for at least 30 consecutive days during a taxable year is required to currently include in its gross income its pro rata share of the CFC's subpart F income for such taxable year, whether or not the United States shareholder receives a dividend distribution from the CFC. I.R.C. § 951(a). The term "CFC" is defined as any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such foreign corporation is owned (within the meaning of I.R.C. § 958) by United States shareholders on any day during the taxable year of such foreign corporation. I.R.C. § 957(a). The term "United States shareholder" is defined, with respect to any foreign corporation, as a United States person who owns (within the meaning of I.R.C. § 958) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. I.R.C. § 951(b). The term "United States person is defined to include a domestic corporation. I.R.C. § 957(c) (cross-referencing the definition in I.R.C. § 7701(a)(30)).

U.S. Sub is a domestic corporation that appears to have been the sole shareholder of Foreign Sub, a corporation organized under the laws of M, since Foreign Sub's formation in r. During the years at issue, therefore, U.S. Sub qualified as a United States shareholder, and Foreign Sub qualified as a CFC. To the extent that Foreign Sub received subpart F income during t and v, U.S. Sub will be required to report its pro rata share of that income (i.e., 100 percent) on its income tax returns for those years.

Determining Whether Foreign Sub Received Subpart F Income

The term "subpart F income" includes foreign base company services income, which is defined as income derived by a CFC in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services for or on behalf of any related person and that are performed outside the country under the laws of which the CFC is organized. I.R.C. § 954(e). Thus, in determining whether income received by Foreign Sub during the years at issue constituted foreign base company services income, three requirements must be shown. First, Foreign Sub must have received its income in the form of compensation for the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services. Id. Second, the services giving rise to the income must have been performed for, or on behalf of, a "related person" as that term is defined in I.R.C. § 954(d)(3). Id. Finally, the services must have been performed outside the country under the laws of which Foreign Sub is created or organized. Id.

Foreign Sub clearly meets the first and third requirements for showing that any income it received for performing services under the t Subcontract with U.S. Sub constitutes foreign base company services income. Foreign Sub received the income as compensation for performing commercial cleaning and other maintenance services, and the services were performed in FC and not in M, the country in which Foreign Sub is organized. Moreover, U.S. Sub is a related person with respect to Foreign Sub since it owns 100 percent of, and thus controls, Foreign Sub. See I.R.C. § 954(d)(3)(A). The issue, therefore, is whether the services performed by Foreign Sub under the subcontract were performed "for, or on behalf of," U.S. Sub.

Under Treas. Reg. § 1.954-4(b)(1), "services which are performed for, or on behalf of, a related person" by the CFC include services performed in any of the following four situations:

(1) The CFC receives compensation or any other substantial financial benefit from a related person for performing the services.

(2) The CFC performs services which a related person is, or has been obligated to perform.

(3) The CFC's performance of the services is a condition or a material term of the sale of property sold by a related person.

(4) The CFC receives substantial assistance from a related party contributing to the performance of the services by the CFC.

With respect to the last situation, the term "substantial assistance" is defined as including (but is not limited to) "direction, supervision, services, know-how, financial

assistance (other than contributions to capital), and equipment, material or supplies." Treas. Reg. § 1.954-4(b)(2)(ii)(a). Assistance in the form of direction, supervision, services, and know-how is considered to be "substantial" only if it:

(1) provides the CFC with skills that are a principal element in performing the services or the cost to the CFC of the assistance equals 50 percent or more of the total cost to the CFC of performing the services, and

(2) directly assists the CFC in performing the services.

Treas. Reg. § 1.954-4(b)(2)(ii)(b) and (e).

Foreign Sub's services under the t Subcontract come within two, and possibly three, of these situations. First, Foreign Sub received compensation from U.S. Sub for performing these services. See Treas. Reg. § 1.954-4(b)(1)(i). Second, U.S. Sub was obligated to perform these services pursuant to its contract with the U.S. Government. See Treas. Reg. § 1.954-4(b)(1)(ii). See also Treas. Reg. § 1.954-4(b)(3), Example (5). Finally, it is possible that Foreign Sub may be treated as having received substantial assistance contributing to the performance of its services under the t Subcontract if it is determined that individuals employed by persons related to Foreign Sub directly assisted it in performing its services and the assistance so furnished was a principal element in producing the income from the t Subcontract. Treas. Reg. § 1.954-4(b)(2)(ii)(b) and (e). Persons who meet these requirements may include, for example, employees of X or U.S. Sub who supervised or otherwise controlled the activities of Foreign Sub's employees. Accordingly, income received by Foreign Sub in the year t and the year v under the t Subcontract qualifies as foreign base company services income and thus must be reported by Foreign Sub's sole U.S. shareholder, U.S. Sub, on U.S. Sub's t and v income tax returns.

3. Whether any of the income received by Foreign Sub from U.S. Sub under the t Subcontract will be excluded from Foreign Sub's subpart F income on account of it qualifying as U.S. source effectively connected income.

It is possible that some of Foreign Sub's income qualifies as U.S. source effectively connected income. If so, such income is specifically excluded from categorization as subpart F income and will not be taxable to U.S. Sub, Foreign Sub's U.S. shareholder. I.R.C. § 952(b). Such income will be taxed instead to Foreign Sub on a net basis at graduated rates. I.R.C. § 882(a).

In general, income derived from the performance of personal services is sourced according to where the services are performed. Thus, income attributable to services performed in the United States are characterized as U.S. source income, and income attributable to services performed outside of the United States are characterized as foreign source income. I.R.C. §§ 861(a)(3) and 862(a)(3). Where income is attributable to services performed both inside and outside the United States, the source of the income is generally determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the case. Treas. Reg. § 1.861-4(b). For example, the income may be apportioned between U.S. and foreign sources on the basis of the amount of time spent in each location.

It appears that most or all of Foreign Sub's income is attributable to services performed by its employees and the dual employment employees at Facility in FC and thus is foreign source income. However, to the extent that any of Foreign Sub's income is attributable to services performed by its employees (or those of U.S. Sub or X acting on its behalf) in the United States, such income will qualify as U.S. source income and may be effectively connected with a U.S. trade or business.

4. Whether I.R.C. § 482 requires a reallocation of income from Foreign Sub to U.S. Sub.

If it is determined that the U.S. citizens who are performing the services required under the t Subcontract are in substance employees of U.S. Sub and not Foreign Sub, I.R.C. § 482 may require a reallocation of Foreign Sub's income that is attributable to these persons to U.S. Sub. I.R.C. § 482 gives the Commissioner authority to reallocate income between taxpayers that are members of a controlled group if such reallocation is necessary to clearly reflect the income of each member of such controlled group. In the present case, U.S. Sub owns all of Foreign Sub, and thus both are members of the same controlled group. A reallocation will be required, therefore, if personnel hired by Foreign Sub to perform under the t Subcontract are recharacterized as employees of U.S. Sub and Foreign Sub

received income as consideration for the performance of these services. This is because Foreign Sub, in order to carry out its obligations under the t Subcontract, will be deemed to have utilized U.S. Sub's employees, thereby entitling U.S. Sub to compensation for the use of its resources by Foreign Sub. The extent of any reallocation will depend upon the standards set forth in Treas. Reg. § 1.482-1(d) (setting forth standards for determining whether a controlled transaction produces an arm's length result). In addition, if a reallocation is required, an appropriate correlative adjustment reducing Foreign Sub's income will be made in accordance with the rules set forth in Treas. Reg. § 1.482-1(g).

5. What legal theories are relevant in determining whether a United States corporation is liable for employment tax with respect to United States nationals performing services for a foreign subsidiary.

Existence of employment relationship

FICA taxes are imposed on "wages," which is defined in section 3121(a) as all remuneration for employment, with certain specific exceptions. "Employment" is defined in section 3121(b) as including, in part, any service, of whatever nature, performed outside the United States by a citizen or resident of the United States as an employee for an American employer. Section 3121(h) defines an "American employer" as including a "corporation organized under the laws of the United States or of any State." A corporation that is organized under the laws of a foreign country or territory would not be an American employer. Services performed by a United States citizen or resident outside the United States for a foreign corporation would not be subject to FICA taxes, unless the services are (1) covered by a section 3121(l) agreement executed by a United States corporation which provides social security coverage with respect to services performed for an affiliate of the United States corporation, (2) recognized as equivalent to employment under a totalization agreement, or (3) services performed in connection with an American ship or aircraft as described in section 3121(b)(A)(ii). The latter two exceptions to the general rule do not apply in this case, but information in the file does not disclose whether a section 3121(l) agreement, Form 2032, has been filed by Parent, X, or U.S. Sub with respect to Foreign Sub. For purposes of the remainder of this memorandum, we will assume that no section 3121(l) agreement has been filed, although this should be verified. Therefore, FICA taxes would not apply with respect to the services of the workers if the workers are employees of Foreign Sub.

FUTA taxes are imposed on "wages," which is defined in section 3306(b) as all remuneration for employment with certain specific exceptions. Section 3306(c) defines "employment" as including, in part, any service, of whatever nature, performed outside the United States by a citizen of the United States as an employee of an American employer. An American employer is defined in section 3306(j)(3) as including a corporation organized under the laws of the United States

or of any State. Thus, services by a United States citizen for a foreign corporation would not be included within the definition of employment (except for certain services in connection with an American ship or aircraft as provided for in section 3306(c)((A)(ii)). Therefore, the taxpayer would not owe FUTA taxes with respect to the services of the workers if the workers are employees of Foreign Sub.

In this case, the taxpayer is not disputing that these workers are employees, the only dispute is over which entity is the employer. The determination of the identity of an employer is based on an application of the common law rules that are also used to determine whether an employer-employee relationship exists.

Sections 31.3121(d)-1(c) and 31.3306(i)-1 of the regulations provides that an individual is an employee if under the usual common law rules the relationship between the worker and the person for whom the services are performed is the legal relationship of employer and employee. 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 business actually direct or control the manner in which the services are performed; it is sufficient if the business has the right to do so.

To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined. See, Weber v. Commissioner, 103 T.C. 378 (1994), aff'd per curiam 60 F.3d 1104 (4th Cir. 1995); Professional and Executive Leasing, Inc. v. Commissioner, 864 F.2d 751 (9th Cir. 1988); Avis Rent-A-Car System, Inc v. United States, 503 F.2d 423 (2d Cir. 1974); Simpson v. Commissioner, 64 T.C. 974 (1975); Kenney v. Commissioner, T.C. Memo. 1995-431. Courts have relied on certain primary categories of evidence to determine whether a business has the right to control and direct a worker performing services to the extent necessary to create an employer-employee relationship. These categories include factors that relate to behavioral control, financial control, and the relationship of the parties.

The category of behavioral control involves facts which illustrate whether there is a right to direct and control how the worker performs the specific tasks for which he or she is engaged. It involves a review of any instructions and training provided by the taxpayer to its workers. The weight of "instructions" in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.

The element of financial control involves facts which illustrate whether there is a right to direct and control how the business aspects of the worker's activities are conducted. The analysis under this element involves five sub-elements:

a. Whether the worker has made a significant investment in his work.

This factor primarily relates to whether an individual is an independent contractor or an employee and would not be very helpful in determining the identity of an employer. Because the status of these workers as employees is not in dispute, we believe this factor is of limited utility.

b. Whether the worker incurs unreimbursed expenses.

This factor is also of limited utility in determining the identity of an employer issue. Because the workers are acknowledged to be employees, we believe that this factor would be of limited usefulness in this case.

c. Whether the worker may provide his services to others.

We think that this factor is not relevant in this case, because its presence would indicate an independent contractor status, which is not at issue here.

d. The method of payment to the worker.

The method of payment to the workers can be important in determining the identity of the employer. Taxpayer argues that in this instance, this factor demonstrates that the workers are employees of Foreign Sub because payments were made by Foreign Sub in FC to the worker and Foreign Sub ultimately bears the cost of all payments to the workers. However, payments were also made to the workers by X in U.S. dollars by direct deposit into their U.S. bank accounts. However, it is possible for an individual to be a common law employee of a subsidiary although paid by a parent. See Rev. Rul. 69-316, 1969-1 C.B. 263, and the analysis of Group (1) in its determination of what entity is the common law employer. (It should be noted that certain other conclusions in Rev. Rul. 69-316 do not reflect current law.)

e. The worker's opportunity to control his own profits and losses.

This last factor does not appear to us to be relevant in this case. It more properly arises in the context of employee-vs.-independent contractor matters.

(3) The element of relationship of the parties deals with facts which illustrate how the parties perceive their relationship. Here there is no question that the parties intended to form an employer-employee relationship. The issue, however, is who was intended to be the employer of these individuals at Facility. Employment agreements were executed in this case. We would note that the contractual designation of the worker is "very significant in close cases." See, Illinois Tri-Seal Products, Inc, v. United States, 353 F.2d 216, 218 (Ct. Cl. 1965). However, a contractual designation in and of itself is not sufficient evidence for determining worker status. Thus, adequate weight should be given to relevant contracts between the worker and the firms, although this factor is not decisive.

An additional fact relating to the relationship of the parties includes which entity provides employee benefits and who is eligible for such benefits. This factor can be important in identity of employer cases, because it shows an intent to compensate for service by the entity providing benefits.

Also relevant is who is responsible for discharge and termination of the employee. This requires an analysis of who employed the management employees who are empowered to terminate the employment of the workers.

A factor that can be important in identity of employer analyses is looking at the services performed by the worker and the extent to which those services are a key aspect of the regular business of the company. This could involve an analysis of the business activities of the corporations and a determination of which corporation the worker is primarily performing services for.

The above facts and circumstances should be considered in their totality to determine the identity of the employer under the common law rules.

Liability for payment of employment taxes

In determining which entity is the employer of an employee, it is necessary to distinguish between (1) the employer under the common law rules and (2) the employer for purposes of the liability for payment of federal employment taxes. The employer for whom the services are performed (i.e., the employer under the common law rules) would be relevant in determining whether services are included within the definition of employment and wages for purposes of the FICA and the FUTA, and whether the payments are wages for federal income tax withholding

purposes. Only if it is determined that payments are wages does it become necessary to determine which entity is the "employer" liable for the payment of the employment taxes.

Section 3401(d) provides that for purposes of federal income tax withholding, the term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that –

> (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” (except for purposes of subsection (a)) means the person having control of the payment of such wages, and
>
> (2) in the case of a person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, the term “employer” (except for purposes of subsection (a)) means such person.

Neither the FICA nor the FUTA contains a definition of employer similar to the definition contained in section 3401(d)(1) of the Code, relating to income tax withholding. However, Otte v. United States, 419 U.S. 43 (1974), 1975-1 C.B. 329, holds that a person who is an employer under section 3401(d)(1) of the Code, relating to income tax withholding, is also an employer for purposes of FICA withholding under section 3102. Otte involved a trustee in bankruptcy who was an employer under section 3401(d)(1) by virtue of having control over the payment of wages owed by the bankrupt. The Court stated:

> The fact that the FICA withholding provisions of the Code do not define "employer" is of no significance, for that term is not to be given a narrower construction for FICA withholding than for income tax withholding. (419 U.S. at 51, 1975-1 C.B. at 332)

The Otte decision has been extended to provide that the person having control of the payment of wages is also an employer for purposes of section 3111 of the Code, which imposes a FICA excise tax on employers, and for purposes of section 3301, which imposes the FUTA tax on employers, provided the person meets the requirements of section 3306(a)(1)(A), (a)(2)(A), or (a)(3). In re Armadillo Corp., 410 F. Supp. 407 (D. Col. 1976), aff'd, 561 F.2d 1382 (10th Cir. 1977), holds that the Otte rule applies equally to the employer's FICA tax and to FUTA. In re Laub Baking Co., 642 F.2d 196 (6th Cir. 1981), and STA of Baltimore --ILA Container Royalty Fund v. United States, 621 F. Supp. 1567 (D. Md. 1985), aff'd, 804 F.2d 296 (4th Cir. 1986) reached similar conclusions.

In our view, the Otte decision does not extend beyond the duties and liabilities in connection with the payment of the taxes under sections 3102 (and the deduction of those taxes under that section), 3111, and 3301 of the Code. For example, it has no effect in determining whether remuneration is "wages" under section 3121(a) and section 3306(b) and whether services are "employment" under sections 3121(b) and 3306(c).

As a result of Otte, when the person for whom an individual performs services as an employee is not the person having control of the payment of wages, the person having control of the payment is liable for the taxes under sections 3102, 3111, and 3301 of the Code and has the duty of filing appropriate returns. (However, third party payors of sickness and accident disability are liable for employment taxes only as provided in section 3121(a).)

In situations in which a third party other than the common law employer has control of the payment of wages, that third party is referred to as a “section 3401(d)(1) employer.” The regulations under section 3401(d) relating to the definition of “employer” interpret the phrase “in control of the payment of wages” as referring to “legal control.” These regulations clearly contemplate that “in control of the payment of wages” means more than simply making the actual payment of wages. See section 31.3401(d)-1(f) of the regulations. For example, with respect to supplemental unemployment compensation benefits, the regulations provide that if the person making such payment is acting solely as agent for another person, the term “employer” shall mean such other person and not the person actually making the payment. See section 31.3401(d)-1(g). Furthermore, section 31.3401(d)-1(h) provides that the special definition of the term “employer” contained in sections 31.3401(d)-1(e), (f), and (g) are designed solely to meet special or unusual situations. The regulations further provide that these special definitions are not intended as a departure from the basic purpose of the regulations to centralize in the employer the responsibility for withholding, returning, and paying the tax and furnishing the Forms W-2.

Status as a section 3401(d)(1) employer requires that the common law employer not have control of the payment of wages and that another party (“third party”) does have the control. The issue of whether a third party is the employer depends on the facts and circumstances of the particular case. Some of the factors that the courts have examined to determine whether a third party is in “control of the payment of wages” are which entity supplies the money for the payroll, who makes up the payroll, who determines the employees to be included therein, and who determines the amounts they are to be paid. See Westover v. Simpson, 209 F.2d 908 (9th Cir. 1954); Arthur Venneri Co. v. United States, 340 F.2d 337 (Ct.Cl. 1965); Phinney v. Southern Warehouse Corp., 212 F.2d 488 (5th Cir. 1954).

In General Motors Corp. v. United States, No. 89-CV-73046-DT (E.D. Mich., December 20, 1990), the General Motors Corp. (GM) entered into a contract with an overseas company, United Technical Services GmbH (UTS), to obtain additional design engineers to supplement its American workers. According to GM, the UTS workers were highly trained design engineers who worked with minimal supervision. UTS provided its own supervisors who performed a function similar to that of a personnel department head. UTS workers kept their own records on UTS timesheets and GM only reviewed timesheets to verify the hours. Timesheets which had been approved by GM were then returned to the UTS supervisor who sent them to UTS representatives. UTS representatives then billed GM for the services provided by UTS workers. UTS paid the wages and benefits of the UTS workers. GM claimed it never treated the UTS workers as employees and did not know the amount of their wages. It did not provide fringe benefits to the workers. GM claimed it maintained no personnel files on the workers. GM was not involved in interviewing the UTS workers or dealing with their applications for employment. GM only reviewed resumes to see if the individuals to be supplied had proper qualifications. According to GM, it had no direct control over UTS workers except to the extent necessary to insure conformity with GM standards. The status of the workers as employees was not at issue. The Service attempted to collect unpaid employment taxes with respect to the workers from GM.

The Court in General Motors held that only the person in control of the payment of wages (UTS in that case) was liable for the employment taxes. The Court interpreted Otte as providing that "the responsibility for withholding employment taxes is directed toward the person who pays the workers and not the person who has control over the workers' duties." The court concluded that: "Regardless of whether GM or UTS ultimately controlled each particular UTS designer while on the job, this Court concludes that UTS was responsible for paying the wages of its own designers."

Although section 3401(d)(1) has been applied to FICA and FUTA through the Otte line of cases, we are unaware of a specific case applying section 3401(d)(2) to the FICA and FUTA. In any event, a case applying section 3401(d)(2) to FICA and FUTA would have limited utility in this case because a determination that a person is paying wages in behalf of a foreign corporation would presumably be based on a determination that the workers are employees of a foreign corporation. If the workers are employees of Foreign Sub, the services are not employment for FICA and FUTA purposes.

As noted above, it is our view that the Otte case and cases applying it to FICA and FUTA do not affect determinations (1) whether workers are employees, and (2) whether workers' services are employment under section 3121(b) or section 3306(c), and (3) whether payments are wages under section 3121(a) or section 3306(b. Accordingly, the determination of which entity is the employer under the

common law rules is critical in determining whether the services performed by the workers are employment for purposes of the FICA and FUTA and thus whether the remuneration they receive is wages for FICA and FUTA purposes.

As noted above, if the United States citizens or residents performing services outside the United States are common law employees of a United States employer (i.e., X or U.S. Sub), their services constitute employment for purposes of the FICA. Further, if the United States citizens performing services outside the United States are common law employees of a United States employer (i.e., X or U.S. Sub), their services constitute employment for purposes of the FUTA. Generally, the common law employer would be liable for FICA and FUTA taxes unless a third party is the employer under section 3401(d)(1).

If the workers are employees of a foreign corporation (i.e., Foreign Sub) and are performing services outside the United States, their services would not be employment for purposes of the FICA unless a section 3121(l) agreement or a totalization agreement provided that their services were employment. Also, if the workers are employees of a foreign corporation (i.e., Foreign Sub) and are performing services outside the United States, their services would not be employment for purposes of the FUTA.

Application of Section 530 of the Revenue Act of 1978

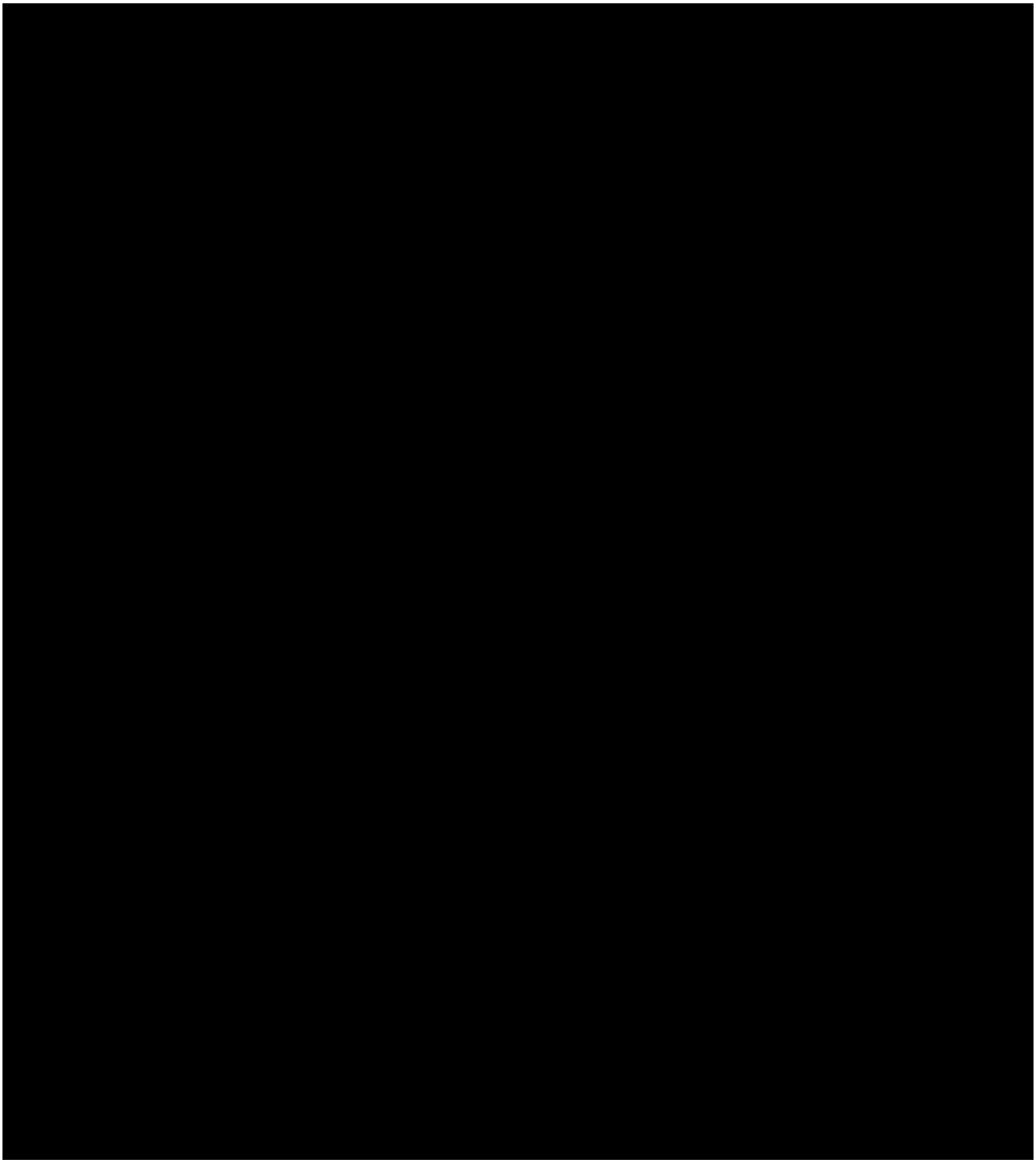
If it is established that the workers are employees of Foreign Sub, neither FICA taxes nor FUTA taxes will apply with respect to the workers' services performed outside the United States. Thus, the question of relief under section 530 of the Revenue Act of 1978 as amended would not be an issue. However, if the workers are common law employees of U.S. Sub or X, then the issue of section 530 relief could be raised.

Section 530 provides businesses with relief from federal employment tax liability if certain requirements are met. The taxpayer must have not treated an individual as an employee for the period and must have filed all federal tax returns (including information returns) on a basis consistent with treating the individual as not being an employee. In addition, the taxpayer must have a reasonable basis for not treating the individual as an employee. However, section 530(a)(3) imposes a consistency requirement under which section 530 relief is not available if the taxpayer or a predecessor has treated any individual holding a substantially similar position as an employee for employment tax purposes after December 31, 1977.

It is unlikely that relief under section 530 would apply if the workers are determined to be employees of U.S. Sub. U. S. Sub treated these workers as employees before the workers were treated as employees of Foreign Sub. Also,

U.S. Sub continued to treat the dual employment employees as employees and to file Forms W-2 with respect to those workers. Therefore, it does not appear that U.S. Sub would satisfy the consistency requirement of section 530(a)(3).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



If you have any questions, call the branch telephone number.