DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR

FROM: Jerry E. Holmes
Chief, Employment Tax Branch 2
CC:TEGE:EOEG:ET2

SUBJECT: Third-Party Payor Situation

LEGEND

= State X

= State Y

= Year 1

= Year 2

= Year 3

= Year 4

= $X

You have requested guidance on whether a formal Field Service Advice memorandum (FSA) is advisable given the following scenario. You believe that the facts and law are straightforward, and that an FSA is not needed. For the reasons set forth below, we concur.

FACTS

The facts are essentially as follows. A State X construction company agreed to provide financing to enable company employees to start a construction company in State Y. The State Y company formally incorporated in State Y. There was no formal written agreement between the two companies. The State X company agreed to pay the expenses of the State Y company in an informal reimbursement arrangement that was not reduced to writing. The State Y company sent funds to the State X company when

it received revenue. The State X company paid the wages to the State Y company employees out of the State X company's payroll bank account, using State X company's checks. The State X company withheld employment taxes and reported the wages and taxes of the State Y employees on the State X company's 941/940 returns.

This arrangement continued from the beginning of the State Y company's operations in Year 1 until October of Year 3. Besides payroll, the State X company paid other expenses of the State Y company. The State Y company did not designate or provide any accounting classifications for the payments sent to State X company. The State X company included the State Y company's expenses and reimbursements it received from the State Y company on the State X company's Form 1120 income tax returns.

Sometime in year 3, the State Y company started experiencing cashflow problems. The State Y company was not able to cover its expenses including the payroll taxes for its employees. The State X company continued to pay the State Y employees their net pay for the first three quarters of Year 3 and reported the wages and taxes on its 941/940 returns even though State X company did not withhold and deposit the appropriate amounts. The State X company stopped handling the payroll of the State Y company in October of Year 3 when the State Y company declined to assign its company's contract proceeds to the State X company. By October of Year 3, the state X company had failed to pay $ in payroll taxes on State Y company's employees.

In early Year 4, the State X company issued the State Y company's employees Forms W-2 showing the wages paid and taxes that should have been withheld for the first three quarters of Year 3 and filed copies with the Social Security Administration. In June of Year 4, the State X company filed a Form 941c reducing the amount of wages reported and paid by the State X company for the first three quarters of Year 3 by the amount of wages and the employment taxes attributable to the State Y company's employees during that period. The State X company also filed Forms W-2c with the Social Security Administration showing $0.00 for wages and withholding taxes for Year 3 on the State Y company's employees.

No assessment has been made for the State Y company's payroll taxes after October of Year 3, the time that the State X company stopped paying the State Y company's employees. The State Y company is out of business. The regional accounting firm representing the State X company disputes owing any amount of payroll taxes on State Y company's employees. They claim that the State X company only functioned as a payroll agent. They also requested a formal Field Service Advice memorandum.

## LAW AND ANALYSIS

Section 3401(d)(1) of the Code provides that 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 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.

Neither the Federal Insurance Contributions Act (FICA) nor the Federal Unemployment Tax Act (FUTA) contain 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), holds that a person who is an employer under section 3401(d)(1) of the code is also an employer for purposes of FICA employee tax withholding under section 3102. Thus, under Otte, if the common law employer does not have control of the payment of wages, the person in control of the payment of wages is an employer with respect to liability for the FICA employee tax. The Otte decision has been interpreted to provide that the person having control of the wages is also an employer for purposes of section 3111 of the Code (the employer portion of FICA tax), and section 3301 (FUTA tax). In re Armadillo Corp., 410 F. Supp. 407 (D. Colo. 1976), aff'd, 561 F. 2d 1382 (10th Cir. 1977).

The Supreme Court's opinion in Otte and section 3401(d)(1) of the Code stand for the proposition that 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 reasoning is to place responsibility for withholding employment taxes on the individual responsible for making the payments.

The issue in this case is whether the State X company had control over the payment of the State Y company's employees' wages. The State X company paid the wages out of its own funds, using its own checks, and issued the appropriate Forms 940/941/W-2. The State X company knew exactly the amount of wages and payroll taxes that needed to be withheld and deposited. The State Y company's reimbursement plan was intermittent and inadequate as evidenced by the $ shortfall in payroll taxes.

The State X company may allege that it was only functioning as the payroll agent for the State Y company. This would negate the control over the wage issue, but the State X company will have difficulty establishing that it was only performing a ministerial function on behalf of the State Y company. The State X company must establish that even though they issued paychecks directly to the State Y company's employees, the State Y company nevertheless had control over the funds that were the source of the payments to the employees. Due to the reimbursement pattern and financial history and relationship between the State Y company and the State X company, it will be difficult to establish that the State X company did not control the payment of the wages.

A review of the cases involving third party payors reveals that the government faces very little litigation risk should the case go to trial. Congress enacted Section 3401(d)(1) to ensure that the payroll taxes would be paid in this type of situation. See Winstead v. U.S., 109 F.3d 989 (1997); Mobile Med Support Services, Inc. v. U.S., 2000 U.S. Dist. Lexis 15564; Alexander Drilling, v. U.S., 1997 U.S. Dist. Lexis 22486; and General

Motors Corporation v. U.S., 1990 U.S. Dist. Lexis 17986. (The firm representing the taxpayer also claimed that Otte was only applicable to the same factual situations where trustees in bankruptcy were paying employees. As seen in Winstead, the argument that Otte should be limited to factual situations involving trustees in bankruptcy has been rejected by other courts.)

If you have any questions concerning this matter, please contact at (202) 622-6040.

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JERRY E. HOLMES