
Does the IRS Consider Us the Employer?

Any business that utilizes labor forces needs to understand whether it is an “employer” for tax purposes under the Internal Revenue Code. Often times, the answer is easy, and the business is the employer for both tax and employment law purposes. However, sometimes, it becomes murky, and failing to follow the rules can land the business in hot water with the IRS. Failing to properly withhold and turnover payroll taxes subjects an employer to severe penalties and interest, in addition to the tax liability. Even worse, if the IRS finds that the owner is a responsible person, that individual or individuals can be held personally liable for the deficiency. Understanding if your business is a tax employer is integral to performing your functions in human resources. Regardless of whether you hire employees or independent contractors, anyone who pays workers should understand these rules.

Who is the Employer for Federal Payroll Tax Purposes

The “employer” is the one responsible for withholding the employee’s income taxes and his share of FICA taxes, as well as the employer’s matching share of FICA and FUTA taxes on wages with respect to employment. The task of identifying the person responsible for payroll tax compliance does not end with identifying the common law employer, because more than one person may have employer-type contacts with the employee. For example, if the payor other than the common law employer has control of the payment of wages, that payor will be treated as the statutory employer. In addition to the common law and statutory employer, other employment arrangements may affect who has responsibility and liability for payroll taxes. These include the following:

- PEOs (professional employer organizations);
- Pay agent authorized under Section 3504;
- Payor designated to perform acts of the employer, but did not use Section 3504;
- Common paymasters (FICA/FUTA)
- Successor employers (FICA/FUTA)
- Third party making a direct payment, such as a lender who provides payment of wages.

So what is a common law employer and a statutory employer?

Following the common law standard, the regulations provide that an employer-employee relationship exists if the service recipient has the *right to direct and control* the worker who performs the services. For example, this includes how the work will be done and not just the type of work that will be done. Moreover, 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.

A common law employer generally is required to deduct and withhold Federal income tax and FICA taxes from the wages it pays to its employees under Sections 3402(a) and 3102(a), respectively, and is separately liable for the employer's share of FICA taxes as well as for FUTA taxes under Sections 3111 and 3301, respectively. The common law employer that pays wages subject to income tax withholding, FICA, and FUTA must file Forms 941, 940 W-2, and W-3.

Section 3401(d)(1) defines a statutory employee. It describes circumstances where a third party that is not the common law employer is treated as the employer for purposes of satisfying employment tax obligations. If the person for whom the individual performs or performed the services (i.e. the common law employer) does not have control of the payment of wages for that person, the term "employer" means the person having control of the payment of those wages.

The Internal Revenue Code imposes Federal income tax withholding obligations upon the Section 3401(d)(1) statutory employer. In fact, case law extended the Section 3401(d)(1) employer's obligations to include withholding of FICA and FUTA taxes. See *Otte v. United States*, 419 US 43 (1974); *In re Armidillo Corp. v. United States*, 561 F.2d 1362 (10th Cir. 1977); *The Lane Processing Trust v. United States*, 25 F.3d 662 (8th Cir. 1994); *Winstead v. United States*, 109 F.3d 989 (4th Cir. 1997).

The inquiry becomes what constitutes control of the payment of wages? The Regulations provide that a third party must have "legal control" of the payment of wages. The Internal Revenue Service has taken the position in certain cases that the third party has legal control over the payment of wages only when the third party is liable to pay the wages and taxes whether or not the client employer transfer funds to cover the wages, taxes, and fees. *General Motors Corp. v. United States*, 67 AFTR 91-520 (E.D. Mich. 1990).

A common law employer cannot transfer common law status to a third party pursuant to a contract, if the facts do not support the third party being treated as a statutory employer. Additionally, for purpose of the OASDI and FUTA tax wage bases, it is the common law employer and not the statutory employer that is taken into account when determining the amount of wages subject to tax, even though the statutory employer remains liable for the taxes imposed on the wages.

Using a Professional Employer Organization (PEO)

In general, the Internal Revenue Service takes the approach that the employer is liable for employment taxes regardless of whether it has a contract with a third party payroll service. However, there are new statutory requirements under Sections 3511 and 7705 that impose liability solely on the PEO for employment taxes on wages paid to worksite employees if certain criteria are met. Under these rules, the customer and the PEO are treated as predecessor and successor for purposes of the social security wage base for worksite employees. Note, however, that self-employees individuals are not work site employees with respect to remuneration paid by a PEO, and thus must still pay SECA tax on that remuneration. The statutory requirements imposed by Section 7705 are as follows:

A contract meets the requirements of this paragraph with respect to an individual performing services for a customer if such contract is in writing and provides that the professional employer organization shall:

- assume responsibility for payment of wages to such individual, without regard to the receipt or adequacy of payment from the customer for such services,
- assume responsibility for reporting, withholding, and paying any applicable taxes under subtitle C, with respect to such individual's wages, without regard to the receipt or adequacy of payment from the customer for such services,
- assume responsibility for any employee benefits which the service contract may require the certified professional employer organization to provide, without regard to the receipt or adequacy of payment from the customer for such benefits,
- assume responsibility for recruiting, hiring, and firing workers in addition to the customer's responsibility for recruiting, hiring, and firing workers,
- maintain employee records relating to such individual, and

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- agree to be treated as a certified professional employer organization for purposes of section 3511 with respect to such individual.

If the contract fails to meet the above-mentioned criteria, then the common law employer will remain liable for the employment taxes regardless of any contractual obligation with a PEO.

Conclusion

It is important for every employer to understand its rights and duties as an employer under the Internal Revenue Code to avoid the imposition of additional taxes, penalties and interest. If you have any questions regarding your status as a common law employer, statutory employer or if you use a PEO, be sure to contact a tax professional to discuss your options.