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UNITED STATES DISTRICT COURT FOR THE

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

BLUE LAKE RANCHERIA and BLUE LAKE RANCHERIA ECONOMIC DEVELOPMENT CORPORATION, **Plaintiffs,** **v.** **UNITED STATES OF AMERICA,** **Defendant.**	**No. C-08-04206-SC** **DATE: DECEMBER 4, 2009** **TIME: 10:00 A.M.**

UNITED STATES NOTICE AND MOTION FOR SUMMARY JUDGMENT AND MEMORANDUM OF POINTS AND AUTHORITIES

TABLE OF CONTENTS

TABLE OF POINTS AND AUTHORITIES

CASES **PAGE**

STATUTES

TABLE OF POINTS AND AUTHORITIES

STATUTES (Cont'd) **PAGE**

TABLE OF POINTS AND AUTHORITIES

STATUTES (Cont'd) **PAGE**

TABLE OF POINTS AND AUTHORITIES

MISCELLANEOUS (Cont'd) **PAGE**

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PLEASE TAKE NOTICE that on Friday, December 4, 2009, at 10:00 a.m., or as soon thereafter as counsel may be heard, before the Honorable Samuel Conte, United States District Judge, in Courtroom No. 1, 17th Floor, 450 Golden Gate Avenue, San Francisco, California, the United States will move for summary judgment pursuant to Rule 56(a) of the Federal Rules of

Civil Procedure. This motion is supported by the accompanying memorandum and the declaration of Phyllis Green.

MEMORANDUM OF POINTS AND AUTHORITIES

I. PRELIMINARY STATEMENT

This is an action brought by plaintiffs Blue Lake Rancheria and Blue Lake Economic Development Corporation to recover $2,005,939 in FUTA (Federal Unemployment Tax Act) taxes alleged to have been erroneously paid to the United States' Internal Revenue Service for the tax periods ending December 31, 2003, and December 31, 2004. The United States denies that the FUTA taxes were erroneously paid and seeks the dismissal of the complaint and action with prejudice.

II. FACTUAL BACKGROUND

Blue Lake Rancheria (the "Tribe") is a Federally recognized Indian Tribe with its reservation located in Blue Lake, California. The Blue Lake Rancheria consists of 91 acres near the City of Blue Lake, California, 17 miles north of Eureka and five miles east of Arcata in Humboldt County. The Tribe's membership consists of 53 adults and children. (Green Decl. ¶ 3, Ex. A) Mainstay Business Solutions ("Mainstay"), the taxpayer, was established by the Tribe in May 2003, as an unincorporated enterprise of the Tribe. Mainstay's designated principal place of business is located at 428 Chartin Road, Blue Lake, California; its headquarters is located at 605 Coolidge Drive, Suite 210, Folsom, California 95630-3155. Mainstay is a wholly owned subsidiary of an Indian tribe as described in section 4(e) of the Indian Self-Determination and Education Assistance Act (25 U.S.C. § 450b(e)). (Green Decl. ¶ 4, Ex. B)

Mainstay alleges that it is an employee staffing company which, during 2003 and 2004, "provided temporary and permanent employee staffing services of [sic] businesses located throughout California, Hawaii, and Nevada." (Comp. ¶¶ 1 and 8) The government determined that Mainstay operated in a like manner to businesses commonly called employee leasing companies or professional employer organizations. (Green Decl. ¶ 5; Answer ¶ 1) The government determined that Mainstay offered client businesses multiple employee benefit and payroll services including paying the wages to the client's workers and withholding, depositing

and reporting all applicable employment related taxes, both state and federal. (Green Decl. ¶ 5)

The government further determined: When a client company hires Mainstay, the client company fires its employees, Mainstay immediately hires those same employees, and then Mainstay leases them back to the client company for a fee. (Green Decl. ¶ 6) From the affected employees' perspective there is no change in their relationship with the client company. The client company continues to control the daily performance of its workers' duties. Mainstay, however, now issues the paychecks to its client's workers. (Green Decl. ¶ 6) The client companies are required to maintain time cards for its workers which are delivered to Mainstay. Mainstay then invoices the client based on the time cards. The invoice includes the gross wages (including deductions for employees portion of FICA and contracted benefits), employer's portion of FICA, FUTA and SUTA, and employer's portion of contracted benefits, together with the fees that Mainstay charged for the services that it provided. (Green Decl. ¶ 7)[1/]

Mainstay aggregates all of its clients and files Form 941, Employer's Quarterly Federal Tax Return and Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return reporting wages, income tax withholding, FICA and FUTA for all of its clients on an aggregate basis under Mainstay's name and employer identification number. (Green Decl. ¶ 8) During the 2003 and 2004, Mainstay filed its Form 940, paid FUTA taxes, and claimed credits for state unemployment insurance (SUI) taxes paid. (Green Decl. ¶¶ 9 and 10, Exs. C and D) Mainstay filed a Form 843, Claim for Refund and Request for Abatement, for each year claiming a refund for all FUTA taxes paid asserting it was exempt from FUTA taxes with respect to all the wages reported because it was an Indian tribe eligible for an exemption pursuant to section 3306(c)(7). (Green Decl. ¶¶ 11 and 12, Exs. E, F and G) The IRS disallowed Mainstay's claims for refund on April 24, 2008. (Green Decl. ¶ 13, Ex. H)

[1/] That the parties may not agree on their characterization of Mainstay's business operations is immaterial to this motion. Mainstay bases its complaint on its claimed status as the I.R.C. § 3401(d)(1) employer for its clients' workers. (Compl. ¶¶ 20 - 24) The sole issue before the Court is whether, as a section 3401(d)1) employer, Mainstay is exempt from FUTA under I.R.C. § 3306(c)(7). (Joint Case Management Statement p. 3) The government submits that, as a matter of law, Mainstay is not exempt from FUTA by virtue of being a section 3401(d)(1) employer.

III. QUESTION PRESENTED

Whether wages paid by Mainstay, a wholly owned unincorporated division of a federally recognized Indian tribe, are exempt from FUTA under section 3306(c)(7) of the Internal Revenue Code (hereinafter "I.R.C." or "the Code") based on Mainstay's claim that it is paying wages as an I.R.C. § 3401(d)(1) employer of workers performing services for Mainstay's clients? (Compl. ¶¶ 20 - 24; Joint Case Management Statement p. 3).

IV. ARGUMENT

A. Summary Judgment Standard

Summary Judgment is appropriate when there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). A party opposing summary judgment may not rest upon the mere allegations or denials in its pleadings. Rather, it must set forth specific facts showing that there is a genuine issue for trial. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986) (citing *First National Bank of Arizona v. Cities Service Co.*, 391 U.S. 253, 288-89 (1968)). A mere scintilla of evidence supporting the opposing party's position will not suffice. *Anderson*, 477 U.S. at 252. A dispute about a material fact is genuine if the evidence is such that a reasonable jury could return a verdict for the non-moving party. *Id.* at 248. The substantive law identifies which facts are material. Only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment. *Id.*

B. Summary of the Issue and Arguments

The Internal Revenue Code imposes employment taxes on wages paid by an employer to its employees. Employment taxes include income tax withholding (Chapter 24, §§ 3401-3406), taxes imposed under the Federal Insurance Contributions Act (FICA) (Chapter 21, §§ 3101-3128) on the employee (§ 3101; the employee portion of FICA) which is required to be withheld by the employer (§ 3102), and the employer (§ 3111; the employer portion of FICA), and tax imposed on the employer under the Federal Unemployment Tax Act (FUTA) (Chapter 23, §§ 3301-3311). The instant litigation involves tax imposed under the FUTA on wages paid by Mainstay to workers providing services to Mainstay's clients.

Generally, a determination of whether employment taxes are imposed on a taxpayer depends on several determinations: first, whether a common-law employee-employer relationship exists between the individual performing the services and the service recipient; second, whether services are determined to be "employment" as defined by the relevant statute; and third, whether a payment is determined to be "wages" as defined by the relevant statute. In this case, Mainstay takes the position that it is exempt from FUTA tax pursuant to I.R.C. § 3306(c)(7), which provides an exception from the definition of "employment" for purposes of the FUTA for services performed in the employ of an Indian tribe. Mainstay asserts that it is the employer under I.R.C. § 3401(d)(1) as the entity in control of the payment of wages to the employees of its clients, and claims that the section 3306(c)(7) exception applies equally to the section 3401(d)(1) employer as it does to the common-law employer. As explained below, however, this theory ignores statutory provisions and legislative history which make clear that the language "in the employ of an Indian tribe" is best understood as meaning that the Indian tribe is the common-law employer of the workers; in other words, the determination of whether a FUTA liability exists is made with reference to the common-law employer, not the section 3401(d)(1) employer. This principle is illustrated by reference to long-standing administrative guidance issued by the IRS, and was recently endorsed by the holding of the Court of Federal Claims in *Cencast Services, L.P., et al. v. United States*, 62 Fed. Cl. 159 (2004). To accept Mainstay's position would provide a means, never intended by Congress, by which any employer could utilize the section 3306(c)(7) exception and escape FUTA tax.

C. Applicable Internal Revenue Code Provisions

The original statutes that were the predecessors of the employment tax provisions now contained in the FICA and FUTA chapters of the Code were enacted as Titles VIII and IX of the Social Security Act of 1935, (Act of August 14, 1935, c. 531, 49 Stat. 620). Although often amended since 1935, the key provisions regarding the imposition of the FICA and FUTA taxes remain essentially unchanged. Income tax withholding on wages, as currently in existence, was introduced into the Code by the Revenue Act of 1942, 56 Stat. 884 ("the 1942 Act"). The income tax withholding provisions of the 1942 Act introduced the concept that the functions of

withholding, collecting, and paying an employment tax may be imposed on a person other than the common-law employer of the employee to whom the wages are paid and with respect to whom the amount of the wages for employment tax purposes is determined. However, the construction of the statute and absence of any contrary intent in the legislative history makes it clear that the determination of whether a tax liability exists is made with reference to the common-law employer. As explained in section D of this motion, the IRS has consistently interpreted these statutes as imposing taxes that are calculated with respect to wages paid by, or attributable to, the common-law employer, irrespective of the identity of the party controlling the payment of wages. The origins and current status of the FUTA and income tax withholding provisions relevant to this case are explained in greater detail.

1. Origins and Current Status of the Federal Unemployment Tax Act Provisions

The Social Security Act of 1935 ("the 1935 Act") was enacted in response to the widespread economic dislocations caused by the Great Depression of the 1930s and created certain worker-based benefit programs, including the Old Age Benefits program under Title II and a Federal-State unemployment program under Title III. Titles VIII and IX of the 1935 Act imposed taxes in connection with these programs and are the original predecessors of today's FICA and FUTA chapters of the Code.[2/]

With respect to the Federal-State unemployment program, §§ 901 et seq. of Title IX imposed an excise tax on employers and contained definitions that correspond almost identically to definitions contained in the current enactment of the FUTA. For that reason, description of the statute is undertaken with reference to its current construction.

Section 3301 imposes a tax under FUTA on every employer equal to a certain percentage of the wages paid by it with respect to employment. Section 3306(b) provides that, for purposes of FUTA, the term "wages" means all remuneration for employment, with certain specified

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[2/] Upon the enactment of the Internal Revenue Code in 1939, Title VIII was superseded by I.R.C. (1939) Ch. 9, Subch. A, §§ 1400-1431. Title IX was superseded by I.R.C. (1939) Ch. 9, Subch. A, §§ 1600-1610. The current chapter and section designations for FICA and FUTA contained in the I.R.C. of 1986 are the same as were adopted upon the enactment of the I.R.C. of 1954.

exceptions. Section 3306(c) defines "employment," in relevant part, as any service of whatever nature performed by an employee for the person employing him. Therefore, unless amounts paid are excepted from "wages," or the services performed are excepted from "employment," FUTA tax will apply.

Section 3306(b)(1) provides an exception from the definition of "wages" for purposes of the FUTA for remuneration paid to an employee that is in excess of $7,000 during any calendar year. This $7,000 limit, typically referred to as the FUTA wage base, applies to remuneration paid by the employer with respect to the employment of each employee during the calendar year. Thus, an employer is only liable for FUTA tax with respect to the first $7,000 it pays to each employee during the calendar year.

Section 3306(c)(7) provides an exception from the definition of "employment" for purposes of the FUTA for service performed in the employ of a State, or any political subdivision thereof, or in the employ of an Indian tribe, or any instrumentality of any one or more of the foregoing, which is wholly owned by one or more States or political subdivisions or Indian tribes. The language of section 3306(c)(7) relating to services performed in the employ of an Indian tribe was added by section 166 of the Community Renewal Tax Relief Act of 2000 ("the 2000 Act"). Prior to the amendment, section 3306(c)(7) and its predecessors going back to the 1935 Act[3/] provided an exception from employment only for service performed in the employ of a state or local government. The legislative history of the 2000 Act indicates that the purpose in extending the exemption under section 3306(c)(7) to Indian tribes was to treat tribes similarly to

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[3/] Section 907(c)(6) of the 1935 Act provided the exception from employment for "service performed in the employ of a state, a political subdivision thereof, or an instrumentality of one or more States or political subdivisions." The Social Security Act Amendments of 1939 (Pub. L. No. 76-379, 53 Stat. 1360, 1393-1394) continued the exemption for service for State governments and their subsidiaries, but limited the exception with respect to instrumentalities so that it applied only to an instrumentality that was wholly owned by the State or political subdivision. "The amendment thus narrows the present exemption and in no case broadens it." H.R. Rept. 76-728, at 73 (1939). This exception is the precursor to current section 3306(c)(7), and nothing in the statute or the legislative history suggests that the exception is available when the state government or subsidiary pays wages to workers who are not common-law employees of the state government or their subsidiaries.

the states. Neither the legislative history nor the statute suggests that the exception from FUTA is available when an Indian tribe pays wages to workers who are not common-law employees of the tribe. Section 3306(u) provides that the term Indian tribe has the meaning given to such term by section 4(e) of the Indian Self-Determination and Education Assistance Act and includes any subdivision, subsidiary, or business enterprise wholly owned by such Indian tribe.

For FUTA purposes, the term employer is generally defined in section 3306(a)(1) as any person who (A) during any calendar quarter in the calendar year or the preceding calendar year paid wages of $1,500 or more, or (B) on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least one individual in employment for some portion of the day.

Employment tax regulation section 31.3306(i)-1 provides that an individual is an employee if the relationship between him and the person for whom he performs services is the legal relationship of employer and employee. Treas. Reg. § 31.3306(i)-1 (1960). The regulation provides that such a relationship exists if the person for whom the services are performed has the right to direct and control the individual who performs the services. Thus, the test applied is the same as the test applied under the common-law.[4/] The regulation further provides that whether

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[4/] In *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992), the Supreme Court held that where a statute containing the term "employee" does not helpfully define it, the common law agency test should be applied. *Id.* at 322-23. The relationship of employer and employee generally exists under common law 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. *Id.* at 323; *see also Chinn v. United States*, 57 F.3d 722, 725 (9th Cir. 1995). "Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party." *Nationwide*, 503 U.S. at 323-24 (quoting *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-52 (1989)); *cf.* Restatement (Second) of Agency § 220(2) (1958)(listing nonexhaustive criteria for identifying master-servant relationship); Rev. Rul. 87-41, 1987-1 C.B. 296, 298-99 (1987)(setting forth 20 factors as guides in determining whether individual qualifies as a common-law "employee" in various tax law contexts).

the relationship of employer and employee exists is determined upon an examination of the particular facts of each case.

2. Origins and Current Status of Income Tax Withholding Provisions and Relevance to FUTA

For purposes of determining liability for FUTA tax, the definition of employer for purposes of the income tax withholding provisions is significant to this case. Section 465(c) of the 1942 Act defined "employer" as "any person for whom an individual performs any service, of whatever nature, as the employee of such person." Thus, "wages" for withholding purposes, as with unemployment taxes, were determined based upon remuneration earned in a common-law employment relationship.

The income tax withholding provisions of the 1942 Act also contained the concept of the "withholding agent." Section 465(c) defined "withholding agent" as "any person required to withhold, collect, and pay the tax under section 466." Further, § 467(a) provided, in part, that the "tax required to be withheld by section 466 shall be collected by the person having control of the payment of such wages by deducting such amount from such wages as and when paid." Thus, the 1942 Act introduced the concept that the functions of withholding, collecting, and paying an employment tax may be imposed on a person other than the common-law employer of the employee to whom the wages are paid and with respect to whom the amount of the wages for employment tax purposes is determined.

The Current Tax Payment Act of 1943, (57 Stat. 126) ("the 1943 Act") eliminated the concept of the "withholding agent" and replaced it by adding to the definition "employer" a provision corresponding to § 3401(d)(1) of current law. Thus, in pertinent part, § 1621(d) of the 1943 Act stated:

> (d) EMPLOYER. – 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 service does not have control of the payment of the wages for such services, the term "employer" (except for the purposes of subsection (a) [defining "wages"]" means the person having control of the payment of such wages . . .

The reasons for enacting this provision were explained in the Conference Report:

> Section 465(c) and (e) of the code contains definitions of the terms "withholding agent" and "employer," respectively. Under the House bill and under the bill as passed by the Senate, the definition of withholding agent has been eliminated. Both bills generally define the term "employer" to mean the person for whom an individual performs, or performed, any service, of whatever nature, as the employee of such person. This general definition is not adequate, however, to cover certain special cases, such as the . . . case of the person making payment of wages in situations where the wage payments are not under the control of the person for whom the services are or were performed, as, for instance, in the case of certain types of pension payments. The House bill provided for these cases by an exception to the general definition of the term "employer" which provided that if the wages are paid by a person other than the person for whom the services are or were performed, the term "employer" means the person paying such wages. The Senate has restated the exception in order to make clear that it is designed solely to meet unusual situations and is not intended as a departure from the basic purpose to centralize responsibility for withholding, returning, and paying the tax and furnishing receipts.

H.R. CONF. REP. NO. 78-510, at 30-31 (May 28, 1943).

The statutory language and conference report make clear that the exception with respect to definition of "employer" where a third-party controls the payment of wages relates only to the responsibilities to withhold, to report, and to pay the withholding tax. Determination of the amount of taxable wages for tax purposes, however, explicitly was not affected by the application of this alternate definition of employer. The concept of wages, for purposes of imposing the withholding tax, was determined with respect to remuneration paid and received in the common-law employment relationship.

Current section 3401(d)(1) is remarkably similar to the definition contained in the 1943 Act. It states:

> (d) EMPLOYER. – For purposes of this chapter, 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 service does not have control of the payment of the wages for such services, the term "employer" (except for the purposes of subsection (a) [defining "wages"]) means the person having control of the payment of such wages. . .

Thus, as regarding income tax withholding, when the common-law employer does not have control of the payment of wages, the entity in control of the payment of wages continues to be the entity liable for the tax. Identically to the 1943 Act, the parenthetical "except for the

purposes of subsection (a)," which is the subsection which defines wages for purposes of income tax withholding, means that section 3401(d)(1) does not alter the principle that the determinations of whether a payment is wages and whether any exceptions apply are made by reference to the common-law employer, not the section 3401(d)(1) employer.

Neither the FICA nor the FUTA contains 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) is also an employer for purposes of withholding the employee portion of FICA. *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.

Id. at 51.

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, which imposes the employer portion of FICA, and for purposes of section 3301, which imposes the FUTA tax on employers. *See In re Armadillo Corp.*, 410 F. Supp. 407 (D. Col. 1976), *aff'd*, 561 F.2d 1382 (10th Cir. 1977); *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.C. Md. 1985), *aff'd*, 804 F.2d 296 (4th Cir. 1986); *In the Matter of: Southwest Restaurant Systems, Inc. v. Internal Revenue Service*, 607 F.2d 1237 (9th Cir. 1979). Thus, an entity that is in control of the payment of wages within the meaning of section 3401(d)(1), as Mainstay has claimed to be, is the entity that is liable for payment of tax imposed by the FICA, the FUTA and the income tax withholding provisions.

However, as explained, section 3401(d)(1) applies only for purposes of assigning liability for withholding, paying and reporting income tax withholding, FICA and FUTA taxes. The parenthetical in section 3401(d)(1) directs that the determination of whether a payment is wages, or is excepted from wages, is still made with reference to the common-law employer. Likewise,

the extension of this alternate concept of "employer" to the FICA and FUTA context by case law cannot affect the computation of tax liabilities under those chapters of the Code. The terms and the legislative history of the 1942 and 1943 Acts, which established the present income tax withholding system, contain absolutely nothing that would indicate that Congress was thereby amending the already established law governing the method by which tax liabilities were determined and calculated. The definition of "employer," including the person who controls the payment of wages, was enacted strictly to require that the obligations to report, collect, and pay employment taxes would be imposed on the party with control of the payment of wages, even if that party was not the common-law employer to whom the payment of the wages is attributable for employment tax computation purposes.

Thus, in this case, whether amounts are "wages" under section 3306(b), whether services performed are "employment" under section 3306(c), and whether workers are employees under section 3306(i), in sum, the determination of whether a FUTA liability exists, is made with reference to the common-law employer. This principle--whether a payment is wages depends on the identity of the common-law employer--has long been recognized in administrative guidance issued by the IRS and has recently been upheld by the Court of Federal Claims in *Cencast Services, L.P., et al. v. United States*, 62 Fed. Cl. 159 (2004).

D. Long-Standing Administrative Guidance Has Consistently Determined Employment Tax Liability With Respect to the Common-Law Employer

The earliest authoritative administrative pronouncement relevant to the issue currently before the Court is S.S.T. 154, 1937-1 C.B. 391 (1937).[5/] That ruling addressed whether a parent corporation or its subsidiary under various fact patterns was the "employer" of certain individuals within the meaning of statutes enacted in 1935 that are the original predecessors of the FICA and FUTA. In one of the fact patterns considered in the ruling, the individuals performed services exclusively for a subsidiary. Those individuals, however, were paid by the parent corporation, which would then bill the subsidiary for the remuneration paid for the services. After analyzing

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[5/] S.S.T.s are Treasury rulings with respect to Social Security taxes. They were similar in force and effect to revenue rulings issued currently.

the relevant provisions of the statute and the regulations promulgated thereunder, the ruling concluded:

> With respect to the individuals in group (1) who perform services solely for the subsidiary of the M Corporation and whose wages are paid initially by that corporation, the particular subsidiary involved being billed by the M Corporation for the amount thereof, it is held that such individuals are employees of the subsidiary for which they render services. In determining liability for the taxes imposed under Titles VIII and IX of the Social Security Act, the subsidiary for which the services are performed is considered the employer.

Thus, as early as 1937, the Treasury Department interpreted the statutes that are the original predecessors of FICA and FUTA as imposing taxes that are determined and calculated with respect to the common-law employment relationship, irrespective of whether a third party controlled the payment of the remuneration with respect thereto.

In 1954, after the income tax withholding provisions were enacted, the IRS issued Rev. Rul. 54-471, 1954-2 C.B. 348 (1954), which again sets forth the IRS's position that the determination of FICA and FUTA liability is made with respect to the common-law employment relationship of the parties, even when a third party is involved in the payment of wages. In this ruling, the IRS considered the application of employment taxes with respect to certain individuals who demonstrated various citrus products on behalf of a State citrus commission. These individuals were paid by an advertising agency that had made arrangements with respect to the citrus demonstrations by the individuals. The State commission would reimburse the agency for the remuneration disbursed to the individuals by the agency. The revenue ruling concludes that the agency, as the entity in control of the payment of wages is the employer responsible for the withholding of Federal income tax from the "wages" of each demonstrator. The ruling held further that the state commission, which was a wholly owned instrumentality of the State, was the common-law employer of the individuals. Because the individuals provided services as the common-law employees of a wholly owned instrumentality of a state, the services were excepted from the definition of employment under section 1607(c)(7) (the predecessor to the section 3306(c)(7) exception at issue in this case) of the FUTA and no FUTA tax liability was incurred. Thus, although the advertising agency was the "employer" for purposes of income tax withholding under the predecessor to section 3401(d)(1), that did not alter the fact that the

determination of FICA and FUTA tax liability was made with respect to the common-law employer.

The government's administrative position on this issue was further developed by Rev. Rul. 57-145, 1957-1 C.B. 332 (1957). That ruling considered employment taxes with respect to individuals known as "clerks of the works." These individuals were retained to ensure that building projects complied with plans and specifications. These individuals were paid by architectural firms and those firms would be reimbursed by the corporation for whom a building was being constructed and for whom the individuals were providing services. The ruling determined that the architectural firms controlled the payments of wages and, thus, were liable for withholding, reporting, and paying over Federal income taxes. Nonetheless, the corporations were the common-law employers and FICA and FUTA tax liabilities were determined based on that employment relationship. The IRS noted that the "fact that their salaries are actually paid them by the architectural firm is immaterial, since their remuneration may properly be ascribed to the corporation."

These revenue rulings demonstrate that by 1957 it had been established by administrative precedent that wages, the payment of which is controlled by third parties within the meaning of the income tax withholding statute, are deemed paid by the common-law employer for purposes of determining FICA and FUTA tax liabilities.

The conclusion of Rev. Rul. 57-145 was reached again that same year in Rev. Rul. 57-316, 1957-2 C.B. 626 (1957). That ruling involved the employment taxes applicable to vacation pay disbursements that were made by an employers' association with respect to vacation benefits earned for services provided to a common-law employer that belonged to the association. In these circumstances, the association controlled the payment of the wages and was treated as the employer for income tax withholding purposes. For purposes of computing FICA and FUTA tax liabilities, the common-law employers were deemed to be the employers paying the wages.

In 1969, the IRS issued Rev. Rul. 69-316, 1969-1 C.B. 263 (1969), updating and restating S.S.T. 154. The IRS affirmed its longstanding position that a third party who controls the

payment of wages is the employer for income tax withholding purposes, but that FICA and FUTA tax liabilities are determined with respect to the employment relationship with the common-law employer.

As outlined above, many key statutory provisions relevant to this case remain in the Code essentially unchanged from their original enactment. This long history of administrative interpretation, going back to shortly after the enactment of the predecessors to the FICA and FUTA provisions in 1935, is entitled to considerable deference in interpreting these statutes. *Davis v. United States*, 495 U.S. 472, 482 (1990) (stating that "the Service's contemporaneous and longstanding construction," in revenue rulings, "constitute[s] strong evidence in favor of [the Service's] interpretation"). *See also*, *United States v. Zenith Radio Corp.*, 562 F.2d 1209, 1219 (C.C.P.A. 1977), *aff'd*, 437 U.S. 443 (1978). Also, the individual rulings themselves are entitled to respect. *Skidmore v. Swift*, 323 U.S. 134, 137 (1944)(stating that the weight accorded to an administrative judgment " will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."). The IRS rulings fare well under these standards. The 1937 S.S.T., which is essentially a contemporaneous interpretation of the statute, considered multiple fact patterns in analyzing the statute. The subsequent rulings each apply similar reasoning and reach the same conclusion. That the IRS has not wavered from the conclusion in over seventy years is persuasive evidence of the thorough consideration and valid reasoning it applied. Further, where Congress has indicated no disagreement with the administrative interpretations of these statutes and has repeatedly amended the statute in other respects, then presumably the legislative intent has been correctly discerned. *North Haven Bd. of Ed. v. Bell*, 456 U.S. 512, 535 (1982).

E. Court of Federal Claims' Holding is Consistent with the IRS Position

The Court of Federal Claims agreed with the IRS's interpretation of how section 3401(d)(1) applies when determining wages under section 3306(b) in its recent decision in *Cencast*, *supra*. In *Cencast*, the Court of Federal Claims considered whether a section 3401(d)(1) employer, paying wages to employees performing services for various common-law

employers, was entitled to use the same wage base for purposes of calculating the FUTA as the common-law employers. The government argued that when defining the term "wages" under section 3306, the only employer to be considered is the person for whom the individual performs or performed any services. Thus, the government argued that while *Otte* and the cases that followed *Otte* have incorporated the section 3401(d) definition of employer into FICA and FUTA, this definition has been incorporated only for purposes "of (1) withholding with respect to the employees' share of FICA and (2) accounting for, reporting, and paying FICA and FUTA taxes." The court in *Cencast* agreed and held that the section 3401(d)(1) employer could not be considered the "employer" for purposes of calculating FICA and FUTA taxable wage bases under sections 3121(a) and 3306(b) and thus, the section 3401(d)(1) employer could not aggregate the wages paid by it to a single employee on behalf of multiple common-law employers for which the employee performed services for purposes of the FUTA wage base. The court agreed with the IRS that Cencast had to start a new wage base each time an employee went to work for a different common-law employer even though Cencast was the entity in control of the payment of wages for each common-law employer.

Applying *Cencast* and its underlying rationale to this case, if a section 3401(d)(1) employer is not the employer for purposes of the definition of wages, then a section 3401(d)(1) employer is also not the employer for purposes of the definition of employment. Wages are defined as remuneration for employment. *Otte* and its progeny extend the definition of "employer" contained in section 3401(d)(1) to FICA and FUTA. *Cencast* affirms the longstanding IRS position that the parenthetical exception contained in section 3401(d)(1) signals that the statutory employer is the employer solely for purposes of withholding, reporting, and payment of the taxes and that the common-law employer remains the employer for purposes of determining whether there is a liability for tax, and if so, how much tax is owed. There is nothing in the statute or legislative history to suggest that the exception to employment provided in section 3306(c)(7) should be read contrary to this general principle.

Furthermore, if Mainstay's argument were accepted, then any employer could receive an exemption from FUTA simply by running its payroll through an Indian tribe, or a wholly-owned

subsidiary of an Indian tribe, in a fashion that would allow the tribe or subsidiary to claim it was a section 3401(d)(1) statutory employer.[6/]

Consistent with the position set forth in Rev. Rul. 54-471 and other administrative pronouncements and supported by the *Cencast* court, whether there is employment that gives rise to wages under section 3306(b), which in turn gives rise to a liability for FUTA, is based upon the common-law employer. As a section 3401(d)(1) employer Mainstay is required to pay the FUTA tax liability existing with respect to payments made to its clients employees for 2003 and 2004. The section 3306(c)(7) exception does not apply because the workers in question are not the common-law employees of Mainstay.

F. Other Legislative Developments of the FUTA Support the IRS's Position

As further evidence that Congress always intended that FUTA tax liabilities be computed with respect to the common-law employer, it is useful to analyze a 1970 amendment to the definition of employer for purposes of the FUTA. From the time of the enactment of the 1935 Act through the end of 1969, the term "employer" for FUTA purposes had always been defined solely in terms of the number of individuals in the employ of the employer for a specified period of time. 1935 Act, § 907(a); I.R.C. 1939 § 1607(a); I.R.C. 1954 § 3306(a). In 1970, § 101(a) of the Employment Security Amendments of 1970, Pub. L. No. 91-373, amended this definition in two respects. First, the minimum number of employees was reduced from four to one, and

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[6/] A significant indicator that Congress only intended the exception to continue to apply to workers who were the common-law employees of the Indian tribe is its estimated revenue effect for future years. The estimated reduction in FUTA revenues for 2001, 2002 and 2003 respectively, were $20 million, $10 million and $9 million. Congress estimated a $25 million increase in collected FUTA revenues in 2004. JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX LEGISLATION ENACTED IN THE 106TH CONGRESS (JCS-2-01), Part Eight: The Community Renewal Tax Relief Act of 2000 (P.L. 106-554; H.R. 5662), Title I. Community Renewal Provisions, J. Treatment of Indian Tribes as Non-Profit Organizations and State or Local Governments for Purposes of the Federal Unemployment Tax ("FUTA")(sec. 166 of H.R. 5662 and sec. 3306 of the Code)(April 19, 2001). These estimates are consistent with the position that Congress intended that only the common-law employees of the Indian tribe would be exempt from FUTA. If Congress intended that all employers could benefit from the exception for Indian tribes merely by running their payroll through an Indian tribe which was set up to have status as a section 3401(d)(1) employer, the figures would be considerably larger.

second, an alternate definition, based upon the amount of "wages," was added. This second change was the original enactment of § 3306(a)(1)(A), which provides that the term "employer" means, with respect to any calendar year, any person who "during any calendar quarter in the calendar year or the preceding calendar year paid wages of $1,500 or more." The legislative histories of this act and of an earlier identical proposal make clear that this amendment simply modified and narrowed the scope of the "small employer" exception to the FUTA definition of employer. The amendment did not alter the fundamental principle that "employer," for purposes of determining and calculating FUTA tax liabilities, was the person for whom the employee provided services in a common-law employer-employee relationship. Simply controlling the payment of wages through calculating the amount thereof and advancing the remuneration to the employee did not make a person an "employer" who "paid wages" under § 3306(a)(1)(A). Rather, the common-law employer is, as has always been the case, the employer and the payment of remuneration to the employees is attributable to that employer. *See* Rev. Rul. 57-145, *supra*.

This 1970 legislation was based upon a proposal of the Nixon administration that was introduced in the House as H.R. 12625, Administration Proposal to Amend the Federal Unemployment Compensation Statutes.[7/] Then-Secretary of Labor George Schultz testified before the House Ways and Means Committee in support of the administration's proposal. During the course of that testimony, Secretary Schultz submitted a written statement to the committee providing a detailed explanation of the bill. That explanation states:

> The $300 must be wages paid for "employment" to an "employee." In general, individuals who are self-employed or independent contractors are not employees under common law and are not covered by the unemployment insurance law. They are not included in the list of occupations which would become exceptions to the common law rule under section 102. Moreover, no change is proposed to the provision now in section 3306(c)(3) of the FUTA which excludes as casual labor services not in the course of the employer's business by an individual who is not so employed for at least 24 days in a calendar quarter, and paid at least $50 in cash wages.

Administration Proposal to Amend the Federal Unemployment Compensation Statutes: Hearings on H.R. 12625 Before the House Comm. on Ways and Means, 91st Cong., 1st Sess. 198

[7/] This bill would have set a $300 minimum quarterly payroll. That amount was increased to $800 in the version passed by the House, and was increased to $1,500 by the Conference Committee.

(October 1, 2, 3, 6 and 7, 1969)(statement of George Schultz, Secretary of Labor)("Hearings").

Thus, "wages" were still deemed to be paid by the common-law employer to an employee for services rendered to the employer in order to be taken into account for FUTA purposes. This point was elaborated upon and clarified in Secretary Schultz's testimony before the committee. Secretary Schultz responded to questions from Rep. John Watts (D-KY) regarding the employment relationship:

> Mr. WATTS: But if I had a regular employee, what kind of a regular employee would he have to be to be covered then?
>
> Secretary SCHULTZ: If you had a regular employee who was just that, regular employee, that you had on a payroll ----
>
> Mr. WATTS: Regular employee for $300.
>
> Secretary SCHULTZ (continuing): You supervise his work. He is not available to other people. He works for you. Then you have an employee-employer relationship and if you then have $300 of payroll you become covered.

Hearings at 237.

H.R. REP. NO. 91-612, at 9 (Nov. 10, 1969), shows that Congress understood that the proposed amendment was intended to limit the scope of the small-employer exception, and not to alter the definition of employer to include persons who controlled the payment of wages, but who were not common-law employers:

> The alternative test in the new definition of "employer" – one having a payroll in any quarter of $800 – is intended to insure coverage of significant operations conducted in fewer than 20 weeks in any one calendar year. An example of such operation would be that of a contracting firm organized to do a particular job employing many workers but completing the job in a short period.

The concept of measuring the small employer exception in terms of payroll of regular, common-law employees was well-understood by Congress. In fact, the House had passed a bill in 1966 that, had it been enacted, would have amended § 3306(a) in precisely the manner as was done in 1970. H.R. 15119, 89th Cong., 2d Sess. (1966). That proposal was explained in H.R. REP. NO. 89-1636, at 9 (June 17, 1966), in substantially the same terms as were used four years later in H.R. REP. NO. 91-612, *supra*:

> The alternative test in the new definition of employer – one having a payroll in any quarter of $1,500 – is intended to assure coverage of large-scale employing operations conducted in fewer than 20 weeks in any 1 calendar year. An example of such an operation would be that of a contracting firm organized to do a particular job employing many hundreds of workers on the job that lasts fewer than 20 weeks in a calendar year. The employees of such a firm now received no unemployment compensation wage credits while employed by it. It is possible for such an operation to last up to nearly 40 weeks spread over 2 consecutive years.

Thus, the definition of "employer" set forth in § 3306(a)(1), as amended by the Employment Security Amendments of 1970, continued to inherently embrace the concept of the common-law employer-employee relationship. Control of the payment of wages within the meaning of § 3401(d)(1) does not make a person an "employer" who has "paid" wages within the meaning of § 3306(a)(1)(A). Rather, the wages so controlled and disbursed are attributed to the common-law employer. If those wages exceed the threshold amount, then the common-law employer falls within the definition of "employer" set forth in § 3306(a)(1)(A), and FUTA tax liabilities are determined and computed accordingly. This analysis reinforces the government's interpretation that the application of section 3306(c)(7) is made with regard to the common-law employer only.

G. The State of California Administrative Law Judge's Decision Does Not Establish That Mainstay Is Exempt From All FUTA Taxes

The fact that the State of California treated Mainstay as the employer for State Unemployment Insurance (SUI) purposes has no bearing on the application of the Internal Revenue Code to this case. The decision was based on language in the State Unemployment Insurance code that treats temporary services employers or leasing employers as employers of individuals who are common-law employees of a third party for purposes of SUI coverage. There is no complementary provision in the Internal Revenue Code nor is there any indication in statutory language or the legislative history of the FUTA that an Indian tribe's status as an employer under state law for SUI purposes makes the tribe an employer for purposes of section 3306(c)(7) or otherwise overrides the common-law test which applies as set forth above.

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V. CONCLUSION

The Court should grant defendant's motion for summary judgment and determine, as a matter of law, that wages paid by Mainstay, a wholly owned unincorporated division of a federally recognized Indian tribe, are not exempt from FUTA under section 3306(c)(7) of the Code based on its claim that it is paying wages as a section 3401(d)(1) employer of workers performing services for its clients.

Respectfully submitted,

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