Office of Chief Counsel
Internal Revenue Service

Memorandum

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to: Andrew Zuckerman, Acting Director
Federal State and Local Government T:GE:FSLG

from: Will E. McLeod
Chief, Employment Tax Branch 1 CC:TEGE:EOEG:ET1

subject: **Taxability of Respite Care and Section 3401(d)(1) Reporting**

This Chief Counsel Advice responds to a memorandum from your predecessor dated April 30, 2002. In accordance with Internal Revenue Code § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

(1) Whether respite care payments made to third parties for purposes of providing relief to foster care providers are excludable from gross income under § 131.

(2) Whether a respite care provider is an independent contractor or a common law employee.

(3) Whether the governmental agency that pays for the respite care is the section 3401(d) employer.

(4) Whether the governmental agency, as the section 3401(d)(1) employer, may file one Form 941 and/or Form 940 for employment tax reporting purposes.

CONCLUSIONS

(1) The payments made to respite care providers are not excludable from gross income under § 131 because they do not meet the requirements of either § 131(b)(1)(B) or §131(b)(2).

(2) To determine whether a respite care provider is an independent contractor or a common law employee of the agency providing remunerations to the respite care provider we need to analyze the facts and circumstances of the relationship between the respite care provider and the business. The facts are insufficient for us to make such a determination here.

(3) If the governmental agency is not the common law employer of the respite care provider, the agency is the section 3401(d)(1) employer because the agency controls the payment of wages to the respite care provider.

(4) The governmental agency as the § 3401(d)(1) employer , may file one Form 941 and/or one Form 940 for employment tax reporting purposes.

FACTS

Governmental entities that place individuals in foster care also pay for respite care. Respite care services are provided to the foster care providers in order for them to have relief from the responsibilities of being providers. Respite care allows the foster care provider to take a vacation or to have a few hours off from the responsibilities of providing foster care.

Most respite care providers are certified by the states as qualified foster care providers for qualified individuals. However, some respite care providers may not be certified as a qualified foster care provider (e.g., relatives of the foster care provider). Also, some respite care providers perform services in their own home while others perform services in the homes of the foster care providers.

Regardless of whether the respite care providers are certified, the government agencies make payments directly to the respite care providers. The governmental agencies, however, provide little direction to the respite care provider in the performance of their services.

The foster care provider may request a specific respite provider to take care of the qualified foster care individual. Additionally, the foster care individual can request a specific respite

care provider. Also, a respite care provider can refuse to provide services to either a specific foster care provider or refuse to care for a specific foster care individual based on length of stay or the circumstances of the foster care individual.

In some states, the governmental agencies do not issue any reporting documents on the payment to respite care providers believing the payments fall under the definition of §131. In other states, the payments are reported on either Form W-2 or Form 1099 MISC, under the assumption that these payments are taxable and not excludable under §131 because they are not payments made to the foster care provider.

LAW AND ANALYSIS

Issue 1: Whether respite care payments made to third parties for purposes of providing relief to the foster care provider are excludable from gross income under § 131.

Section 131(a) states that gross income shall not include amounts received by a foster care provider as qualified foster care payments. Section 131(b)(1) defines a qualified foster care payment as a payment made pursuant to a foster care program of a state or a political subdivision of a state: (A) that is paid by a state, a political subdivision of a state, or a qualified foster care placement agency; and (B) that is (i) paid to the foster care provider for caring for a qualified foster care individual in the foster care provider's home, or (ii) a difficulty of care payment.

Section 131(b)(2) defines a qualified foster care individual as any individual who is living in a foster family home in which the individual was placed by an agency of a state, a political subdivision of a state, or a qualified foster care placement agency.

Section 131(b)(3) defines a qualified foster care placement agency as any placement agency that is licensed or certified by a state or a political subdivision of a state, or an entity designated by a state or a political subdivision of a state for its foster care program to make foster care payments to providers of foster care.

Section 131(c) defines a difficulty of care payment as a payment to an individual that is not described in §131(b)(1)(B)(i) and that is compensation for providing the additional care of a qualified foster care individual that is required by reason of a physical, mental, or emotional handicap of the qualified foster care individual, if the state has determined a need for additional compensation because of the handicap, if the additional care is provided in the home of the foster care provider, and if the payment is designated by the payor as compensation for that purpose.

We conclude that payments to respite care providers in the factual situations listed above are not excludable from gross income under §131 because the requirements of § 131(b)(1)(B) or §131(b)(2) are not met. A governmental agency or qualified foster care placement agency does not place the individual in foster care with the respite care provider.

Section 131(b)(2) requires a placement in foster care. It also requires that a governmental agency or a qualified foster care placement agency make the payment. The respite care is not provided in the respite care provider's home. See §131(b)(1)(B). The payment to the respite care provider is a payment for services and not a payment to cover the costs of care or a difficulty of care payment. See § 131(b)(1)(B). These conclusions do not differ even if the respite care provider is certified as a foster care provider.

Because the requirements of §131 are not satisfied, the payments received by the respite care provider are income under § 61. Thus, if the respite care provider is an independent contractor a Form 1099-MISC, Miscellaneous Income, should be issued to the provider for the payments received from the agency. On the other hand, if the respite care provider is a common law employee a Form W-2, Wage and Earnings Statement, should be furnished to the respite care provider.

Issue 2: Whether a respite care provider is an independent contractor or a common law employee.

For employment tax purposes, an employee includes an individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. See § 3121(d)(2); § 3306(i);§ 31.3121(d)-1(c)(1); § 31.3306(i)-1(a); and 31.3401(c)-1.

The employment tax regulations describe an employer-employee relationship:

> 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 employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer . . . are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services.

Section 31.3121(d)-1(c)(2). See also, §§ 31.3306(i)(b)-1(b) and 31.3401(c)-1(b).

In determining whether an individual is an employee or an independent contractor under the common law, all evidence of control, and lack of control or autonomy must be considered. In doing so, one must examine the relationship of the worker and the business. Relevant

facts generally fall into three categories: (1) behavioral controls, (2) financial controls, and (3) the relationship of the parties.

Behavioral controls are evidenced by facts which illustrate whether the service recipient has a right to direct or control how the worker performs the specific tasks for which he or she is hired. Facts which illustrate whether there is a right to control how a worker performs a task include the provision of training or instruction.

Financial controls are evidenced by facts which illustrate whether the service recipient has a right to direct or control the financial aspects of the worker's activities. These factors include whether a worker has made a significant investment, has unreimbursed expenses, and makes services available to the relevant market; the method of payment; and the opportunity for profit or loss.

The relationship of the parties is generally evidenced by the parties' agreements and actions with respect to each other, including facts which show not only how they perceive their own relationship but also how they represent their relationship to others. Facts which illustrate how the parties perceive their relationship include the intent of the parties as expressed in written contracts, the provision of or lack of employee benefits, the right of the parties to terminate the relationship, the permanency of the relationship, and whether the services performed are part of the service recipient's regular business activities.

Rev. Rul. 56-502, 1956-2 C.B. 688*,* involved individuals engaged by an agency to perform domestic services for its clients. Rev. Rul. 56-502 stated that the agency is the employer of the individuals where the facts showed that: (1) the agency was engaged in the business of furnishing such services and so held itself out to the general public; (2) the agency furnishes the employment of the individuals and fixes their remuneration; (3) the clients for whom the services were performed looked to the agency for duly qualified and trained individuals; (4) the services were necessary to the conduct of the agency's business and promoted or advanced its business interests; and (5) the total business income of the agency was derived through a percentage of the remuneration received by the individuals for the performance of their services.

In Rev. Rul. 73-268, 1973-1C.B. 415, workers were employed under separate contracts with a county to perform personal care and household management services for disabled welfare recipients. The contract between the county welfare department and a worker provided homemaker services included a description of the workers duties, the minimum hours of service per month, the amount of remuneration, a statement that the homemaker assumed responsibility for work-related expenses, and that the worker would notify the department in the event he or she was unable to provide the contracted services. The contract could be terminated by either party by giving 30 days notice. However, the county could terminate the agreement at any time if the worker failed to meet his or her contractual obligations. The ruling concluded that the county exercised the degree of direction and

control over the workers necessary to establish the relationship of employer and employee. Therefore, the workers were employees of the county.

Because of the general nature of the factual situations you have presented, we are not able to provide you with a definitive answer as to whether respite care workers are employees or independent contractors.

Issue 3: Whether the governmental agency that pays for the respite care is the section 3401(d) employer.

If the governmental agency is not the common law employer of the respite care provider, the agency is considered to be the section 3401(d)(1) employer. Section 3401(d)(1) provides that the term "employer", for federal income tax withholding purposes means the person for whom an individual performs or performed any service, of whatever nature, as an 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 wages for such services, the term "employer" means the person having control of the payment of such wages. Regulation section 31.3401(d)-1(f) provides that the term "employer" means the person having legal control of the payment of the wages. Since the governmental agency has legal control of the payment of the wages, the agency is the employer for purposes of section 3401(a) which defines "wages" as all remuneration for services performed by an employee for his or her employer.

Neither the Federal Insurance Contributions Act (FICA) nor the Federal Unemployment Tax Act (FUTA) provisions contain a definition of employer similar to the definition contained in § 3401(d)(1). However, *Otte v. United States*, 419 U.S. 43 (1974), holds that a person who is an employer under § 3401(d)(1) is also an employer for purposes of FICA withholding under § 3102. Circuit courts have applied the *Otte* holding to conclude that the person having control of the payment of the wages is also the employer for purposes of § 3111, which imposes FICA excise tax on employers and for purposes of § 3301, which imposes the FUTA tax on employers. See for example, *In re Armadillo Corp.*, 561 F.2d 1382 (10th Cir. 1977). Thus, the governmental agency is the employer for purposes of FICA, FUTA and income tax withholding.

Issue 4: Whether the governmental agency, as the section 3401(d)(1) employer, may file one Form 941 and/or Form 940 for employment tax reporting purposes.

Pursuant to Treas. Reg. section 31.6011(a)-1, every employer must make a return for the first calendar quarter in which payment of wages is made subject to the tax imposed by the FICA. Form 941, Employer's Quarterly Federal Tax Return, is the form prescribed for making the return unless a composite return has been authorized by the Commissioner. Also, pursuant to section 31.6011(a)-3, every employer must make a return of tax under the FUTA for each calendar year. Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, is the form prescribed for making the return

unless use of a composite return as been authorized by the Commissioner. As the section 3401(d)(1) employer, the governmental agency may file one return for all of the employees of the agency.

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WILL E. MCLEOD

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