

#58 AUTHORIZE INDEPENDENT CONTRACTORS AND SERVICE RECIPIENTS TO ENTER INTO VOLUNTARY WITHHOLDING AGREEMENTS WITHOUT RISK THAT THE AGREEMENTS WILL BE USED TO CHALLENGE WORKER CLASSIFICATION DETERMINATIONS

Present Law

Under Internal Revenue Code (IRC) § 3402(p), the IRS is authorized to accept withholding agreements. Specifically, IRC § 3402(p)(3) authorizes the Secretary to promulgate regulations to provide for withholding from any type of payment that does not constitute wages if the Secretary finds withholding would be appropriate and the payor and recipient of the payment agree to such withholding.²⁴³ However, the provision specifically states that the Secretary must find the withholding would be appropriate “under the provisions of [IRC chapter 24, *Collection of Income Tax at Source on Wages*].”

IRC chapter 24 addresses collection of taxes at the source with respect to employees (*e.g.*, wage withholding). Although current regulations provide that the Secretary may issue guidance by publication in the Internal Revenue Bulletin describing other payments for which withholding under a voluntary withholding agreement would be appropriate,²⁴⁴ the only such guidance that has been issued to date is Notice 2013-77, dealing with dividends and other distributions by an Alaska Native Corporation.²⁴⁵

Reasons for Change

Unlike employees, whose wage payments are subject to federal income tax withholding, independent contractors are generally responsible for paying their own income taxes. Independent contractors are required to make four estimated tax payments during the year. However, many contractors fail to make estimated tax payments for a variety of reasons and therefore face penalties under IRC § 6654. Some have difficulty saving money and finish the year with substantial tax liabilities they cannot afford to pay. As a result, they face additional penalties and interest charges, and they may face IRS collection action, including liens and levies.

The absence of withholding on payments to independent contractors also has a negative impact on revenue collection. IRS National Research Program studies show that tax compliance is substantially lower among workers whose income taxes are not withheld.²⁴⁶

This problem may be increasing as more workers are choosing to work in the so-called “gig economy.” To reduce the risk that they will not save enough money to pay their taxes, some independent contractors would prefer that taxes be withheld throughout the year, as they are for employees. There is a legitimate debate about the circumstances under which withholding should be required. However, the National Taxpayer Advocate believes workers and businesses should have the option to enter into voluntary withholding agreements when both parties agree to do so.

For many businesses, withholding on payments to independent contractors will not impose additional burden. In addition to paying independent contractors, most large companies have full-time employees, such as administrative staff, so they already have procedures in place to withhold. We understand some businesses are reluctant to withhold due to concern the IRS may use the existence of a withholding agreement to challenge

243 Payments made when a voluntary withholding agreement is in effect are treated as if they are wages paid by an employer to an employee for purposes of the income tax withholding provisions and related procedural provisions of subtitle F of the IRC.

244 See Treas. Reg. § 31.3402(p)-1(c).

245 Notice 2013-77, 2013-50 I.R.B. 632.

246 Government Accountability Office (GAO), GAO-17-371, *Timely Use of National Research Program Results Would Help IRS Improve Compliance and Tax Gap Estimates* (Apr. 18, 2017), <https://www.gao.gov/products/GAO-17-371>.

the worker classification arrangement. This concern would be addressed if the IRS is restricted from citing the existence of a voluntary withholding agreement as a factor in worker classification disputes. Indeed, the IRS could, on a case-by-case basis, provide a safe-harbor worker classification in which it affirmatively agrees not to challenge the classification of workers who are a party to such agreements at all, since these agreements will ensure the IRS collects the full amount of income taxes due.

Recommendations

- Amend IRC § 3402(p) to clarify that when voluntary withholding agreements are entered into by parties who do not treat themselves as engaged in an employer-employee relationship, the IRS may not consider the existence of such agreements as a factor when challenging worker classification arrangements.
- Direct the Secretary to evaluate the benefits of agreeing not to challenge worker classification arrangements when voluntary withholding agreements are in place.²⁴⁷

²⁴⁷ For legislative language generally consistent with this recommendation, see Small Business Owners' Tax Simplification Act, H.R. 3717, 115th Cong. § 9 (2017).