PacificCPE

COURSE

34502A

Small Business Tax: Employment and Worker Classification

Worker classification mistakes are among the costliest errors a small business can make. This course breaks down federal employment tax obligations and takes a close look at how the IRS distinguishes employees from independent contractors. It also covers statutory worker classifications that fall outside the usual rules. Ideal for practitioners advising clients on payroll compliance, contractor arrangements, or anyone facing potential reclassification risk.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the factors used to determine if a worker is an employee or an independent contractor and the tax implications of this status.

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Chapter 1: FEDERAL EMPLOYMENT TAXES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the factors used to determine if a worker is an employee or an independent contractor and the tax implications of this status.

I. EMPLOYMENT TAXES

A. OVERVIEW

Employers large and small are responsible for the collection and/or remittance of the following federal employment taxes:

- Federal income tax withholding;
- Social security and Medicare taxes; and
- Federal unemployment tax (FUTA).

Sections 3111 and 3301 of the Internal Revenue Code impose FICA (social security) and FUTA (unemployment) taxes on employers for wages paid to their employees. The Federal Insurance Contributions Act and Federal Unemployment Tax Act both define "wages" as "all remuneration for employment" [26 U.S.C. §§ 3121(a) & 3306(b) (1988)].

1. Federal Unemployment (FUTA) Tax

The federal unemployment tax is part of the federal and state program under the Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs.

Employers must report and pay FUTA tax separately from social security and Medicare taxes and withheld income tax. Employers pay FUTA tax only from their own funds. Employees do not pay this tax or have it withheld from their pay.

2. Federal Insurance Contributions Act (FICA)

Social security and Medicare taxes pay for benefits that workers and their families receive under the Federal Insurance Contributions Act (FICA).

Social security tax pays for benefits under the old-age, survivors, and disability insurance part of FICA. Medicare tax pays for benefits under the hospital insurance part. Employers withhold part of these taxes from their employee’s wages and pay a matching amount.

For purposes of FICA, all wages (cash or non-cash) derived from employment, unless specifically excluded by statute, are subject to tax. It is immaterial what the wages are called as long as the payment is for services performed. Wages subject to FICA taxes do not include amounts paid to an employee that are in excess of the taxable wage base. Starting in 1991 there is a separate wage base for the social security and the Medicare portions of the FICA tax.

Wages are considered to be paid when they are actually made available to the employee; that is, when they are actually or constructively received by the employee. Wages are paid constructively when credited to the account of the employee or when set apart to permit the employee at his or her discretion to draw upon the account or take possession of the amount without substantial limitations or restrictions.

At the end of the year, businesses must provide employees with a Form W-2, which details the employees’ earnings for the year as well as the amounts withheld by the employer for taxes. Independent contractors do not receive a Form W-2. Rather, businesses that utilize an independent contractor who is paid $2,000 (for 2026) or more in the calendar year are required to furnish the worker with a Form 1099.

The Internal Revenue Service is the federal agency charged with collecting employment taxes and self-employment taxes. Given that responsibility, the IRS also has the authority to determine whether employment taxes are owed. This determination requires finding that a worker is in fact an employee.

TABLE 3.1 MANDATORY FEDERAL FILING REQUIREMENTS FOR BUSINESSES

Employees	Independent Contractors
• Form W-2 to report payments to employees, including wages and tips	• Form 1099-NEC for payments of $2,000 or more for services performed for business by people not classified as employees tax (FUTA)
• Form 940 to report federal unemployment	

3. Federal Penalties

To be sure that all taxpayers pay their fair share of taxes, the law provides penalties for not filing returns or paying taxes as required. Criminal penalties may be imposed for willful failure to file, tax evasion, or making a false statement.

Failure to File Tax Returns

Employers that do not file tax returns by the due date are subject to a penalty. The penalty is based on the tax not paid by the due date.

Failure to Pay Tax

An employer who does not pay required employment taxes is liable for a penalty for each month, or part of a month, that its taxes are not paid.

Failure to Withhold, Deposit, or Pay Taxes

An employer who fails to withhold income, social security, or Medicare taxes from employees, or one who withholds taxes but does not deposit them or pay them to the IRS, may be subject to a penalty of the unpaid tax, plus interest. They may also be subject to penalties if the taxes are deposited after their due date.

Failure to Follow Information Reporting Requirements

The following penalties apply to employers who fail to follow informational reporting requirements:

- Failure to file information returns. A penalty applies to employers who do not file information returns by the due date, if they do not include all required information, or if they report incorrect information; and
- Failure to furnish correct payee statements. A penalty applies if employers do not furnish a required statement to a payee by the required date, if they do not include all required information, or if they report incorrect information.

Waiver of Penalty

Penalties can be waived under certain circumstances when the employer can demonstrate that the failures were due to reasonable cause and not willful neglect. Once again, remember that it is the worker's status that determines who pays various taxes and the reporting obligations. If an employer-employee relationship exists, the employer is liable for employment taxes under IRC § 3102 and § 3403. Certain workers are subject to FICA taxes even though they are independent contractors under the common law test. These workers are commonly called "statutory employees" and are discussed later.

4. Employer's Credit for Income Tax Withholding

The income tax not withheld but paid by the employer on behalf of the employee after January 31 of the following year cannot be taken as a credit on the employee's tax return. The income tax withholding not withheld but paid by the employer after January 31 of the following year as an additional assessment is subject to the provisions of IRC § 3402(d). This section provides relief to the employer provided the employer can show that the employee filed a return, reported the wages, and paid the tax. Income tax not withheld from an employee's wages but paid by the employer on behalf of the employee before January 31 of the following year constitutes gross income and is wages subject to FICA, FUTA and income tax withholding.

5. Section 530 Relief

Section 530 of the RevenueAct of 1978 provides relief to employers for federal employment tax purposes only. The effect of Section 530 is on taxes imposed under FICA, FUTA, the withholding of income tax at source on wages (WT), and RRTA.

Section 530 does not change in any way the status, liabilities, and rights of the worker whose status is at issue. Section 530 only terminates the liability of the employer for the employment taxes and has no effect on the workers. It does not convert individuals from the status of employee to the status of self-employed. The worker is still considered an employee for income tax and tax qualified benefit plan eligibility purposes.

6. IRC Section 3509

IRC § 3509 enacted in 1982 provides "statutory offset mechanisms that will apply in reclassification cases."

IRC § 3509 provides different rates for determining an employer's employment tax liability on the employee's share of the FICA tax on wages paid to an employee. This procedure does not relieve the employer of the employer's share of FICA and FUTA. The employee's liability for FICA tax under IRC § 3101 is not affected by IRC § 3509 and the employer is not entitled to recover any part of the employee tax assessed under this section.

7. Interest-Free Adjustments

IRC § 6205 provides that an employer who makes, or has made an under collection or underpayment of employee taxes (FICA/RRTA) or income tax (withholding), may make interest-free payments of the tax due when certain conditions are met. This provision does not apply to FUTA.

The employer may report the additional tax due on wages and compensation paid as an adjustment on a current return or on a supplemental return for the period in which the adjustment is made. The supplemental return must be filed on or before the due date of the return for the period in which the error was ascertained. If an adjustment is reported but the amount is not paid when due, interest thereafter accrues.

An error is ascertained when the employer has sufficient knowledge of the error to be able to correct it. Such knowledge may be obtained in the course of an examination. In an agreed case, this is when the employer submits one of the Form 2504 series agreements. For an unagreed case, it could be at the conclusion of an Appeals conference or when the taxpayer declines to exercise its right to go to Appeals. Form 2504 is considered to stand in lieu of a supplemental return.

The interest-free provisions do not apply if:

- The amounts under-reported relate to an issue that was raised in a prior period examination,
- The taxpayer knowingly under-reports employment tax liability,
- The taxpayer receives notice and demand for payment after assessment and prior to filing the adjusted return,
- The taxpayer receives Letter 3523, Notice of Determination of Worker Classification, prior to filing the adjusted return (see Treas. Reg. 31.6205-1(a)(2) and (a)(6)), or
- The adjusted return is not timely filed; i.e., by the due date of the return for the return period in which the error was ascertained.

The submission of one of the Form 2504 series agreements at the close of an examination or Appeals conference (and prior to the issuance of a notice and demand for payment) fulfills the requirements for correcting a return for purposes of the interest-free adjustment provisions of IRC 6205 and the regulations. For errors discovered, full payment of the tax must be made at the time of the submission of the agreement in order to receive complete interest-free treatment and avoid failure to deposit (FTD) penalties. If the tax adjustment is not paid when the signed agreement is submitted, interest and penalties accrue. Consider the following examples.

Example 1

An employer files and pays the tax for a timely filed employment tax return that is incorrect. During an audit, an error in the FICA tax liability is discovered by the examiner and an adjustment is proposed to the employer on September 15th. The employer submits a signed Form 2504 and pays the additional tax on November 10th. As the amount was paid at the time the agreement was secured, the taxpayer is entitled to an interest-free adjustment.

Example 2

Same situation as Example 1 above, except that the taxpayer submits the signed agreement on November 10th but does not pay the tax at that time. The interest computation date entered on line 11 of Form 5344 or Form 5599 is November 10th, and interest begins to accrue starting November 11th.

8. Relief for Employer When Employees Have Paid Income Tax on Wages

When income tax withholding is involved, and IRC § 3509 is not applicable, the withholding is either computed under existing law and regulations or the alternate percentage withholding rate of 22% provided in Regulation section 31.3402(g)-1(a)(2)(ii) of the Regulations. Employers' requests under IRC § 3402(d) for relief from the payment of income tax withholding are generally handled at service centers. Since these requests do not constitute claims, Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund, will not be solicited.

The employer is entitled to the abatement of the employee share of FICAunder IRC 6521 if the employee paid self-employment tax and the statute has expired for claiming a refund of such tax. FICA and FUTA taxes are not abatable under IRC § 3402(d). In addition, penalties or interest adjustments are not abated by these procedures.

9. Misclassification Penalty

When an employer erroneously classifies an employee as an independent contractor and does not withhold federal payroll taxes, the employer is liable under IRC § 3102 and IRC § 3403 for the employee's share of FICA tax and the employee's income tax withholding. This is true even if the employer does not withhold the tax from the employee.

Although relief provisions under IRC §§ 3402(d) and 6521 are available, employers sometimes find it difficult to locate and get the cooperation of former employees in

order to avail themselves of the relief. Public Law 97-248 provides "statutory offset mechanisms that will apply in reclassification cases."

Section 3509 applies where § 530 relief is not available and gives reduced rates for income tax withholding and the employee's share of FICA where an employer failed to deduct employment taxes by reason of treating such employee(s) as an independent contractor. The procedure does not relieve the employer of the employer's share of FICA and FUTA taxes. If Form 1099s were filed with respect to the workers:

- Income tax withholding is computed at the rate of 1.5% with no abatement under IRC § 3402(d). Abatement rules do not apply.
- The employer's liability for FICA is computed at the rate of 20% of the employee's share, plus the entire employer's share.

If no Form 1099s were filed:

- The income tax withholding rate becomes 3%. Abatement rules do not apply; and
- The FICA tax liability is the employer's share plus 40% of the employee's share.

The failure to file penalty (IRC § 6651) should be applied if there is no reasonable cause. The failure to deposit penalty (IRC § 6656) will apply to delinquent employment tax returns unless there is reasonable cause. The penalty (10%) applies only to the employer's share of FICA tax.

If a taxpayer has not filed a return, no accuracy-related penalty would apply. A substitute for return is not considered a return for this purpose.

Application of § 3509 is mandatory for all determinations involving worker reclassification assessments. A taxpayer cannot waive § 3509 when its conditions are met. The section does not apply:

- In cases of intentional disregard of the requirement to deduct and withhold employment taxes (IRC § 3509(c));
- In cases where the employer deducts income tax from the wages of an employee but does not deduct FICA tax (IRC § 3509(d)(2)); or
- In cases of certain statutory employees for FICA tax purposes (IRC § 3509(d)(3));

In agreed and unagreed cases, the provisions of IRC § 3509 will be applied to all quarterly returns required to be filed for any completed calendar year under examination. If different rates under IRC § 3509 are applied to the same employer, the