Legislative Recommendation #61

Encourage and Authorize Independent Contractors and Service Recipients to Enter Into Voluntary Withholding Agreements

PRESENT LAW

IRC Chapter 24 (Collection of Income Tax at Source on Wages) provides for required withholding of taxes on wages paid to employees, certain gambling winnings, certain pensions and annuities, amounts subject to backup withholding, and certain other payments. In addition, IRC § 3402(p) provides for voluntary withholding at the option of the income recipient on certain payments such as Social Security benefits, unemployment benefits, and certain other benefits. IRC § 3402(p)(3) authorizes the Secretary to promulgate regulations to provide for withholding from any 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.

Although 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, the only such guidance issued to date is Notice 2013-77, dealing with dividends and other distributions by Alaska Native Corporations.

IRC § 6654(a) generally imposes a penalty for failure to pay sufficient estimated tax during the year, computed by applying (i) the underpayment rate established under IRC § 6621 (ii) to the underpayment (iii) for the period of the underpayment.

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 generally must 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. In addition, some do not save enough funds to pay their taxes at the end of the year. 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.
This problem may be increasing as more workers are working in the so-called “gig economy.” To reduce the risk 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 the law should not discourage workers and businesses from entering into voluntary withholding agreements when both parties wish 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 businesses are reluctant to withhold due to concerns that the IRS may cite the existence of withholding agreements to challenge underlying worker classification arrangements. These concerns 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 party to such agreements, since these agreements will help ensure the IRS collects taxes.

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.\(^6\)

\(^6\) For legislative language generally consistent with this recommendation, see Small Business Owners’ Tax Simplification Act, H.R. 3717, 115th Cong. § 9 (2017).