

Determination of Employer's Liability for Certain Employment Taxes

Cross References

- Rev. Rul. 2025-3

The IRS has released guidance that addresses the application of Section 530 of the Revenue Act of 1978 (Section 530), IRC section 3509 reduced rates, and the requirements to issue a Notice of Employment Tax Determination under IRC section 7436 in several distinct factual situations.

IRC section 3509 allows an employer to remit unpaid taxes at reduced rates if an employer fails to deduct and withhold income tax or the employee share of FICA tax with respect to any of its employees because the employer treated that employee as a non-employee. The reduced rates under IRC section 3509 may apply when the taxpayer does not meet the statutory requirements for Section 530 relief. The legislative history of IRC section 3509 indicates that it was intended to provide relief for employers in cases in which a worker treated as a non-employee by the employer is reclassified by the IRS as an employee, and to deter employers from misclassifying employees to avoid employment taxes. The reduced rates do not apply to the determination of the employer's liability for income tax withholding or the employee portion FICA tax if such liability is due to the employer's intentional disregard of the requirement to deduct and withhold such taxes.

Section 530 was enacted to provide relief to taxpayers involved in worker classification disputes with the IRS. Section 530 provides that a taxpayer will not be liable for federal employment taxes, with respect to an individual or class of workers if certain statutory requirements are met. For more information on the Section 530 provisions, see TheTaxBook news article: "*Section 530 Relief for Worker Classification Disputes*," published on 1/13/2025.

The following examples are provided to illustrate the application of these provisions.

Example 1. Taxpayer (TP) hires individuals who provide services to TP during the year. For those services, TP pays each individual a weekly fixed amount and a weekly bonus amount. TP does not withhold or pay federal employment taxes with regard to any of the payments and reports the total amount of the fixed weekly amounts and the weekly bonus amounts on Form 1099-NEC, "*Nonemployee Compensation*." During an audit of TP by the IRS for the year, the IRS determines (1) that TP does not meet the statutory requirements for Section 530 relief, and (2) that the individuals are employees of TP. The IRS proposes to assess federal employment taxes on the weekly fixed amounts and the weekly bonus amounts, which should have been reported as wages on Form 941, "*Employer's QUARTERLY Federal Tax Return*," and Form(s) W-2, "*Wage and Tax Statement*." TP claims it satisfies the statutory requirements for Section 530 relief and does not agree that the individuals are its employees.

Section 530 is applicable to this situation because the TP did not treat the individuals as employees, and the IRS is reclassifying the individuals as employees. Whether TP is entitled to Section 530 relief depends on whether the TP satisfies the substantive consistency, reporting consistency, and reasonable basis requirements. If Section 530 does not apply, IRC section 3509 may be applicable because the TP treated the individuals as non-employees and did not deduct and withhold federal employment taxes from the weekly fixed amounts and bonus amounts that it paid to the individuals, and the IRS is reclassifying the individuals as employees. Whether TP is entitled to IRC section 3509 reduced rates depends on whether it meets the statutory requirements in IRC section 3509. The IRS will issue TP an IRC section 7436 notice at the conclusion of the audit or after appeals consideration if no agreement is reached. An IRC section 7436 notice will be issued because (1) there was an examination in connection with an audit, (2) there were determinations that (a) the individuals were employees of TP, and (b) TP was not entitled to relief under Section 530 with respect to these individuals, and (3) the IRS and TP disagree on the employment status of the workers and whether the statutory requirements for Section 530 relief have been met (there is an actual controversy involving the determination as part of the audit).

Example 2. TP employs individuals who perform services during the year. TP treats the individuals as employees for the services that they perform. For those services, TP pays each individual a weekly salary and a weekly bonus amount. TP treats the weekly salary as wages for federal employment tax purposes. TP withholds and pays federal employment taxes with respect to the weekly salary and reports the salary and federal employment taxes on Form 941 and Form(s) W-2. TP does not treat the weekly bonus amounts as wages for federal employment tax purposes. It does not withhold or pay any federal employment taxes with regard to the bonus amounts and reports the bonus amounts on Forms 1099-NEC. During an audit of TP by the IRS for the year, the IRS concludes that the bonus amounts are wages. The IRS proposes to assess federal employment taxes on the bonus amounts, which should have been reported as wages on Form 941 and Form(s) W-2. TP claims it satisfies the statutory requirements for Section 530 relief with respect to the bonus amounts and does not agree that the bonus amounts are wages.

Section 530 is not applicable to this situation because the IRS is not reclassifying the individuals as employees. TP treated the individuals as employees for the services they performed and paid additional wages in the form of bonuses for the same services, there is no controversy over whether the individuals are employees or independent contractors with respect to their services. The reduced rates under IRC section 3509 are not applicable for the same reason. The IRS will issue TP an IRC section 7436 notice at the conclusion of the audit or after appeals consideration if no agreement is reached. An IRC section 7436 notice will be issued because (1) there was an examination in connection with an audit, (2) a determination was made that TP was not entitled to relief under Section 530 with respect to the bonuses paid to the individuals, and (3) the IRS and TP disagree on whether the statutory requirements for Section 530 relief have been met (there is an actual controversy involving the determination as part of the audit).

Author's Comment

Section 530 relief does allow for dual status workers in which a worker is an employee for certain services and a non-employee for other services. However, in such case, the services performed as a non-employee must be completely separate and distinct from the services giving rise to the employment relationship. Example 2 above implies that the services performed for the weekly salary and the services performed for the weekly bonuses are essentially the same services.

Example 3. Same facts as example 2 except TP does not report the weekly bonus amounts on Form(s) 1099-NEC or any other information return.

Section 530 and IRC section 3509 are not applicable to this situation for the same reasons stated in example 2. The IRS will issue TP an IRC section 7436 notice at the conclusion of the audit or after appeals consideration if no agreement is reached. An IRC section 7436 notice will be issued because (1) there was an examination in connection with an audit, (2) a determination was made that TP was not entitled to relief under Section 530 with respect to the bonuses paid to the individuals, and (3) the IRS and TP disagree on whether the statutory requirements for Section 530 relief have been met (there is an actual controversy involving the determination as part of the audit).

Example 4. Same facts as example 2 except TP does not report the weekly bonus amounts on Form(s) 1099-NEC or any other information return and does not claim it satisfies the statutory requirements for Section 530 relief with respect to the bonus amounts.

Section 530 and IRC section 3509 are not applicable to this situation for the same reasons stated in example 2. The IRS will not issue TP an IRC section 7436 notice at the conclusion of the audit or after appeals consideration if no agreement is reached because TP did not claim that TP was entitled to relief under Section 530 concerning the bonuses paid to the individuals, and there is no controversy over whether the individuals are employees or independent contractors.

Example 5. TP employs individuals who perform services during the year. TP enters into a contract with a third party (3P) to pay each individual a weekly salary, withhold and pay federal employment taxes, and file federal employment tax returns. 3P pays the weekly salaries, withholds, pays federal employment taxes, and reports the weekly salaries and taxes on Form 941 and Form(s) W-2 using its own employer identification number (EIN). In December of that same year, TP pays a year-end bonus amount directly to each individual for the individual's services during the year but does not treat the year-end bonus amounts as wages. TP does not withhold or pay any federal employment taxes or report the bonus amounts on any information return. During an audit of TP by the IRS for the year, the IRS concludes that the bonus amounts are wages. The IRS proposes to assess federal employment taxes on the bonus amounts, which should have been reported as wages on Form 941 and Form(s) W-2. TP claims it satisfies the statutory requirements for Section 530 relief with respect to the bonus amounts and does not agree the bonus amounts are wages.

Section 530 is not applicable to this situation because the IRS is not reclassifying the individuals as employees. The year-end bonus amounts are additional wages for the same services performed by the individuals who were treated as employees by TP. The reduced rates under IRC section 3509 are not applicable for the same reason. The IRS will issue TP an IRC section 7436 notice at the conclusion of the audit or after appeals consideration if no agreement is reached. An IRC section 7436 notice will be issued because (1) there was an examination in connection with an audit, (2) a determination was made that TP was not entitled to relief under Section 530 with respect to the year-end bonus amounts paid to the individuals, and (3) the IRS and TP disagree on whether the statutory requirements for Section 530 relief have been met (there is an actual controversy involving the determination as part of the audit).