Legislative Recommendation #63

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

SUMMARY

- *Problem:* Independent contractors are not subject to wage withholding. Instead, they are required to pay their taxes on their own. Many do not. If the IRS audits them or otherwise detects their noncompliance, they become liable for unpaid tax, penalties, and interest charges. If the IRS does not detect their noncompliance, federal revenue collection is impaired.
- *Solution:* Encourage independent contractors and businesses 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, some pensions and annuities, amounts subject to backup withholding, and certain other payments. In addition, IRC \S 3402(p) provides for voluntary withholding at the option of the income recipient on certain payments such as Social Security benefits, unemployment benefits, and other benefits. IRC \S 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 payments for which withholding under a voluntary agreement would be appropriate,³ the only such guidance issued to date is Notice 2013-77, dealing with dividends and other distributions by Alaska Native Corporations.⁴

IRC \S 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 \S 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 independent contractors fail to make estimated tax payments for a variety of reasons and therefore face penalties under IRC § 6654. In addition,

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¹ IRC § 3402(p)(1)(C), (p)(2).

² IRC § 3402(p)(3) authorizes the promulgation of regulations for withholding from (i) an employee's remuneration for services that do not constitute wages and (ii) any other agreed-upon source that the Secretary finds appropriate. The Secretary must find the withholding would be appropriate "under the provisions of [IRC Chapter 24, Collection of Income Tax at Source on Wages]." 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.

³ See Treas. Reg. § 31.3402(p)-1(c).

⁴ IRS Notice 2013-77, 2013-50 I.R.B. 632, Voluntary Withholding on Dividends and Other Distributions by Alaska Native Corporations, https://www.irs.gov/pub/irs-drop/n-13-77.pdf.

some do not save enough money 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.⁵

This problem may be increasing as more people are working in the so-called "gig economy." It is projected that by 2028 there will be about 90 million U.S. workers participating in the gig economy. To reduce the risk they will not save enough money to pay their taxes, some independent contractors would prefer to have taxes 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 encourage workers and businesses to enter into voluntary withholding agreements when both parties wish to do so.

For many businesses, withholding on payments to independent contractors will not impose an 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. The National Taxpayer Advocate understands some businesses may be reluctant to withhold due to concerns that the IRS may cite the existence of withholding agreements to challenge underlying worker classification arrangements. Although the existence of a withholding agreement is generally not a factor the IRS considers when determining whether a worker should be classified as an employee or independent contractor, clarifying this point in the law will provide both businesses and independent contractors with reassurance that entering into a voluntary withholding agreement will not affect worker classification.⁷

RECOMMENDATION

Amend IRC § 3402(p) to clarify that when voluntary withholding agreements are entered into by
parties for the withholding of income tax and these parties 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.⁸

⁵ See IRS, Pub. 1415, Research Analysis and Applied Statistics Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016 (Oct. 2022), https://www.irs.gov/pub/irs-pdf/p1415.pdf.

Gig Economy in the U.S. – Statistics & Facts, Statista, July 3, 2024, https://www.statista.com/topics/4891/gig-economy-in-the-us.

⁷ See Treas. Reg. § 31.3121(d)–1(c); Rev. Rul. 87-41, 1987-1 C.B. 296; Internal Revenue Manual 4.23.5.7.1, Control Test (Dec. 10, 2013), https://www.irs.gov/irm/part4/irm_04-023-005r.

⁸ For legislative language generally consistent with this recommendation, see Small Business Owners' Tax Simplification Act of 2017, H.R. 3717, 115th Cong. § 9 (2017), https://www.congress.gov/bill/115th-congress/house-bill/3717.