This Chief Counsel Advice responds to questions in connection with our separate review of Publication 4341, *Information Guide for Employers Filing Form 941 or Form 944, Frequently Asked Questions About the Reclassification of Workers as Employees*. All section references refer to the Internal Revenue Code of 1986, as amended (Code), unless otherwise noted. This advice may not be used or cited as precedent.

**ISSUES**

1. May an employer use section 3509 to determine its employee Federal Insurance Contributions Act (FICA) tax and federal income tax withholding liability for prior years when the employer is reclassifying a worker following receipt of a determination letter from the Internal Revenue Service (Service) regarding the worker’s classification as an employee?

2. May an employer make an interest-free adjustment to pay its employee FICA tax and federal income tax withholding for prior years, as determined under section 3509, attributable to a reclassified worker following receipt of a determination letter from the Service regarding the worker’s classification as an employee?
CONCLUSIONS

1. Yes, if an employer satisfies the requirements of section 3509, the employer may use section 3509 to determine its employee FICA tax and federal income tax withholding liability for prior years when the employer is reclassifying a worker following receipt of a determination letter from the Service regarding the worker’s classification as an employee.

2. Yes, the employer is eligible to make an interest-free adjustment to pay its employee FICA tax and federal income tax withholding liability for prior years, as determined under section 3509, when the employer is reclassifying a worker following receipt of a determination letter from the Service regarding the worker’s classification as an employee.

FACTS

Either a worker or a firm may request that the Service determine whether the worker is an employee or a nonemployee for federal employment tax purposes through the Form SS-8 process. The requester files a Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, to request a determination or ruling letter regarding a worker’s status for federal employment tax purposes. If the firm is an entity other than a federal government agency, the completed Form SS-8 is submitted to one of two SS-8 Units. If the worker has submitted the form, the SS-8 Unit requests that the firm also provide the information requested by the form. The SS-8 Unit reviews all the submitted information and, where appropriate, issues a determination letter based upon the facts and circumstances presented. If the worker has requested the determination, the determination letter is issued to both the worker and the firm. If the firm has requested the determination, the determination letter is issued to the firm only.

A determination letter is a written determination issued by the Service that applies the principles and precedents previously announced to a specific set of facts. Rev. Proc. 2008-1, 2008-1 I.R.B. 1, § 2.03. Neither the Form SS-8 determination process nor the review of any records in connection with the determination constitutes an examination (audit) of any federal tax return. A determination letter with respect to worker classification does not have an effective date. Thus, the determination letter applies to all periods for which the facts are the same as those presented in the request.

If the firm is determined to be the employer of the worker, it will generally be liable for the resulting underpayment of employment taxes.¹ See sections 3102, 3111, and 3403.

¹ The firm may not be liable for employment taxes if another party is the statutory employer under section 3401(d)(1) as the party in control of the payment of wages, or if the firm is entitled to relief under section 530 of the Revenue Act of 1978, P.L. 95-600, as amended.
At any time, including throughout the determination process, the firm may reclassify a worker as an employee and resolve any resulting employment tax liability.

The SS-8 Units provide assistance to employers on how to comply with any such determination. The SS-8 Units provide Publication 4341, Information Guide for Employers Filing Form 941 or Form 944, to aid employers who have received a determination letter reclassifying the employer’s workers as employees in completing and filing the correct employment tax returns and issuing the correct information returns to the reclassified workers. The SS-8 Units requested guidance as to the applicability of sections 3509 and 6205 of the Code to the Form SS-8 determination process. Section 3509 provides reduced rates for certain employment taxes when a worker is reclassified as an employee. Section 6205 permits employers to adjust underreported employment taxes without the imposition of interest. The SS-8 Units inquired whether both sections are available to calculate and pay the taxes when an employer reclassifies a worker as an employee after receipt of a determination letter from the Service indicating the worker is an employee.2

LAW AND ANALYSIS

1. Application of section 3509 to determine an employer’s employment tax liability attributable to worker misclassifications.

Subtitle C of the Code sets forth the provisions for employment taxes. Chapter 21 imposes the FICA tax upon both the employer and employee. In addition to being exclusively liable for its own portion of the FICA tax under section 3111, the employer is obligated under section 3102 to collect the employee’s FICA tax imposed under section 3101 and is liable if it does not deduct or withhold such tax. Sections 3102(a) and 3102(b).

Chapter 24 requires the employer to deduct and withhold income tax from the payment of wages to the employee. Section 3402(a). The amount the employer is required to withhold generally depends upon the employee’s Form W-4, Employee’s Withholding Allowance Certificate, and the employer’s authorized withholding method. The employer is liable for the payment of this withholding tax whether or not it is collected or deducted from the employee. Section 3403.

Generally, the Code imposes employment taxes on wages paid by an employer to an employee as remuneration for employment. Section 3121(d)(2) of the Code provides that the term employee means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. See also Treas. Reg. §§ 31.3121(d)-1(c)(1) and 31.3401(c)-1(a). Such a

2 Sections 3509 and 6205 do not apply to the Federal Unemployment Tax Act (FUTA) tax imposed by Chapter 23 of the Code. See §§ 3509(a) and 6205(a)(1). Thus, this memorandum will not discuss the effect of a reclassification of workers on an employer’s liability for FUTA tax.
relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. Treas. Reg. §§ 31.3121(d)-1(c)(2), and 31.3401(c)-1(b). This determination is based on the facts and circumstances.

In order to further compliance with worker classification for employment tax purposes, the Code prescribes reduced rates of tax for employers in certain situations involving misclassification of workers. Section 3509 reduces an employer’s liability for federal income tax withholding and the employee portion of the FICA taxes where the employer failed to deduct and withhold those taxes because it treated the employee as a nonemployee. Section 3509(a). That liability is reduced from the amount the employer was required to withhold to 1.5% of the employee’s wages for federal income tax withholding, and from 7.65% of the employee’s wages to 20% of such amount for the employee’s portion of the FICA tax. Section 3509(a). If the employer failed, without reasonable cause to comply with applicable information reporting requirements consistent with the treatment of the employee as a nonemployee (e.g., filing a Form 1099-MISC, Miscellaneous Income), the percentages are doubled so that the employer pays 3% of the employee’s wages for federal income tax withholding and 40% of the amount of the employee’s FICA tax (i.e., 40% of 7.65% of the employee’s wages). Both rates must be used and they cannot be applied separately, except under special circumstances applicable only to statutory employees.³

An employer must meet several requirements to be eligible to apply section 3509 rates. The employer must have treated the worker as a nonemployee for purposes of both income tax withholding and FICA tax. Thus, if the employer withheld federal income tax but did not withhold the employee’s share of FICA tax, section 3509 rates are not available. Section 3509(d)(2). The employer must also have treated the worker as a nonemployee for purposes of information reporting. Thus, if the employer filed a Form W-2, Wage and Tax Statement, with respect to such employee, section 3509 rates are not available. Further, if the employer intentionally disregarded the deduction and withholding requirements, the reduced rates do not apply, and the employer is liable for the full taxes that should have been withheld. Section 3509(c).

If section 3509 rates apply to determine the employer’s tax liability for the employee’s share of FICA tax and income tax withholding, the employer nonetheless remains liable for the full amount of the employer’s share of FICA tax. Furthermore, if section 3509 applies, the employer may not recover any of the amount of tax so determined from the employee. Nor do the abatement provisions of sections 3402(d) and 6521 apply.

³ If the employee would be a statutory employee described in section 3121(d)(3) but for the fact that the employee is also a common law employee or an officer, the section 3509 rate for federal income tax withholding could be used but not the section 3509 rate for the employee’s share of FICA tax. Section 3509(d)(3).
Section 3509(d)(1)(B) and (C). Since these abatement procedures are unavailable, any payment of federal income tax by the employee will not abate the employer’s liability under section 3509 for income tax required to be withheld; similarly, the employee’s payments of self-employment tax do not offset the employer’s liability under section 3509 for the employee’s share of FICA tax.

The legislative history specifies that the section was enacted to relieve the “serious retroactive tax burdens that may arise when a worker who has been treated as an independent contractor is reclassified as an employee.” S. Rep. No. 97-494, at 370 (1982). The section provides a “statutory offset mechanism” that was intended as a “substantial simplification of present law procedures and will reduce burdens on employers whose workers are reclassified” by making the abatement provisions of section 3402(d) unnecessary for reducing the attending employment tax liabilities. Id. at 371. The committee report states that assessment under section 3509 would “serve the dual function of deterring noncompliance on the part of employers, and compensating the Treasury for the revenue loss typically associated with employer noncompliance with wage withholding.” Id. at 372.

Section 3509 is silent as to whether it applies only if the reclassification occurs pursuant to an examination by the Service. Like the statute, the legislative history refers to reclassification of workers but does not discuss whether the reclassification is triggered by a Service enforcement action in an examination or may be initiated by the employer due to the receipt of a determination letter regarding the worker’s classification as an employee. Nothing in the statute or legislative history of section 3509 limits the availability of the special rates to circumstances where a worker misclassification is determined pursuant to examination by the IRS. Furthermore, the legislative history indicates that section 3509 was enacted in part to facilitate compliance by simplifying procedures. Allowing employers to determine employment tax liability using section 3509 rates following an SS-8 determination to correct underpayments will encourage compliance with the SS-8 determination.

The Code and legislative history are also silent as to whether section 3509 applies only to a prior year or whether it also applies to determine the employer’s liability for the current year when an employer discovers a misclassification during the calendar year. If an employer fails to deduct and withhold employment taxes during a calendar year because it erroneously views the worker as a nonemployee and discovers such error during that year, the employer can remedy such failure to withhold before the calendar year ends and correctly report such wages to the worker for the calendar year. According to the legislative history, section 3509 is a mitigation and simplification procedure when the employer has come across a mistake for the past. If the mistake is made and discovered in the current year, there is no need for a simplified procedure.

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4 Section 3402(d) provides that income tax required to be deducted and withheld will not be collected from the employer who was required to deduct and withhold such tax and failed to do so, if the tax is paid by the employee. Section 6521 provides an offset of self-employment tax paid against FICA tax owed, or vice versa, in certain circumstances.
The need for simplification arises only when the calendar year is over because there is no further opportunity to withhold the income tax for the calendar year and the employee may have already paid self-employment tax. Without simplification the abatement provisions in sections 3402(d) and 6521 would otherwise apply. Moreover, the statute defines the type of mistake that qualifies for section 3509 in part by the employer’s reporting behavior with respect to the worker. Until the year is over and the employer does or does not issue an information return to the worker (such as a Form 1099-MISC), it cannot be determined whether the employer met the qualifications for section 3509 and which rates apply. Thus, it seems implicit that section 3509 was intended to calculate only prior year liabilities attributable to reclassified workers.

Based on the above analysis, we conclude that employers may use section 3509 rates to calculate their liability for income tax withholding and the employee’s share of FICA tax where the employer (a) has become aware of a misclassification after receiving a determination letter from the Service regarding a worker’s classification as an employee, (b) meets the requirements of section 3509, and (c) seeks to correct a failure to withhold employment taxes for a prior year.

2. Eligibility for section 6205 interest-free adjustments to pay employment tax liability under section 3509 attributable to worker misclassifications.

Under section 6205(a), if less than the correct amount of employee’s FICA tax (section 3101), employer’s FICA tax (section 3111), or federal income tax withholding (section 3402) is paid with respect to any payment of wages, proper adjustments of both the tax and amount deducted shall be made, without interest, as prescribed by regulations.

The Employment Tax Regulations permit employers to correct their employment tax underpayments without incurring any interest if the error is timely reported and the tax is timely paid. Treas. Reg. § 31.6205-1(a). For purposes of section 31.6205-1, an error is ascertained when an employer has sufficient knowledge of the error to be able to correct it, such as the date of the Service’s determination letter.

Section 31.6205-1(a) provides two methods for correcting underpayments for FICA tax and federal income tax withholding. For purposes of an underpayment of FICA tax, the regulation provides that the employer shall adjust the underpayment either by: (a) reporting the additional tax due as an adjustment on a return filed on or before the last day on which the return is required to be filed for the quarter in which the error is ascertained; or (b) reporting the additional tax on a supplemental return for the quarter in which the wages were paid. Other than in an examination, there are no forms or procedures for filing a supplemental return for the quarter in which the wages were paid. If the underpayment is reported on the return for the period in which the error is ascertained and the missing FICA tax is paid by the due date of the return for the

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quarter in which the error is ascertained, the reported underpayment will not be subject to interest. However, if the adjustment is properly reported, but the additional FICA tax due is not paid by the due date of the return for the quarter in which the error is ascertained, interest thereafter accrues.

Section 31.6205-1(c)(2) provides that an employer may adjust an underpayment of federal income tax withholding either by: (a) reporting the additional tax on a return for any quarter in the calendar year in which the wages were paid; or (b) reporting the additional tax on a supplemental return for the quarter in which the wages were paid. There is no calendar year limitation for adjustment on a supplemental return; however, other than in an examination, there are no forms or procedures for filing a supplemental return for the quarter in which the wages were paid. If the underpayment is reported on the return for the period in which the error is ascertained and the missing federal income tax withholding is paid by the due date of the return for the quarter in which the error is ascertained, the reported underpayment will not be subject to interest. However, if the adjustment is properly reported, but the additional federal income tax withholding due is not paid by the due date of the return for the quarter in which the error is ascertained, interest thereafter accrues.

During an examination, section 6205 may apply when an employer reclassifies workers as employees. Rev. Rul. 75-464, 1975-2 C.B. 474. When workers are reclassified pursuant to an examination and the employer agrees to the resulting assessment, Form 2504-WC, Agreement to Assessment and Collection of Additional Employment Tax and Acceptance of Overassessment in Worker Classification Cases, serves as a supplemental return reporting the additional wages for the period in which the wages were paid to the misclassified workers. Assessments in examination generally relate to prior calendar years. The Form 2504-WC, as a supplemental return, can include assessments for federal income tax withholding for prior calendar years as an interest-free adjustment.

Nothing in section 6205 limits employers to making interest-free adjustments for income tax withholding for prior years solely in the context of an examination by the Service. Nor does the statute limit an employer’s ability to make interest-free adjustments for income tax withholding for prior years to satisfy underpayments resulting from only certain types of errors. The regulations provide for interest-free adjustment of federal income tax withholding for wages paid in prior calendar years only on supplemental returns. Currently, only Forms 2504 and 2504-WC, used in an examination context, are supplemental returns.

As discussed in Issue 1 above, employers may use section 3509 rates, if permitted by the rules of that section, to determine their tax liability attributable to worker

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6 An error is ascertained when Form 2504 or Form 2504-WC is signed either at the examination level or at the appeals level, when the taxpayer pays the full amount due so as to file a refund claim (if prior to notice and demand), or at the conclusion of in-Service appeal rights if no agreement is reached. Rev. Rul. 75-464.
reclassification following receipt of a determination letter from the Service. However, as discussed above, based on the intent of section 3509, employers are limited to using such rates to determine employer tax liabilities for wages paid in prior years (that is, not in a current calendar year). Taken together, the section 6205 regulations and the available processes limit interest-free adjustments of federal income tax withholding outside the examination context to the liability for the current calendar year, and section 3509 limits the use of such rates to calculate the liability for prior calendar years.

While these limitations together appear to prevent employers from making interest-free adjustments for worker reclassifications for prior years using section 3509 rates outside of an examination by the Service, both section 3509 and section 6205 are intended to facilitate compliance, including with respect to correction of worker misclassification. Furthermore, the general current year limitation in the section 6205 regulations for adjusting underpayments of federal income tax withholding is intended to maintain the separate nature of each tax year for income tax withholding purposes. While the employer remains liable for the underpayment of federal income tax withholding for prior years, the employer cannot adjust the federal income tax withholding for prior years because the employer can no longer withhold the tax from the employee for such prior years. Since the use of 3509 rates proscribes the application of the abatement rules of section 3402(d) and prohibits the employer from collecting any of the tax paid under section 3509 from the employee, the rationale for the current calendar year limitation for adjusting income tax withholding does not apply. Additionally, the supplemental return provision in the section 6205 regulations would have a broader effect if the Service provided a supplemental return process outside the examination context.

There are no direct tax effects for the reclassified employees when an employer makes adjustments using section 3509 rates. Accordingly, interest-free adjustments should be permitted for employers using section 3509 rates to correct worker misclassifications for prior calendar years following receipt of a determination letter from the Service regarding the worker’s classification as an employee. This result is consistent with the policy of both provisions to encourage compliance with determinations of worker classification by the Service. Indeed, the Service’s proposed regulations under section 6205 issued in 1992 indicate an intent for employers to make interest-free adjustments by using rates in section 3509 when correcting a misclassification of workers. See Interest-Free Adjustments of Underpayments of Employment Taxes, 57 Fed. Reg. 58423-02, 1993-1 C.B. 640.7

If an employer satisfies the requirements of section 3509, the employer may use section 3509 to determine its employee FICA tax and federal income tax withholding liability for prior years when the employer is reclassifying a worker following receipt of a determination letter from the Service regarding the worker’s classification as an employee.

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Furthermore, the employer is eligible to make an interest-free adjustment to pay its employee FICA tax and federal income tax withholding liability for prior years, as determined under section 3509, when the employer is reclassifying the worker.

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