**Subject:** Gross Up of Employment Taxes During Examination

**Question Presented:**

1. Can IRS employment tax exam (Exam)\(^1\) “gross up” an employment tax adjustment to include the employee’s share of Federal Insurance Contributions Act (FICA) tax and federal income tax withholding attributable to a wage payment made by an employer in a prior year?

2. If Exam cannot “gross up” an employment tax adjustment, what are the information return reporting implications for the employer for the year under examination?

3. If Exam cannot “gross up” an employment tax adjustment, what are the information return reporting requirements for the employer in the year of payment of the proposed employment tax liabilities?

**Conclusion:**

1. No. An employer’s payment of taxes that should have been withheld in a prior year does not create additional wages to the employee for the prior year.

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\(^1\) The question presented does not concern settlements in situations that involve parties entering into closing agreements.
2. For the year under examination, the employer is required to prepare a Form W-2c reporting the additional wages as set forth in the body of this memorandum, furnish the employee with the appropriate copy of the Form W-2c, and file the appropriate copy of the Form W-2c with the Social Security Administration.

3. For the year in which the employment tax liability is paid, if the employer deducts the employee FICA tax from other remuneration paid to the employee or otherwise collects the amount from the employee in accord with the regulations under section 6205, the payment of employee FICA tax by the employer is not additional compensation to the employee in 2018. However, if the employer does not seek repayment of the employee FICA tax from the employee, the employer’s payment of employee FICA tax in 2018 without collecting the amount from the employee is additional wages to the employee when paid in 2018 and is subject to employment taxes.

Facts:

During an examination performed in 2018 of an employer’s Forms 941, Employer’s QUARTERLY Federal Tax Return, for all quarters of tax year 2016, Exam identifies $10,000 of taxable fringe benefits provided by the employer to an employee that was not included in wages in 2016 or reported on a Form W-2, Wage and Tax Statement, or Form 1099-MISC, Miscellaneous Income, provided to the employee. The employee earned less than the annual social security wage limit for 2016 after inclusion of the $10,000 fringe benefit amount in the employee’s wages.

Exam correctly characterizes the $10,000 fringe benefit amount as additional wages in 2016 and computes the total employment tax due from the employer on the additional wages as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Income Tax Withholding:</td>
<td>$10,000</td>
</tr>
<tr>
<td>Employer share of FICA</td>
<td>$10,000</td>
</tr>
<tr>
<td>Employee share of FICA</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total Tax3</td>
<td>$4,030</td>
</tr>
</tbody>
</table>

2 When income tax withholding is involved and the rate determined under Code section 3509 is not applicable, the withholding is either computed under ordinary income tax withholding requirements or using the supplemental withholding rate in Treas. Reg. 31.3402(g)-1. See Internal Revenue Manual § 4.23.8.4. The supplemental withholding rate in 2016 is 25%, but this rate was changed to 22% for taxable years 2018 through 2025 in Notice 2018-14, 2018-7 I.R.B. 353.

3 Although the employer may also have a tax liability under the Federal Unemployment Tax Act (FUTA) (Code sections 3301-3311) with respect to the additional wages, this question is not addressed here as FUTA is a tax imposed solely on an employer and would not impact the employee. Similarly, this memorandum does not address the imposition of interest and penalties on the employer since the employer’s payment of interest and penalties would not impact the employee. Finally, this memorandum does not address the situation in which section 530 of the
The employer pays the full tax assessment of $4,030 in 2018.

**Law:**

Internal Revenue Code (Code) section 6201 provides the general authority for the IRS to assess taxes. Specifically, section 6201 provides the authority to make the inquiries, determinations, and assessments of all taxes (including interest, additions to the tax, and assessable penalties) imposed under the Code.

Subtitle C of the Code imposes taxes on employers, including FICA tax under Chapter 21 and income tax withholding under Chapter 24.

FICA tax consists of Old-Age, Survivors, and Disability Insurance (social security) tax and Hospital Insurance (Medicare) tax and is computed as a percentage of wages paid by the employer to the employee with respect to employment. Code section 3121(a) defines wages for FICA tax purposes. Code sections 3101(a) and 3101(b)(1) impose the employee’s share of the social security tax (6.2 percent of wages) and the Medicare tax (1.45 percent of wages), respectively. Code sections 3111(a) and 3111(b) impose the employer’s share of the social security tax and the Medicare tax, respectively.

Code section 3102(a) imposes a requirement on the employer to withhold the employee share of FICA tax from wages and pay it over to the government. Code section 3102(b) provides that every employer required to deduct the employee share of FICA tax shall be liable for the payment of such tax.

Section 31.3102-1(d) of the Employment Tax Regulations provides that the employer is liable for the employee FICA tax with respect to all wages paid by it to each of its employees whether or not the tax is collected from the employee.

Section 31.3102-1(d) of the regulations provides that, until collected from him, the employee also is liable for the employee FICA tax with respect to all the wages received by him.

Code section 3401(a) defines wages for income tax withholding purposes. Code section 3402(a) requires employers to withhold federal income tax from wages paid to employees. Section 3402(a) provides that every employer making a payment of wages shall deduct and withhold upon such wages a tax determined

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4 Effective for tax years beginning after December 31, 2012, employees are also subject to Additional Medicare Tax (0.9 percent) on wages paid by an employer in excess of enumerated dollar thresholds, that are dependent upon each employee’s filing status in a calendar year. See Revenue Act of 1978 nor the special procedures in section 3509 of the Code apply to determine the employer’s liability.

5 Special rules are provided in the context of Additional Medicare Tax imposed by Code section 3101(b)(2) for tax years beginning after December 31, 2012. See Code section 3102(f).
in accordance with tables or computational procedures prescribed by the Secretary of the Treasury.

Code section 3403 provides that the employer shall be liable for the payment of the tax required to be deducted and withheld under Chapter 24 (i.e., income tax withholding).

Section 31.3403-1 of the Employment Tax Regulations provides that every employer required to deduct and withhold the tax under section 3402 from the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee by the employer. If, for example, the employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax.

Code Section 3402(d) provides that "if the employer . . . fails to deduct and withhold the tax . . . and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer."

Section 31.3402(d)-1 of the Employment Tax Regulations provides that "if the employer . . . fails to deduct and withhold the tax, and thereafter the income tax against which the tax under section 3402 may be credited is paid, the tax . . . shall not be collected from the employer."

Code section 31 provides that the amount withheld as income tax under chapter 24 (i.e., income tax withholding) during any calendar year shall be allowed as a credit against the tax imposed by subtitle A (income taxes) to the recipient of the income for the taxable year beginning in such calendar year.

Section 1.31-1(a) of the Income Tax Regulations provides that the tax deducted and withheld at the source upon wages is allowable as a credit against the tax imposed upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer.

Code section 6051(a) provides that every person required to deduct and withhold tax from an employee under section 3101 or 3402 shall furnish to each employee a written statement including the total amounts of wages as defined in sections 3401(a) and 3121(a) and the total amounts deducted and withheld as tax under sections 3402 and 3101.

Section 31.6051-1(c)(1) of the Employment Tax Regulations provides that, for FICA tax purposes, if the amount of wages as defined in section 3121(a), or tax under section 3101, entered on a statement to an employee for a prior year was incorrect, a corrected statement for the prior year reflecting the correct data shall be furnished to the employee.
Section 31.6051-1(c)(2) of the Employment Tax Regulations provides that, for income tax withholding purposes, a corrected statement shall be furnished to the employee with respect to a prior calendar year to show the correct amount of wages, as defined in section 3401(a), paid during the prior calendar year if the amount of such wages entered on a statement furnished to the employee for such prior year is incorrect and shall be indicated as corrected.

**Analysis:**

Pursuant to the rules described above, Exam is authorized to assess against the employer the FICA taxes (both the employee and employer shares) and income tax withholding attributable to the additional $10,000 wage payment. The payment of the assessment by the employer satisfies the employer’s FICA obligations under sections 3102 and 3111, and income tax withholding liability under section 3403. The payment of the taxes by the employer in 2018, in satisfaction of its own liability, does not result in additional compensation or wages to the employee in 2016. In other words, the employer’s payment in a subsequent year of taxes that should have been withheld from wages paid in the prior year does not create additional compensation or wages to the employee for the prior year. Accordingly, the employer’s payment of the assessment does not provide a basis for Exam to assess an additional FICA tax and income tax withholding amount on the employer with respect to the $10,000 payment for the prior year. To the extent the $10,000 payment creates any income tax liability for the employee, section 6201 does not provide a basis for assessing the employee’s income tax liability against the employer.

However, the determination of additional wages, tax assessment, and employer’s payment of its FICA tax and income tax withholding liability with respect to the $10,000 does have certain consequences for the employee who received the wages in 2016.

Consistent with the determination of additional wages, the tax assessment and the employer’s payment of its income tax withholding and its FICA tax liability in a subsequent year for amounts not treated as wages in a prior year, the employer is required to prepare a Form W-2c for the prior year, furnish the employee with the appropriate copy of the Form W-2c, and file the appropriate copy of the Form W-2c with the Social Security Administration. Accordingly, the employer is required to file and furnish Form W-2c for 2016 to include the $10,000 taxable fringe benefit paid to the employee.

In accordance with section 31, because the income tax withholding assessed in 2018 was not tax actually withheld from the employee in 2016, the employee

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6 The employer’s liability for the $765 of employee FICA tax cannot be abated (even if the employee reported the income and paid self-employment tax on the income) since the period of limitations on the employee’s 2016 Form 1040 is still open. See Code section 6521.
gets no credit for the income tax withholding liability paid by the employer as a result of the examination and assessment. Accordingly, no amount should be reported by the employer in box 2, Federal income tax withheld, of the 2016 Form W-2c for the income tax withholding assessed and paid by the employer in 2018, and the employee does not get credit for the employer’s payment of its assessed income tax withholding liability under section 3403 on any 2016 Form 1040X filed by the employee.7

Furthermore, the Employment Tax Regulations do not authorize the employer to recover the amount paid in 2018 as its income tax withholding liability for 2016 from the employee. See section 31.6205-1(d)(2).8

Accordingly, the employer’s payment of its liability under section 3403 in 2018 with respect to the additional wages does not affect the employee’s income tax liability in 2016 with respect to such wages and does not create additional income for the employee in 2018 when paid by the employer.9

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7 If the employee files Form 1040X and pays his or her income tax liability on the additional wages reported on Form W-2c, the employer can receive an abatement of the $2,500 it paid as income tax withholding in 2018 by securing Form 4669, Statement of Payments Received, from the employee. The abatement can be made prior to the completion of the audit by submitting Forms 4669 and 4670, Request for Relief of Payment of Certain Withholding Taxes, to Exam, or after the audit is closed, by filing the Forms 4669 and 4670 with a claim for refund. Abatement of income tax withholding would not result in abatement of any applicable penalties. There are no tax ramifications to the employee if the employer receives an abatement of income tax withholding.

8 Under section 31.6205-1(d)(2) of the Employment Tax Regulations, if an employer collects less than the correct amount of income tax required to be withheld from wages during a calendar year, the employer must collect the amount of the undercollection on or before the last day of the year by deducting the amount from remuneration of the employee, if any, paid after the employer ascertains the error. The regulation also provides that, if such a deduction is not made, the obligation of the employee to the employer with respect to the undercollection is a matter for settlement between the employee and the employer within the calendar year.

9 Section 31.3401(a)-1(b)(6) of the Employment Tax Regulations provides that the term "wages" for income tax withholding purposes includes amounts paid by an employer on behalf of an employee (without deduction from the remuneration of, or other reimbursement from, the employee) on account of any tax imposed on the employee, including the tax imposed by section 3101 (the employee portion of FICA taxes). See also Rev. Rul. 58-113, 1958-1 C.B. 362. However, amounts are not paid "on behalf of an employee" if the employer is paying its liability under section 3403 in a subsequent calendar year that is attributable to wages paid in a prior calendar year, for which the employee does not get credit as tax withheld under section 31 and for which the employer cannot recover from the employee as an adjustment of income tax withholding. Accordingly, the income tax withholding liability paid by the employer in a subsequent year is not additional wages to the employee under this regulation because it is not a payment of taxes on behalf of the employee. To the extent GCM 39577, (February 21, 1986), indicates that the employer’s payment of its income tax withholding liability under section 3403 in a subsequent calendar year is additional compensation to the employee, it is in error.
The impact to the employee in 2018 is different with regard to the employer’s payment of the employee FICA tax liability. Unlike the federal income tax withholding liability of section 3402 that is only imposed on the employer, the employee FICA tax is a tax imposed on the employee under section 3101. The employer is required to withhold the employee FICA tax under section 3102 and is liable for the payment of such tax under section 3102(b) whether or not it withholds the tax from the employee. The employee also is liable for the tax until it is collected from the employee. See section 31.3102-1(d). Accordingly, while both the employer and employee are liable for the tax, the employee is ultimately liable for the tax imposed by section 3101 regardless of whether it is the employer or the Government who collects it from the employee. Rev. Rul. 86-111, 1986-2 C.B. 176.10

Consistent with this placement of liability on both the employer and employee, but ultimately on the employee, the regulations under section 6205 provide that, if an employer collects less than the correct amount of FICA tax from an employee, the employer must collect the amount of the undercollection by deducting the amount from remuneration of the employee, if any, paid after the employer ascertains the error. The correct amount of employee tax must be reported and paid in accordance with these regulations, whether or not the undercollection is corrected by a deduction under this regulation and even if the deduction is made after the return on which the employee tax must be reported is due under these regulations. If such deduction is not made, the obligation of the employee to the employer is a matter for settlement between the employee and the employer. See section 31.6205-1(d)(1).

Once the employee FICA is paid by the employer or employee, the employee receives credit for the employee FICA tax. In this case the $10,000 should be added by the employer to the corrected wages on the 2016 Form W-2c in box 1, Wages, tips other compensation, box 3, Social security wages, and box 5, Medicare wages and tips, and the additional employee FICA tax paid by the employer should be reported in box 4, Social security tax withheld, and box 6, Medicare tax withheld, as applicable.

If the employer deducts the employee FICA tax from other remuneration paid to the employee or otherwise collects the amount from the employee in accord with section 31.6205-1(d)(1), the payment of employee FICA tax by the employer is not additional compensation to the employee in 2018. However, if the employer

10 Cf. Navarro v. United States, 72 AFTR2d (P-H) 93-5424 (W.D.Tex.1993), in which the court indicates the IRS could have pursued either party, employer or employee, for the employee portion of FICA taxes, though in the facts of this case the IRS pursued the employee. Cf. IRS Policy Statement 5-14, IRM 1.2.14.1.3 (06-09-2003) (“If a business has failed to collect or pay over income and employment taxes, or has failed to pay over collected excise taxes, the trust fund recovery penalty may be asserted against those determined to have been responsible and willful in failing to pay over the tax. The withheld income and employment taxes or collected excise taxes will be collected only once, whether from the business, or from one or more of its responsible persons.”)
does not seek repayment of the employee FICA tax from the employee, the $765 of employee FICA tax paid by the employer in 2018 without collecting the amount from the employee is additional wages to the employee when paid in 2018 and is subject to employment taxes. The employer may either withhold the employee’s FICA tax and income tax on such additional wages in 2018 from other wages or via payment by the employee or may calculate the applicable employment taxes on such additional wages in 2018 by grossing up the employee FICA tax and income tax withholding under the procedures of Rev. Proc. 81-48 and Rev. Rul. 86-14.\textsuperscript{11}

Please call Elliot Rogers at (202) 317-6798 if you have any questions.

\textsuperscript{11} The formula for calculating income tax withholding under the guidance on the additional wages would include the rate at which income tax is withheld in lieu of the rate of employee FICA tax.