Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Sunita Lough
(Director, Federal, State & Local Governments)

from: Marie Cashman
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subject: Internal Revenue Code Section 3509

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether state and local government employers that have entered into "section 218 agreements" with the Social Security Administration may use Code section 3509's reduced tax rates for determining Federal Insurance Contributions Act (FICA) tax liabilities due when workers who have not been treated as covered by a section 218 agreement are determined to be covered by the agreement and therefore to be employees for FICA purposes under Internal Revenue Code (Code) section 3121(d)(4)?

CONCLUSION

Yes, state and local employers are entitled to use section 3509's reduced tax rates in figuring employment tax liabilities with respect to workers who were not treated as covered by a section 218 agreement and are determined to be covered by the agreement and therefore, to be employees under section 3121(d)(4).

FACTS

In examinations of state and local entities FSLG often encounters state or local government employers (together "public entity employers") that are subject to section 218 agreements with the Social Security Administration. When FSLG determines that there is a FICA tax liability with respect to workers who were not previously treated as

employees under section 3121(d)(4), the employers want to determine their liability for the employee portion of FICA tax based on the reduced rates in section 3509 of the Code available in worker reclassifications

LAW AND ANALYSIS

Section 3509

Section 3509(a) provides that if any employer fails to deduct and withhold any tax under chapter 24 (ITW) or subchapter A of chapter 21 (employee FICA) with respect to any employee by reason of treating such employee as not being an employee for purposes of such chapter or subchapter, the amount of the employer's liability for withheld income tax and the employee portion of the FICA tax shall be determined under section 3509.

The use of the lower rates provided under section 3509 is mandatory, except where the employer intentionally disregarded the requirements to deduct and pay employment taxes. See Esser v. United States, 750 F.Supp. 421(D. Az. 1990). Section 3509(d)(2) provides that it shall not apply if the employer withheld income taxes, but not FICA taxes. Section 3509 also does not apply when the issue is whether payments for services are for "wages" under section 3121(a) or whether services are employment under section 3121(b). See Flamingo Fishing v. United States, 32 Fed.Cl. 377 (1994). In addition, it does not apply to statutory employees described in section 3121(d)(3).[1]

If section 3509 applies, and the employer meets the applicable reporting requirements of section 6041(a), 6041A, or 6051, the employer is generally liable for income tax withholding equal to 1.5 percent of total wages paid to the employee, and for employee FICA taxes equal to 20 percent of the employee FICA tax liability determined without regard to section 3509. If the employer failed to meet the applicable reporting requirements, the percentages are increased to 3 percent and 40 percent, respectively.

The employee remains liable for the employee portion of the FICA tax as section 3509(d)(1)(A) provides that the employee's liability for the tax shall not be affected by the assessment or collection of the tax under section 3509. However, section 3509(d)(1)(B) provides that the employer may not recover from the employee any of the tax it pays that is determined under section 3509. Also if section 3509 applies, section 3509(d)(1)(C) provides that the mitigation provisions of sections 3402(d) and 6521 shall not apply. Under section 3402(d), an employer who failed to withhold income tax can be relieved from liability for income tax withholding if the employer can establish that the employee paid income tax on the wages at issue. Under section 6521, a reclassified employee is permitted to offset FICA tax owed with self-employment tax paid if the statute of limitations to claim a refund of the self-employment taxes has closed.[2]

[1] The section 3509 rates for income tax withholding liabilities have consistently been available for state and local employers as income tax withholding is not dependent upon section 218 coverage.
[2] Proposed regulations under section 3509 were published in the Federal Register on January 7, 1986. They have not been finalized and they do not address the issue at hand.

Section 3509 was enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which also indefinitely extended the relief from federal employment tax obligations afforded under section 530 of the Revenue Act of 1978. See Pub. L. No. 97-248, Secs. 269(c)(1) and (2), and 270(a), 96 Stat. 552 (September 3, 1982). The legislative history makes clear that section 3509 was intended to provide some financial relief to taxpayers that did not qualify for relief under section 530.

The Senate Finance Committee ("the Committee") articulated the three major problems that arose for employers when workers were reclassified: (1) the employer may be assessed FICA and FUTA taxes for tax years that are not barred by the assessment statute of limitations, (2) overpayments of income taxes may occur if the employer is required to pay income tax withholding on reclassified employees who may have already paid income tax, and (3) overpayments of FICA may occur if the employer is required to pay FICA taxes on behalf of employees who may have already paid SECA tax own their own behalf. S. Rep. No. 97-494, at 370. In other words, an employer could be assessed for significant tax liabilities when at least some of the assessed taxes had been paid by the reclassified workers.

The Committee further noted that it was "aware that employment tax controversies that led to the enactment of the interim relief provisions of the Revenue Act of 1978 were aggravated by 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. The Committee recognized and understood that the Service would adjust the assessments for an employer's failure to withhold income tax only if the employer could furnish certificates, signed by the reclassified workers verifying that they had paid their income taxes. However, the Committee noted that obtaining this evidence from reclassified workers could be impractical and difficult in particular for employers with either a high employee turnover rate, or who may have employees who are uncooperative in furnishing the required certificates. The Committee also noted the possibility of double collection of social security taxes. Id. at 371.

Congress intended that section 3509 would substantially simplify the procedures for reclassification and reduce burdens on employers whose workers were reclassified. Under section 3509, the fractional amounts of employment taxes an employer would owe were intended to reflect "appropriate sanctions for an employer's erroneous failure to withhold taxes from compensation paid to an employee, regardless of the actual level of taxpayer compliance in any particular case." S. Rep. No. 97-494, at 372. The fractions Congress implemented in section 3509 are intended to approximate the average amount of liability the employer would incur under current law after reducing the employer's initial liability by the taxes paid by the employee. The Committee believed that the assessment of the amounts 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. The Committee, however, stressed that section 3509 would not provide relief to those employers that treat workers as "an employee for income tax

purposes but not for social security purposes." Id. In addition, the Committee stated that relief under section 3509 would not be available to those employers that intentionally disregard the law. Id.

Section 3121(d)(4)

Section 3121(d)(4) defines "employee" for FICA tax purposes to include "any individual who performs services that are included under an agreement entered into pursuant to section 218 of the Social Security Act" (the Act). Section 218 of the Act allows states to enter into voluntary agreements with the Commissioner of Social Security that extend the social security insurance system to services performed by individuals (within specified coverage groups) as employees of the state, or any political subdivision thereof. 42 U.S.C. section 418(a)(1). The Act requires that an individual who performs services included in an agreement under section 218 of the Act must be an employee of the State or political subdivision. The definition of employee in the Act at section 210(j)(2) is identical to the definition in Code section 3121(d)(2). Both the Act and the Code provide that the term employee means an individual who, under the usual common law rules applicable in determining the employer-employee relationship has the status of an employee. Thus each statute looks to the common law test to determine whether a worker is an employee.

Section 3121(d)(4) of the Code was enacted in the Omnibus Budget and Reconciliation Act of 1986 (OBRA '86). OBRA '86 repealed certain provisions of the Act and enacted new Code provisions thereby converting social security contributions made under a section 218 agreement into FICA taxes governed by the provisions of the Code. See Pub. L. No. 99-509, Sec. 9002 100 Stat. 1971 (October 21, 1986).

OBRA '86 also enacted section 3121(b)(7)(E) providing that service included under a section 218 agreement is not exempt from the definition of employment for FICA tax purposes. Together sections 3121(d)(4) and 3121(b)(7)(E) deem any individual who is covered by a section 218 agreement to be an employee engaged in employment for FICA tax purposes. Thus, an employer whose workers are covered by a section 218 agreement is required to withhold and pay FICA taxes on wages paid to those employees.

Congress' intent in enacting section 9002 of OBRA '86, as reflected in the legislative history, was to eliminate each state's intermediary role and raise revenue by requiring states and local entities to deposit their FICA taxes under the same deposit schedule as private employers. Prior to the amendment, local governments passed their contributions to the states that in turn paid the contributions to the Federal Reserve bank on a semimonthly basis. Congress noted that private employers were required to make payroll tax payments under a "schedule that links the frequency of deposits to the amount of taxes withheld." H.R. Conf. Rep. No. 99-1012, at 368. These same deposit rules already applied to government employers for depositing federal income taxes withheld. Hence, state and local employers were placed under "the same schedule for frequency of deposits as applies under present law to the private-sector employers (and

to deposits of Federal income taxes withheld by State and local government employers)." Id.

OBRA '86 also repealed provisions generally addressing how social security contributions made pursuant to a section 218 agreement were to be assessed and collected, and how controversies and disputes between Health and Human Services (which then administered the Act) and the states regarding social security contributions were to be resolved.[3] There is no indication in the legislative history that Congress took into account that the enforcement provisions in the Code, including the relief provided under certain circumstances by section 3509, were different than the enforcement provisions under the Act. For example, if a state or local entity failed to pay its social security contributions, HHS was authorized to reduce amounts it might otherwise pay to the state. See Section 218(j).

Under the plain language of section 3509 a state or local government employer that is subject to a section 218 agreement may use section 3509 rates to determine its liability for taxes where it has erred by failing to treat certain employees as covered by the agreement such that their wages were subject to FICA. Section 3509(a) provides:

> In General – If *any* employer fails to deduct and withhold *any* tax under chapter 24 (ITW) or subchapter A of chapter 21 (employee FICA) with respect to any employee by reason of treating such employee as not being an employee for purposes of such chapter or subchapter, the amount of the employer's liability for . . . . (*emphasis added*).

Thus, the general rule applies to "any" employer, and to the extent certain employers and employees are excluded, the exclusions are specified in the statute. See, e.g., section 3509(c), which provides the section shall not apply in cases of intentional disregard and section 3509(d)(3), which provides that the section shall not apply to any employer with respect to any wages if the employer withheld income tax but failed to withhold and pay FICA taxes. Also see section 3509(d)(3) which excludes statutory employees.

In addition, following the enactment of OBRA '86 Congress took action to correct a flawed cross reference between section 3509 and section 3121(d). Congress had intended for section 3509 to be available where employees had been improperly treated as outside of coverage of a section 218 agreement. However, when section 3121(d)(4) was enacted, what is currently referred to as section 3121(d)(4) (section 218 workers) was codified at section 3121(d)(3), while what was codified at section 3121(d)(3) (pertaining to statutory employees), was redesignated as section 3121(d)(4). See Pub. L. No. 99-509, Sec. 9002(b)(2). The sections as we know them today were reversed. Congress later recognized that by originally codifying the present-day section 3121(d)(4) at section 3121(d)(3), the cross reference in section 3509(d)(3) to section 3121(d)(3) had the effect of denying section 3509 rates where section 218 agreements

[3] Regulations still exist, which guide states on how to pay social security contributions that were required to be paid prior to 1987. See 20 C.F.R. sections 404.1200, et seq.

were involved, but leaving section 3509 rates available with respect to statutory employees. Congress attempted to correct this in section 2003 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). See Pub. L. No. 100-647, Sec. 2003(d), 102 Stat. 3598 (November 10, 1988). The technical amendment amended section 3509(d)(3)'s reference to section 3121(d)(3) to reference section 3121(d)(4), the newly-designated statutory employee provisions. That Congress switched the cross reference implies that Congress wanted section 3509 rates to be available in cases involving section 218 agreements. Because this technical correction was not coordinated with another technical correction within TAMRA amending section 3121(d), see Pub. L. No. 100-647, Sec. 8016(a)(3), yet another correction was required to put the statute in its present form.

Furthermore, the underlying factual problem and policy concern that section 3509 was enacted to address applies equally with respect to employees under section 3121(d)(4) as it does under section 3121(d)(2). In both instances, the common law standard applies to determine whether or not a worker is an employee. The authority to make the determination is admittedly different. For workers evaluated under section 3121(d)(2), the Service has the authority to make the determination. For workers evaluated under section 3121(d)(4), the Social Security Administration has the authority to make the determination as it is a party to the section 218 agreements, not the IRS. Nevertheless, the possibility that an employer applying the common law standard in good faith in the context of section 3121(d)(4) may nonetheless reach a flawed result because of the heavily factual nature of the inquiry is still present.

As a practical matter, when the Service examines a public entity employer with a section 218 agreement, the Service will apply the common law test to determine whether the worker is an employee for income tax withholding purposes. If the Service concludes the worker is a common law employee, the SSA will usually agree that the worker, as an employee, is covered under the Section 218 agreement since only employees may be covered by section 218 agreements. As noted, the definition of employee in the Code and in the Act are the same. Thus, when applying the common law test for income tax withholding purposes, the Service is performing the exact analysis that needs to occur for purposes of section 218 of the Act. The Social Security Administration typically concurs with that determination. Accordingly, these examinations involve worker reclassification for both income tax withholding and FICA purposes, thus implicating application of section 3509 to determine the amount of the liability.

While application of section 3509 is somewhat in tension with the terms of the section 218 agreements themselves, which require the participating state and local governments to make full payment with respect to covered employees, we believe this tension results from the evolution of the law over time. When the states entered into their section 218 agreements, their social security contributions were distinct from FICA taxes. Only with the passage of OBRA '86 were their payments converted into FICA taxes under the Code.

Before OBRA ’86, if SSA established an underpayment of social security contributions under a section 218 agreement, the state was the party liable under the contract, not the governmental entity employing the individual. The Secretary of Health and Human Services, who was previously charged with governance of the section 218 agreements, was empowered to exercise discretion to deduct unpaid contributions and interest from any payment due to the state. See section 218(j) of the Social Security Act prior to repeal in 1986. With the enactment of OBRA ’86, Congress gave the enforcement provisions to the Service and made the employing government entity – rather than the state -- liable for the FICA taxes by enacting section 3121(b)(7)(E). Although the legislation did not explicitly address whether this change meant that section 3509 rates could apply rather than enforcement under the agreement of a requirement for full payment, the changes in the enforcement provisions suggest that Congress intended for disputes with respect to the amount of the liability for FICA taxes owed pursuant to a section 218 agreement to be resolved in the same way as other employers resolve disputes with respect to FICA taxes. Congress’s subsequent activity in correcting the cross references between section 3121(d) and section 3509 suggests that it contemplated that section 3509 rates would be available.

In conclusion, state and local government employers are entitled to use section 3509’s reduced tax rates in figuring FICA tax liabilities with respect to workers who were not treated as covered by a section 218 agreement and are determined to be covered by the agreement and therefore, to be employees under section 3121(d)(4).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand that in some examinations taxpayers will not agree with the determination that a worker is an employee and as such is covered by the section 218 agreement. This raises the issue of whether the Service can use the section 7436 procedures and issue a Notice of Determination of Worker Classification in connection with the reclassification or whether the FICA tax liability must be assessed. If FSLG encounters this concern in a case, please request assistance from this office at your earliest convenience. This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call me at (202) 622-7235 if you have any further questions.