

# EMPLOYMENT TAX BASICS AND PATHS TO COMPLIANCE<sup>1</sup>

**Author**  
Fanny Karaman

**Tags**  
Employment Tax  
Form 941  
Tax Compliance

When non-U.S. entities expand to the U.S., they face several issues, all of them new. These include the legal form under which business will be conducted in the U.S., certain elections for U.S. income tax purposes, filing obligations and disclosures of certain information relating to the non-U.S. owners, deciding whether to hire local employees or employees that have a background both in the U.S. and the country of the parent company, determining comparable U.S. wages to wages paid for the same job in the country of the parent, and many others. Last but not least, the newly created U.S. subsidiary must also comply with U.S. employment tax requirements relating to their employees.

If set up correctly, compliance is generally straightforward. Non-compliance often arises because certain payments made to employees are not identified as wages. Once non-compliance is identified, the matter becomes substantially more complicated and the burden on the U.S. subsidiary is considerable.

## WITHHOLDING OBLIGATION

The term “employment taxes” broadly refers to the income tax and social security taxes that must be withheld by employer’s on an employee’s wages.

Code §3402 requires employers to deduct and withhold income tax on the amount of wages that are paid to employees. Similar rules may exist at the state and local levels. For this purpose, the definition of wages is broad and the fact that an individual no longer is an employee at the time of payment is immaterial.<sup>2</sup>

“Wages” are generally defined as any remuneration for services performed by an employee for his or her employer, including the cash value of all remuneration (including benefits) paid in a medium other than cash.<sup>3</sup> This is where issues generally start for non-U.S.-owned subsidiaries. The name by which the remuneration is actually designated is immaterial. Wages include the following:<sup>4</sup>

- Salaries
- Fees
- Bonuses

---

<sup>1</sup> The author would like to acknowledge the contribution of Michael A. Zimmerman of Kane Kessler in the preparation of this article.

<sup>2</sup> Treas. Reg. §31.3401(d)-1.

<sup>3</sup> Code §3401(a).

<sup>4</sup> Treas. Reg. §31.3401(a)-1(a)(5).

- Commissions on sales
- Commissions on insurance premiums
- Pensions
- Retired pay

An employer is liable for the payment of the tax whether or not it is collected from the employee by the employer.<sup>5</sup>

In addition to income taxes, an employer must withhold employee Federal Insurance Contributions Act (“F.I.C.A.”) taxes from an employee’s wages.<sup>6</sup> The employer is liable for these taxes with respect to all wages paid to each employee whether or not it is collected from the employee.<sup>7</sup> The employer is also liable for employer F.I.C.A. taxes<sup>8</sup> and must withhold Federal unemployment tax (“F.U.T.A.”).<sup>9</sup>

F.I.C.A. taxes are divided into old-age, survivor, and disability insurance (“O.A.S.D.I.”) and hospital insurance (“H.I.”) taxes.<sup>10</sup> The employee’s part of F.I.C.A. taxes must be withheld by the employer at a combined 7.65% rate,<sup>11</sup> 6.2% for O.A.S.D.I. and 1.45% for H.I. An additional 0.9% tax must be withheld on wages in excess of \$250,000 for joint filers (the “Additional Medicare Tax”).<sup>12</sup> The maximum amount of wages subject to F.I.C.A. is \$127,000 in 2017.<sup>13</sup>

F.U.T.A. is withheld at a 6% rate on the first \$7,000. No limit on withholding exists for F.U.T.A. purposes.<sup>14</sup>

Generally, employers must file Form 941, *Employer’s Quarterly Federal Tax Return*, to report quarterly F.I.C.A. and income tax withholdings.<sup>15</sup> The filing deadline is the last day of the month following the end of each quarter. F.I.C.A. and income tax deposits must be made either monthly or semi-weekly.<sup>16</sup>

F.U.T.A. is reported annually on Form 940, *Employer’s Annual Federal Unemployment Tax Return*,<sup>17</sup> which must generally be filed by January 31 of the following year.<sup>18</sup> F.U.T.A. taxes must generally be deposited with an authorized financial institution by the last day of the month following the end of any calendar quarter in which

**“An employer is liable for the payment of the tax whether or not it is collected from the employee by the employer.”**

<sup>5</sup> Treas. Reg. §31.3403-1.

<sup>6</sup> Code §§3101 and 3102.

<sup>7</sup> Treas. Reg. §31.3102-1(d).

<sup>8</sup> Code §3111.

<sup>9</sup> Code §3121(b); Treas. Reg. §31.3301-1.

<sup>10</sup> Code §3101.

<sup>11</sup> Code §§3101(a), 3111(a), and 3101(b)(1).

<sup>12</sup> Code §3101(b)(2).

<sup>13</sup> Code §3121(a)(1); S.S.A. Notice, 81 Fed. Reg. 74,854 (Oct. 27, 2016).

<sup>14</sup> Code §3121(a)(1).

<sup>15</sup> Treas. Reg. §§31-6011(a)-1(a)(1) and 31.6011(a)-4(a).

<sup>16</sup> Treas. Reg. §31.6302-1.

<sup>17</sup> Treas. Reg. §31.6011(a)-3(a).

<sup>18</sup> Treas. Reg. §31.6071(a)-1(c).

the employer's undeposited tax liability exceeds \$500.<sup>19</sup>

Additionally, employers must file Forms W-2, *Wage and Tax Statement*, and W-3, *Transmittal of Wage and Tax Statements*, with the social security administration by January 31 following the calendar year of the withholdings and provide employees with copies B, C, and 2 of Form W-2 by the same date.<sup>20</sup>

## FAILURE TO COMPLY

### Interest

Underpayment interest is due for any tax imposed by the Code that is not paid on or before the payment due date for such tax.<sup>21</sup> As an exception, interest-free adjustments are available for F.I.C.A. and income tax underreporting and underpayments, unless, *inter alia*, the employer knowingly underreported such taxes.<sup>22</sup>

Interest-free adjustments are available for F.I.C.A. tax purposes (other than the Additional Medicare Tax) for the current year and previous years, by filing Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*. The filing deadline is determined by the return period in which the error is ascertained (*i.e.*, when the employer has sufficient knowledge of the error to be able to correct it).

Interest-free adjustments are available for income tax and Additional Medicare Tax purposes only if (i) the adjusted return is filed by the Form 941 filing deadline for the return period in which the error is ascertained and (ii) the error is ascertained within the same calendar year that the wages are paid to the employee.<sup>23</sup> Corresponding payments must be made by the time the adjusted return is filed.<sup>24</sup> In addition, Forms W-2c, *Corrected Wage and Tax Statement*, and W-3c, *Transmittal of Corrected Wage and Tax Statements*, must be filed with the social security administration and a copy must be provided to the employee(s). For prior years, the Federal income tax withholding amount reported on Form W-2c and Form W-3c will not change, since the employer may not withhold income taxes from an employee after the calendar year in which the wages were paid.<sup>25</sup>

### Penalties

In addition to interest payments, penalties can also be assessed. Their purpose is to enhance voluntary compliance,<sup>26</sup> which is achieved when a taxpayer (i) makes a good faith effort to meet the tax obligations defined by the Code<sup>27</sup> or (ii) conforms to

---

<sup>19</sup> Treas. Reg. §31.6302(c)-3(a).

<sup>20</sup> Treas. Reg. §31.6051-1(d)(1).

<sup>21</sup> Code §6601.

<sup>22</sup> Code §6205; Revenue Ruling 2009-39; Treas. Reg. §31.6205-1(b)(2).

<sup>23</sup> Treas. Reg. §§31.6205-1(b)(4) and 31.6205-1(c)(2).

<sup>24</sup> Treas. Reg. §§31.6205-1(b)(2), 31.6205-1(b)(4), and 31.6205-1(c)(2).

<sup>25</sup> Treas. Reg. §31.6051-1(c)(2).

<sup>26</sup> Internal Revenue Manual ("I.R.M.") 1.2.20.1.1 (06-29-2004); I.R.M. 20.1.1.2.1 (11-25-2011).

<sup>27</sup> I.R.M. 20.1.1.2.1(6) (11-25-2011).

the law without compulsion or threat.<sup>28</sup>

Code §6651 provides a penalty for failure to pay tax, unless the taxpayer can show that the failure is due to reasonable cause and not due to willful neglect. For this purpose, “willful neglect” is defined as “a conscious, intentional failure or reckless indifference.”<sup>29</sup>

Code §6656(a) provides a penalty for failure to deposit tax on the date prescribed, unless that failure is demonstratively due to reasonable cause, rather than willful neglect. Further, when adjusted returns are filed pursuant to Treas. Reg. §31.6205-1, the taxes will be deemed paid timely for purposes of Code §6656, if the payments are submitted at the same time as the adjusted filings.<sup>30</sup>

Code §6662 provides an accuracy-related penalty for underpayments of tax required to be shown on a return when the underpayment is due to (i) negligence or disregard of rules or regulations, (ii) a substantial understatement of income tax, (iii) a substantial valuation misstatement, (iv) a substantial overstatement of pension liabilities, or (v) a substantial estate or gift tax valuation understatement. For this purpose, “negligence” includes any failure to make a reasonable attempt to comply with the provisions of the Code. The term “disregard” includes any careless, reckless, or intentional disregard. No penalty is imposed with regard to any portion of an underpayment if it is shown that there was a reasonable cause and that the taxpayer acted in good faith with respect to such portion.<sup>31</sup> Reliance on the opinion of a professional tax advisor can constitute reasonable cause for this purpose, no matter the form of the particular advice.<sup>32</sup> All facts and circumstances must be taken into account and the tax advisor must be competent with respect to the specific tax matter.<sup>33</sup> Reasonable cause relief is generally granted when a taxpayer exercises ordinary care and prudence in determining its tax obligations but nevertheless is unable to comply with these obligations.<sup>34</sup>

**“If the employee pays the under-withheld tax, it cannot be collected a second time from the employer.”**

## COMING INTO COMPLIANCE

As previously stated, an employer is liable for the income tax payment, whether or not it is collected from the employee.<sup>35</sup> However, if the employee pays the under-withheld tax, it cannot be collected a second time from the employer.<sup>36</sup> Thus, an employer can eliminate its liability for failure to withhold income taxes in prior years if it can show that the relevant employee paid the related income taxes.<sup>37</sup> For this purpose, the employer must secure Form 4669, *Statement of Payments Received*,

<sup>28</sup> I.R.M. 20.1.1.2.1(1) (11-25-2011).

<sup>29</sup> *U.S. v. Boyle*, 469 U.S. 241 (1985).

<sup>30</sup> Treas. Reg. §31.6302-1(c)(7).

<sup>31</sup> Code §6664(c)(1).

<sup>32</sup> Treas. Reg. §§1.6664-4(c)(1) and 1.6664-4(c)(2).

<sup>33</sup> Treas. Reg. §§1.6664-4(c)(1).

<sup>34</sup> I.R.M. 20.1.1.3.2. (11-25-2011) – *Reasonable Cause*; Treas. Reg. §301.6651-1(c).

<sup>35</sup> Treas. Reg. §31.3403-1.

<sup>36</sup> Code §3402(d).

<sup>37</sup> Code §3402(d); Treas. Reg. §31.3402(d)-1.

from the employee.

Equivalent forms can generally be obtained for state and local tax purposes by contacting the relevant authorities. At the New York level, for instance, the taxpayer can request Form AU-7 from the New York State Department of Taxation and Finance. This form essentially requests the same information as Form 4669.

A question often arises when (i) a former employee cannot be located or (ii) an employee, generally a former employee, does not want to cooperate. In such cases, the income tax liability could potentially be collected twice by the I.R.S.: once from the employee who paid income taxes on the compensation and once from the employer upon coming into compliance.

This exact issue was addressed by the U.S. Tax Court in *Mescalero Apache Tribe v. Commr.*<sup>38</sup> In this case, the I.R.S. reclassified independent contractors of the Mescalero Apache Tribe (“Taxpayer”) as employees (the “reclassified contractors”), which resulted in an assessment of uncollected income tax withholdings. Taxpayer tried to secure Forms 4669 from the reclassified contractors but was unable to locate 70 of them. Taxpayer then made a motion to compel discovery, arguing that the I.R.S. had access to the information requested by Form 4669 since it had access to the reclassified contractors’ past tax returns. Although returns and return information generally cannot be disclosed under Code §6103, Code §6103(h)(4)(C) provides that:

A return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration, but only if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

The Tax Court held that the disclosure of third-party taxpayer information to absolve an employer of its income tax withholding obligation is not barred by Code §6103(h). This case is relevant for taxpayers in the judicial or administrative proceeding stage. However, taxpayers generally come into compliance well before this stage.

Even when providing Form 4669, the employer remains liable for any penalties or additions to tax that arise from the failure to withhold.<sup>39</sup>

Further, any underwithheld employment taxes paid at the time the employer comes into compliance on behalf of the employees constitute additional wages for the respective employees. These must be included in the wages of every employee in the year of compliance.<sup>40</sup>

In addition to any state and local amendments, the following Federal forms must be filed when coming into compliance:

- Form 941X, *Adjusted Employer’s Quarterly Federal Tax Return or Claim for Refund*, to be filed with the I.R.S.

---

<sup>38</sup> *Mescalero Apache Tribe v. Commr.*, 148 T.C. 11, April 5, 2017.

<sup>39</sup> Code §3402(d).

<sup>40</sup> Treas. Reg. §1.61-14(a).

- Amended Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, to be filed with the I.R.S.
- Form W-2c, *Corrected Wage and Tax Statement*, to be filed with the Social Security administration
- Form W-3c, *Transmittal of Corrected Wage and Tax Statements*, to be filed with the Social Security administration

In order to track any mismatch between the payments made at the time of submission and the amounts requested on follow-up notices issued by the I.R.S., the taxpayer should request a transcript of the taxpayer's account. This can be obtained by calling the I.R.S. and requesting that the transcripts either be mailed or faxed. Notably, since processing takes about two months, the transcripts may not reflect the latest communications with or payments to the I.R.S.

## CONCLUSION

Employment taxes include a range of income and social security taxes that must be withheld from an employee's paycheck, although the liability for these taxes rests on the employer.

While coming into compliance always involves a substantial amount of paperwork and numerous communications, in most compliance cases, the only parties involved are the taxpayer and the I.R.S. Employment tax compliance involves an additional taxpayer: the employee. This adds complexity with an internal corporate management aspect. A voluntary disclosure program would be a welcome addition to the current regime, as it could alleviate the compliance process and costs.

