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NEW IRS DEVELOPMENTS TO ADDRESS IMPROPER EMPLOYEE CLASSIFICATION

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As the federal government and states look for revenue, an increased emphasis has been put on taxpayers to report and file amounts paid to independent contractors using Internal Revenue Service (“IRS”) Form 1099 and the equivalent state forms. A byproduct of this has been an increased emphasis by special teams within the IRS on the review of whether these independent contractors are actually employees of a taxpayer’s business. The reasons for this are two-fold. First, if taxing authorities can force employers to treat independent contractors as employees, there is less involved in enforcing the tax collection and payment since it is easier to seek payment from an employee than it is to chase down independent contractors who may not be fully compliant with tax withholding and paying requirements. Secondly, there is a perception of abuse in the misclassification of employees as independent contract as a way to avoid tax burdens placed on employers.

As a result of this increased focus by IRS and the States, the IRS has recently implemented a new Voluntary Classification Settlement Program (“VCSP”) to try to entice employers who might be reluctant to review their treatment of independent contractors. As part of this effort, the IRS has also entered into a Memorandum of Understanding (“MOU”) with the Department of Labor (“DOL”). This MOU allows for the IRS and DOL to share information related to worker misclassification in order to coordinate agency efforts to reduce future misclassifications. Existing programs already allow the IRS to share information with the states should either an IRS or state level audit prove fruitful.

The VCSP allows an employer who may be facing this issue of whether it has improperly classified non-employees (e.g., independent contractors) as employees to reclassify those workers as employees and in so doing limit their potential tax liability for prior years. Depending on the size of this misclassification (in dollar terms), the IRS has the ability to go back more than the standard three year statute of limitations and in any case assess substantial tax, interest and penalties if a misclassification is discovered. Employers who are concerned

about a potential misclassification issue and its economic effect should at least consider the new VCSP. What follows are some frequently asked questions related to the VCSP and a few words of caution concerning pursuing the VCSP option.

Questions and Answers:

Is my company required to participate in the VCSP if I have misclassified workers?

No, the VCSP is an optional program, but the IRS has attempted to incentivize employer participation by limiting federal employment tax liability for past nonemployee treatment of workers. Further, a company choosing to participate in the VCSP is not obligated to reclassify all of its misclassified workers. A company can, for example, elect to reclassify a class of workers under the VCSP, but in doing so all workers in that class must be classified as employees for employment tax purposes.

Is my company eligible to participate in the VCSP?

In order to qualify for the program, an employer must meet three criteria:

- The employer must have consistently treated the class of worker it seeks to reclassify as non-employees and must have filed all required Forms 1099 with respect to those workers in the previous three (3) years.
- The employer must not be subject to an IRS audit for any reason or subject to a DOL or related state agency audit with respect to that employer's classification of its workers.
- Any employer who was previously subject to an audit described above must have fully complied with the results of that audit.

What must my company do to participate in the VCSP?

After meeting the eligibility requirements above, an employer must submit a VCSP application on [Form 8952](#) to the IRS at least sixty (60) days prior to the date an employer wants to begin treating the workers in question as employees. If the IRS approves an employer's application, the IRS and employer will enter into a closing agreement in which the employer will agree to: (1) treat the class of workers it wishes to reclassify as employees for future tax periods; (2) pay a reduced employment tax amount that may have been due on compensation paid to those workers in the most recent tax year; and (3) be subject to a special six-year statute of limitations on the assessment of employment taxes, instead of the three-year period normally applicable for three calendar years after the agreement is signed.

What is my federal employment tax liability following reclassification?

An employer participating in the VCSP agrees to pay ten percent (10%) of the employment tax liability calculated pursuant to the reduced rates of Section 3509(a) of the Internal Revenue Code. This calculation is based on compensation paid to workers for the most recent tax year. For example, a 2011 VCSP application will have tax liability determined from 2010 tax percentages under Section 3509(a).

What is the significance of the MOU entered into between the IRS and DOL?

The information sharing agreement entered into on September 19, 2011 between these two departments will allow the IRS to provide the DOL with information relating to trends in worker misclassification including evidence of a violation of any Federal criminal law that the DOL enforces. Importantly, the agreement does not expressly exempt information that the IRS may gain from employers through the VCSP. As the DOL [press release](#) indicates, the DOL is concerned with the evasion of federal labor laws that may arise out of worker misclassification. Thus, although the VCSP may provide reduced tax liability following reclassification, there is concern that in doing so, an employer may expose itself to liability involving federal labor laws relating to pensions, employee benefits, and other similar federal regulations.

Conclusion

Employers should carefully evaluate their worker classifications to see if it would be beneficial to participate in the VCSP, but are cautioned to consider possible exposure to labor related liability that may arise following reclassification including potential employee benefit concerns. Employers should weigh the tax benefits with the potential labor law exposure that may arise out of participation in the VCSP.

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