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LEGAL ALERT

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IRS Announces the 'Voluntary Classification Settlement Program' to Reduce Federal Employment Tax on Worker Misclassification

by Geoffrey L. Gunnerson, Carlene Y. Lowry, Mark A. Ziemba and Tiffanny Brosnan

Misclassifying workers as independent contractors rather than employees can carry significant tax consequences. These tax consequences impact not only the employer entity but can also result in personal tax liability to the persons with an ability to direct the employer's finances. For this reason, many employers who may have misclassified workers are hesitant to come forward, even if their workers may be more accurately classified as "employees."

On September 21, 2011, the Internal Revenue Service (IRS) announced the Voluntary Classification Settlement Program (VCSP), in which the IRS permits employers to prospectively reclassify workers as employees with limited federal employment tax liability and without an IRS audit or administrative correction procedure. No change would need to be made to the treatment of the workers on a retroactive

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basis for federal employment tax purposes.

In lieu of the usual federal unemployment tax, Social Security and Medicare taxes and federal income tax wage withholding and related penalties and interest that would otherwise be due for all open tax years if the IRS reclassified workers pursuant to an audit, an employer who meets the VCSP requirements would, instead, resolve its federal employment tax obligations by paying 10 percent of the prior year's employment taxes, calculated under a reduced rate structure. The result would be a tax approximating one percent of the wages paid to the reclassified workers for the past year.[1] The employer would not be liable for penalties or interest on the payment and would not be subject to a federal employment tax audit with respect to the classification of such workers for prior years. Normal audit rules would apply to any workers who were not reclassified.

In order to participate in VCSP an employer must: (1) have consistently treated the workers as nonemployees; (2) have filed all required Forms 1099 for the workers for the previous three years; (3) not currently be under audit by the IRS for any reason; (4) not currently be under audit by the Department of Labor or by a state government agency concerning the classification of the workers; (5) complete an application; (6) enter into a closing agreement with the IRS in which the employer agrees to prospectively treat the class of workers as employees; (7) pay the full amount due under VCSP when the closing agreement is submitted; and (8) agree to extend the period of limitations on assessment of federal employment taxes for three additional years for the first, second and third calendar years beginning after the date on which the employer enters the VCSP closing agreement. As an example, if the employer reclassified its workers starting in 2012, then the 2012-2014 tax years would be open to IRS audit for six years rather than three.

Note that the application should be filed 60 days before the date the employer wants to begin treating the workers as employees. Further, the IRS retains

discretion whether to accept a VCSP application. While it appears applications would only be rejected for ineligibility, the employer must consider that—although it did not admit worker misclassification through its application—unless accepted into the program, there is no protection from an IRS audit.

The IRS has yet to provide a definitive answer regarding whether an employer who has failed to *timely* file all Forms 1099 for all reclassified workers for the previous three years would be eligible for VCSP (i.e., if the Form 1099-MISC was filed late for one worker or has yet to be filed for certain workers, regardless of the reason). In our call with the IRS, they indicated that this issue is still being discussed, but they anticipate that guidance on the issue is forthcoming.

Private businesses, tax-exempt organizations and government entities (with certain limited exceptions) are eligible to participate in VCSP. Additionally, employers who have been audited in the past by the IRS or Department of Labor regarding worker classification and who have complied with the results of the audit are eligible participants so long as the audit is not ongoing. An employer currently under audit may be eligible for the IRS Classification Settlement Program.

The decision of whether to enter VCSP must also be considered in light of the fact that the employer would generally have to reclassify the workers for both state and federal employment tax purposes. If corollary programs at the state level are not forthcoming, then the employer may be responsible for state employment taxes for all open tax years.[2]

As one example, California employers should be particularly cautious before entering the VCSP because of an anticipated new state law labeled by some as the "Job Killer Act." California Senate Bill 459 was passed by the legislature and is expected to be signed by Governor Jerry Brown. Senate Bill 459 makes it unlawful for an employer to willfully misclassify an individual as an independent

contractor. It defines "willful misclassification" as "avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor." Willful misclassification can lead to penalties ranging from $5,000 up to $25,000 per violation where there is a pattern or practice of violations. This puts employers between the proverbial rock and a hard place: enter the VCSP to satisfy the feds, but risk steep state penalties if a willful misclassification is found. Given that both the federal and the state law have not yet been tested, California employers considering the VCSP should undergo fact-specific, particularized analysis of each position on a case-by-case basis. Employers in other states should consider the risks of entering VCSP under their state-specific laws as well.

Additionally, worker reclassification would have to be considered from a non-tax perspective, such as issues that could arise regarding overtime, workers compensation, employee benefits, immigration filing requirements (e.g., Form I-9) and Title VII requirements. These issues would need to be considered on a prospective and a retroactive basis.

Note that VCSP has no impact on an employer's eligibility for relief from employment taxes pursuant to Section 530 of the Revenue Act of 1978. At a general level, Section 530 relief exists when the employer: (i) had a reasonable basis for not treating the workers as employees; (ii) treated the workers, and any similar workers, as independent contractors; and (iii) filed all required federal tax returns (including Forms 1099-MISC) consistent with the employer's treatment of each worker as a non-employee.

VCSP is part of a larger "Fresh Start" initiative at the IRS that is designed to help taxpayers and businesses address their tax responsibilities. The IRS has not currently provided an end date for VCSP.

It should also be noted that the IRS and Department of Labor have both announced increased efforts to identify and correct employee misclassification. For more information on this topic, see the article in the

October 2011 issue of The Workplace Word newsletter.

If you have any questions about the content of this legal alert, you may contact the authors or another Snell & Wilmer attorney by email or by calling 602.382.6000.

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Notes:

[1] The tax is 10 percent of the prior year employment tax liability with respect to the reclassified workers using the reduced rates under IRC § 3509. The tax due under IRC § 3509 is calculated based on assumed withholding and FICA rates. Whereas IRC § 3509 applies so long as the failure to treat the workers as employees was not willful, there is no indication that a willful misclassification of the workers would disqualify an employer from VCSP or would result in the higher alternative penalty structure present in IRC § 3509 for intentional misclassification. However, the IRC § 3509 penalty structure may apply to an employer despite late-filed Forms 1099-MISC, whereas employers may ultimately be ineligible for VCSP if any Forms 1099-MISC were late filed. [back]

[2] In certain situations, there may be steps an employer can take to help preserve an argument that its workers were independent contractors prior to the reclassification date, but this would depend upon the specific employer's facts. [back]

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