

The IRS Announces New Program For Reclassification Of Independent Contractors

Last week we discussed pending California legislation that would add penalties for employers who misclassify workers as independent contractors. The federal government has also expressed concern about misclassification of workers and on September 21, 2011, the IRS announced a new program designed to encourage employers to voluntarily reclassify those independent contractors who should be classified as employees. The IRS hopes to induce employers to make a voluntary reclassification by offering certain immunity for past practices through its Voluntary Classification Settlement Program (“VCSP”).

According to the Government Accountability Office, the federal government loses over two billion dollars in unpaid federal taxes annually because employers improperly classify some workers as independent contractors. The new VCSP initiative offers employers the opportunity to prospectively reclassify individuals as employees without being subject to an IRS audit or the standard administrative correction process. In addition, the VCSP initiative offers certain financial incentives for employers who participate. An employer who voluntarily reclassifies workers through the program will pay only 10% of the previous year’s employment tax liability and will not have exposure to interest, penalties, back taxes or misclassification audits for previous years for the voluntarily reclassified workers. In order to obtain these benefits, the participating employer will sign an agreement with the IRS that extends the statute of limitations for IRS misclassification audits from three to six years and must fully pay the total amount of employment taxes due under the reclassification program at the same time the employer signs the agreement.

In order to be eligible for the VCSP, employers must have consistently treated the workers it wishes to reclassify as independent contractors for three previous years. In other words, the employer must show that it filed 1099s for each of the workers for prior years. If the worker has been employed less than three years, the employer must show 1099s for the entire period of employment until application to participate in the program.

The new IRS program is not available to employers currently under investigation by the Department of Labor or a state agency for worker misclassification. Neither is the program available to an employer currently being audited by the IRS or an employer currently contesting a worker classification issue with the IRS. Also, the IRS has not issued any guidance about how participation in the voluntary program will affect employers who subsequently face an audit by a state or local agency. In light of the recent agreement between the IRS, the Department of Labor and several states to share information on the topic of worker misclassification, this is a worrisome issue that needs resolution.

As we have discussed many times in these Alerts, improper classification of workers creates significant economic risk for employers from IRS audits, Department of Labor investigations and their state counterparts. The new Voluntary Classification Settlement Program may provide a good opportunity to correct past errors while minimizing exposure to back taxes, interest and penalties. If



you have any questions about the program, other issues involving worker classification, or any employment related issues, please contact one of our attorneys:

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