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Misclassifying Employees vs. Independent Contractors: A New World of Forgiveness

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On Sept. 21, 2011, the IRS announced a new voluntary disclosure program, the Voluntary Classification Settlement Program (VCSP), to provide an incentive for taxpayers to comply with their employment tax obligations. The VCSP is part of a larger "fresh start" initiative by the IRS to encourage taxpayers and businesses to become compliant while giving them financial certainty under the VCSP's penalty framework. As described in IRS Announcement 2011-64, under the VCSP, eligible businesses will pay minimal back taxes and avoid all interest and penalties if they properly reclassify workers from nonemployees or independent contractors to employees for future tax periods. The VCSP currently has no deadline.

The announcement of the new VCSP was made in the wake of recent efforts by the IRS and the Department of Labor (DOL) to increase enforcement of worker classification and related employment tax obligations.

Classification as an Employee

Significant tax consequences result from the classification of a worker as an employee or as an independent contractor. For example, if a worker is an employee, the employer is responsible for withholding income tax, Social Security and Medicare tax from amounts paid to the employee and for paying over to the IRS the employer's portion of Social Security and Medicare tax ("FICA"), as well as the federal unemployment tax ("FUTA"). Under Internal Revenue Code (IRC) section 3121(d), whether a worker is performing services as an employee or an independent contractor is generally determined under the common law test of whether the recipient of the services has the right to direct and control the worker performing the services. In other words, an employer-employee relationship exists if the employer controls what work will be done and how it will be done. This is so whether or not the employer actually exercises that control; what is important is that the employer has the *right* to exercise control. In contrast, a worker is an independent contractor if the service recipient has the right to control only the result of the work, but not the means and methods by which that result is accomplished. But there are limited circumstances where workers treated as independent contractors under the common law test may nevertheless be treated as "statutory employees" for certain employment tax purposes. (See generally IRC section 3121(d)(3)-(4).)

Worker classification determined under the common law model is made on a case-by-case basis, depending on various facts and circumstances that fall under three general categories—

- behavioral control;
- financial control; and

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- relationship of the parties.

When analyzing behavioral control, the key factors that the IRS will consider are whether the business retains the right to control the worker and how the services are performed. The IRS will look to the level of instruction and training imposed on the worker, because more detailed instructions reflect greater control over the worker, making it more likely that the worker is an employee.

Financial control refers to whether or not the business has the right to direct and control the economic aspects of the worker's job. Facts that illustrate whether the business has financial control over a worker's activities include: any significant investments made by the worker, unreimbursed expenses, whether the worker's services are available to the general public, the method of payment and the worker's opportunity for profit or loss.

Lastly, the IRS looks at how the parties perceive their relationship and considers the parties' intents (as may be evidenced by a written agreement), whether employee benefits are provided, the business's right to discharge the worker or terminate services at will and whether the services provided are a key activity of the business. When analyzing the relationship of the parties, the length of time a worker performs services is not a standalone factor in determining status, and a worker may be an employee even if he or she only performs a few hours of services.

Eligibility and Terms

Under IRC section 3509, an IRS challenge to the classification of workers can result in the assessment of significant employment tax liabilities. The VCSP offers an opportunity to substantially reduce these liabilities, as well as to avoid the disruption and expense of a full-blown audit.

The VSCP has three basic eligibility requirements.

- The business must have consistently treated its workers as independent contractors or other nonemployees for the past three years. Not all workers have to be reclassified as employees under the VCSP, but once a taxpayer chooses to reclassify certain of its workers as employees, all workers in the same class must be treated as employees for employment tax purposes.
- The business must have filed all required IRS Forms 1099 for the workers for the previous three years, or if the workers have been with the business for less than three years, for the period of time that they worked for the business. Under the IRS's examination Classification Settlement Program, discussed below, if the business filed the required Forms 1099 for some workers, but not for others, relief is only available for those workers for whom the 1099s were filed. The VCSP Frequently Asked Questions are silent on this particular scenario.
- The business cannot currently be under audit by the IRS, even if unrelated to worker

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classification, and cannot the subject of a worker classification audit by the DOL or a state agency. For businesses that cannot participate in the VCSP due to an open IRS audit, the examination Classification Settlement Program ("CSP") may be available to resolve employment tax issues related to worker classification. Under the CSP, worker classification issues are resolved as early in the administrative process as possible, and businesses may reclassify certain workers as employees while incurring reduced employment tax liabilities for past years if certain criteria are met. Furthermore, if the IRS or the DOL previously audited the business with regard to worker classification, the business may participate in the VCSP only if it complied with the results of that audit.

The Penalty Framework

Under the VCSP, participating businesses that agree to properly treat a class or classes of workers as employees for future tax periods will pay 10 percent of the employment tax liability due on compensation paid to those workers for the most recently closed tax year at the time the VCSP application is filed. Adding further relief, the amount of the employment tax liability due on compensation will be calculated at the reduced rates provided by IRC section 3509(a), under which income tax withholding is computed at a rate of 1.5 percent of wages, and the employer's liability for FICA is computed at a rate of 20 percent of the employee's share, plus the entire employer's share. Under this penalty framework, participating businesses will pay "an amount effectively equaling just over one percent of the wages paid to the reclassified workers for the past year." In addition, participating businesses must agree to extend the statute of limitations on assessment of employment taxes for the three years subsequent to the first year for which they are participating in the program (i.e. they will be subject to a special six-year statute of limitations, rather than the usual three years that generally applies to payroll taxes).

In return, the IRS will not impose any interest or penalties, and the business will not be subject to an employment tax audit for prior years with respect to those workers reclassified under the program. Businesses accepted into the program will enter into a closing agreement with the IRS to finalize the terms of the VCSP. Participating businesses must make full and complete payment of all amounts due under the VCSP when they return the signed VCSP closing agreement to the IRS. The VCSP FAQs provide no provision for a payment plan for those businesses unable to settle their liabilities under the VCSP penalty framework.

Applying for the VCSP

Businesses interested in participating in the program should refer to the VCSP FAQs on the IRS website. Exempt organizations and government entities may also participate in the VCSP if they meet all of the eligibility requirements outlined above.

Eligible businesses can apply for the VCSP by filing IRS Form 8952, "Application for Voluntary

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Classification Settlement Program," at least 60 days before they intend to begin treating their workers as employees. On Dec. 5, 2011, the IRS issued an announcement on its website that submitting payment with a VCSP application could cause a processing delay.

A Safe Harbor Provision

Section 530 of the Revenue Act of 1978 may also provide relief from employment tax obligations resulting from worker misclassification.

Section 530's safe harbor provision terminates the liability of a business—but not a worker—for federal income tax withholding, FICA, and FUTA if certain stringent requirements are met. (It also means the business is not liable for any interest or penalties resulting from those employment taxes.) In order to receive relief under section 530, a business must meet the first two aforementioned eligibility requirements under the VCSP. In addition, a business must also have a reasonable basis for not having treated the workers as employees. Under section 530(a)(2), a business has a reasonable basis for not treating workers as employees if it can show that—

- it reasonably relied on a court case about federal taxes or a ruling issued by the IRS;
- it was audited by the IRS at a time when it treated similar workers as independent contractors and the IRS did not reclassify those workers as employees;
- it treated the workers as independent contractors because it knew that was how a significant segment of its industry treated similar workers; or
- it relied on some other reasonable basis, such as the written advice of an attorney or accountant.

If a business is engaged in worker misclassification and believes that it meets all three of the requirements outlined above, that business may be able to secure more substantial relief from potential past employment tax liabilities than those offered under the VCSP's penalty framework. Though the safe harbor provision under section 530 is not addressed in any of the VCSP guidance published by the IRS, businesses that participate in the VCSP should still be able to apply for relief under section 530. Whether businesses will have to "opt-out" of the VCSP to do so is yet to be seen.

The VCSP, like other recent IRS initiatives, uses a carrot-and-stick-approach. The program offers businesses the opportunity to come into compliance while limiting their tax liability and avoiding penalties and interest, the "carrot." At the same time, the IRS has intensified its enforcement efforts with regard to those worker misclassification practices the program aims at correcting, the "stick." Accordingly, businesses should carefully review their worker classification practices now in order to assess their compliance with employment tax obligations, and make an informed decision whether or not apply for the VCSP.

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