WORKER CLASSIFICATION

WORKER MISCLASSIFICATION: THE REAL COST OF THE IRS'S NEW SETTLEMENT PROGRAM

The "fresh start" offered by the IRS's Voluntary Classification Settlement Program is limited and could expose businesses to consequences the program does not address.

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On 9/21/11, 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 get compliant, while giving them financial certainty under the VCSP's penalty framework. Under the program, 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. [1] The VCSP has no deadline. [2]

The IRS developed the VCSP in response to the growing employment tax gap, a significant portion of which is caused by misclassified workers. A February 2009 report of the Treasury Inspector General for Tax Administration (TIGTA) reported that, although there have not been any recent studies of the impact of worker misclassification, the IRS's most recent estimate is that worker misclassification issues are attributable to approximately $1.6 billion of the approximately $345 billion tax gap. [3] These estimates are based on 1984 data, and the preliminary analysis of the 2006 data indicates that the underreporting attributable to misclassified workers is likely to be much higher. [4]

The announcement of the VSCP was made in the wake of recent efforts by the IRS and the U.S. Department of Labor (DOL) to increase enforcement of worker classification and related employment tax obligations. In 2011, the IRS and the DOL entered into an agreement that would allow for information sharing between the two agencies. [5] Under this agreement, the DOL will provide the IRS with information from their Wage and Hour investigations. [6] In addition, the IRS has entered into similar information-sharing agreements with eleven states. [7]

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."

In 2007, the IRS announced its Questionable Employment Tax Practices (QETP) initiative; the QETP program provides a collaborative, centralized means for the IRS and state unemployment insurance agencies to exchange data in order to better identify employment tax schemes and illegal practices, and increase voluntary compliance. [8] In addition, proposed amendments to the Fair Labor Standards Act (FLSA) have been introduced before Congress. [9] If passed, the legislation would increase FLSA penalties for misclassification, require detailed records on worker classification, and enhance enforcement of worker classification rules for

unemployment insurance. [10]

Who is an employee?

Significant tax consequences result from the classification of a worker as an employee or independent contractor. For example, if a worker is an employee, the employer is responsible for withholding income tax, and Social Security and Medicare tax (FICA) from amounts paid to the employee; the employer is also responsible for paying over to the IRS the employer's portion of FICA, as well as the federal unemployment tax (FUTA). A successful IRS challenge to the classification of workers can result in the assessment of significant employment tax liabilities. [11]

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. [12] Under the common law test, a worker is an employee if the employer retains the right to direct and control the means and details of the work. [13] In other words, an employer-employee relationship exists if the employer can control 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. [14] In contrast, a worker is an independent contractor if the service recipient has the right to control only the end result of the work, but not the means and methods by which that result is accomplished.

Worker classification determined under this common law model is made on a case-by-case basis, depending on the existence of various facts and circumstances, which fall under three general categories: (1) behavioral control, (2) financial control, and (3) relationship of the parties. [15] In 1987, based on an examination of case law, the IRS developed a list of 20 factors relevant to the three categories described above, which assess whether or not an employer-employee relationship exists. [16] There is no one or specific set of “the 20 factors” that is determinative; instead, it is a matter of looking at the whole relationship and seeing where the “preponderance of evidence” lies. The degree of importance of each factor varies depending on the facts surrounding the services performed, and additional factors may also be relevant. [17]

When analyzing behavioral control, for example, the key facts to consider are whether the business retains the right to control the worker, the details of how the services are performed, and the level of instruction and training imposed on the worker(s). More detailed instructions reflect more control over the worker, indicating that the worker is more likely to be an employee. Similarly, if the business provides the worker with specific training on how to do the job, it indicates that the business wants the job done in a particular way, suggesting 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. Factors that illustrate whether or not the business has financial control over how a worker's activities are conducted include: any significant investments made by the worker, unreimbursed expenses, whether the worker's services are available to the general public, method of payment, and the worker's opportunity for profit or loss.

With regard to the relationship of the parties, factors that illustrate how the parties perceive their relationship include: intent of the parties (as may be evidenced by a written contract(s)), employee benefits, right to discharge the worker or terminate services, and whether the services provided are a key activity of the business.

The length of time the worker performs services is not a stand-alone factor in determining his or her status. A worker can be an employee even if he or she performs only a few hours of services.

Eligibility and terms of the 2011 VCSP

There are three requirements to be eligible to participate in the VCSP. First, 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. [18]

Second, the business must have filed all required IRS Forms 1099 for the workers for the previous three years. [19] If workers have been with the business for less than three years, the business will still have satisfied its filing requirements if it provided IRS Forms 1099 to the workers being reclassified for the period they worked for the business.

Third, the business, including any subsidiary thereof, cannot currently be under audit by the IRS, or the subject of a worker classification audit by the DOL or a state agency. [20] Under the VCSP guidelines, a business currently under audit by the IRS for any reason, even if unrelated to worker classification, is ineligible to participate in the program. [21]

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, if certain criteria are met. Under the CSP, businesses may reclassify certain workers as employees, while incurring reduced employment tax liabilities for past years. [22] The program allows businesses and tax examiners to resolve worker classification issues as early in the administrative process as possible, in order to reduce taxpayer burden and promote efficiency for both the taxpayer and the government. [23]

An audit by a state tax department that causes an employer to reclassify its workers or pay employment taxes will not necessarily prevent the employer from participating in the VCSP. [24] Furthermore, if the IRS or 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.

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 Classification Settlement Program,” at least 60 days before they want to begin treating their workers as employees. It should be noted that payment should not be submitted with the VCSP application, and doing so could cause a delay in processing the application. [25] After reviewing the application and verifying the applicant's eligibility, the IRS will then contact the applicant or authorized representative to complete the process. [26] If an application is rejected because a business is ineligible at the time of application, the business may still reapply at a later date. [27]

In this climate of increased enforcement, businesses that are not eligible for the VCSP because they paid their workers “off the books,” and did not issue Forms 1099 should consider making a traditional voluntary disclosure pursuant to IRM 9.5.11.9 to avoid criminal prosecution and to obtain some leniency on civil penalties.

VCSP penalty framework

Under the VCSP, participating businesses that consent to properly classify their workers as employees for future tax periods will pay 10% of the employment tax liability that may have been due on compensation paid to those workers for the most recent year, calculated at the reduced rates under **Section 3509(a)**, [28] “an amount effectively equaling just over one percent of the wages paid to the reclassified workers for the past year,” according to the IRS. [29] The amount due under the VCSP is based on compensation paid in the most recently closed tax year, which is determined at the time the VCSP application is filed. [30] 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. [31] 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). [32]

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. [33] The VCSP FAQs do not provide for a payment plan for businesses unable to afford to pay their liabilities under the VCSP penalty framework.

Misclassification of employees and section 530 safe harbor provision

Section 530 of the Revenue Act of 1978 may also provide relief from employment tax obligations resulting from worker misclassification. [34] This “safe harbor” provision terminates a business's (but not an employee's) liability for federal income tax withholding, FICA, and FUTA taxes if certain stringent requirements are met. [35] (It also necessarily means the business is not liable for any interest or penalties resulting from those employment taxes.) [36] To receive relief under section 530, a business must meet the first two eligibility requirements under the VCSP: (1) it must have treated all workers in similar positions the same, (2) it must have filed all required Forms 1099 on a consistent basis, and additionally, (3) it must have a reasonable basis for not having treated the workers as employees. To establish a reasonable basis for not treating workers as employees, the business can show any of the following:

- 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.
- It relied on some other reasonable basis, such as the written advice of an attorney or accountant. [37]

If a business is engaged in worker misclassification and believes that it meets all three of the requirements outlined above, it may be able to secure more substantial relief from potential past employment tax liabilities than is 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.

Impact of the VCSP on employees

Both the VCSP and section 530 relate only to the *employer's* liability, raising the question of what impact reclassification will have on workers. The IRS has not signaled how employees of employers who participate in the VCSP will be treated or established any procedures for employers and employees to coordinate resulting classification issues. This is a flaw in the VCSP because it leaves the workers, who in most cases had no control over their original classification, vulnerable to additional employment tax liability as well as penalties and interest.

Reclassification of an employee may result in the employee's liability for his or her share of FICA tax. **Section 3102** provides that FICA tax "shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid." The employer is required to pay the FICA tax regardless of whether it actually deducted the tax from wages. [38] If an employer does not collect FICA taxes from the employee's wages, but nonetheless remits the FICA tax to the IRS, the employee has an obligation to the employer, but this is described as "a matter of settlement between the employee and the employer," [39] and not of concern to the IRS. If the FICA tax is not paid, however, the employer *and* employee are jointly liable. [40] **Reg. 31.3102-1(c)** provides that:

> The employer is liable for the employee tax with respect to all wages paid by him to each of his employees whether or not it is collected from the employee. If, for example, the employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax. Until collected from him the employee also is liable for the employee tax with respect to all the wages received by him.

The safe harbor provision of section 530(a) relieves an employer of liability for FICA taxes, but as noted above, it does not apply to employees. Accordingly, even though the employer is relieved of FICA tax liability, the IRS could still attempt to collect the tax from the employee.

In *Stewart,* [41] a Wisconsin federal district court held that an employee was liable for FICA taxes to the extent that his employer was relieved from paying those taxes under section 530(a)(1). The court stated that "even without the release of the employer, the plaintiff remains liable to his portion of the FICA taxes since they were never withheld from his wages."

In *Myers*, [42] an Arizona federal district considered the case of an employee who had underreported his income, and the IRS also assessed and collected the taxpayer's share of the FICA tax owed on the underreported income. The employee filed a refund claim for the FICA taxes, arguing that only the employer was directly liable. The district court initially held that the IRS could not collect from the employee without first attempting to collect from the employer. The government moved for reconsideration of this decision, and the district court vacated its earlier ruling and announced the narrow holding that "in an action for refund of sums obtained by the government due to clerical error in assessing taxes admittedly owed, the government may redetermine the taxpayer's liability for the tax year in question and retain such funds to the extent of the taxpayer's full liability, including liability for the employee's share of FICA taxes not previously paid by his employer." [43] Subsequently, in *Navarro*, [44] a Texas federal district court expanded on *Myers* and explicitly held that, regardless of whether the taxpayer is seeking a refund or the IRS is assessing additional tax, the IRS need not attempt to collect FICA taxes from the employer before seeking payment from the employee.

Ordinarily, there is some relief for the reclassified employee charged with unpaid FICA tax because, under **Section 6521(a)**, workers can apply their self-employment taxes to their FICA tax liability. [45] **Section 3509(d)**, however, which is referenced in the VCSP FAQ's, provides that when an employer is assessed liability under that section, the employee cannot offset self-employment taxes against his

or her FICA liability, but remains liable for the entire amount of FICA tax that was not withheld. [46]

In **Rev. Rul. 86-111**, the IRS ruled that when the employer's liability for the employee's share of FICA tax is determined under **Section 3509**, the employee is liable for the *entire amount* of the FICA tax that is not withheld, reduced by any amount paid by the employer. [47] In that ruling, the employer had failed to deduct and withhold employment taxes from the wages of a misclassified worker. The IRS reclassified the worker as an employee and assessed tax under **Section 3509**, which the employer then paid. The IRS ruled that the employee's liability was not reduced by this payment, and further that the self-employment taxes paid could not be used to offset the liability. Accordingly, if the IRS views the VCSP as a resolution under **Section 3509**, the employee may still be liable for the entire amount of FICA tax.

Workers who believe that they have been misclassified and who would like to voluntarily resolve this issue can file Form SS-8, “Determination of Employee Work Status for Purposes of Federal Employment Taxes and Tax Withholding” with the IRS. This submission may lead to an audit of the employer, as the IRS views the Form SS-8 as a potential source of leads for employment tax examination, and, indeed, the Internal Revenue Manual requires that the forms be reviewed to determine whether there is any audit potential. [48] The benefit of securing a determination from the IRS through this process is that it will force the employer to properly classify the worker as an employee and withhold and pay over FICA and FUTA tax. The downside, of course, is that it may jeopardize the worker's employment and the worker may end up owing additional employment tax, interest, and penalties for past years.

Participation in the VCSP and state tax ramifications

In addition, the VCSP and section 530 do not address potential ramifications of worker reclassification on businesses' state tax obligations. Businesses that participate in the VCSP may also be liable for unpaid state unemployment tax (SUTA), workers' compensation, disability insurance, as well as income tax withholding, plus interest and penalties. (As implied above, the VCSP and section 530 also do not address the potential state tax consequences to employees of businesses participating in the VCSP.)

In determining whether a worker is an employee or independent contractor for state tax purposes, most states use some version of what is commonly referred to as the “ABC test.” [49] Similar to the common law test employed by the IRS, the ABC test focuses on control, and looks to whether: (1) the worker is free from control and direction in the performance of services, (2) the services performed are outside of the usual course of the business's work or are performed outside of the business's premises, and (3) the worker is customarily engaged in an independently established trade, occupation, or profession of the same nature as that involved in the services performed. [50]

Most states do not have a comprehensive, integrated process to address the effects of worker reclassification, and the extent of exposure to businesses will likely hinge on whether or not the reclassified workers properly filed and paid state income taxes on wages they received. State taxing authorities hold businesses liable for the personal income taxes they failed to withhold and almost all states require that taxes be paid on all income earned in-state, whether or not the employee is a resident. [51] Thus, if an employee failed to file and pay state income taxes in the state where he or she worked and/or lived, the business may be responsible for the unpaid withholding taxes, plus penalties and interest. [52]

Several states, particularly those with common borders, have entered into reciprocal agreements that exempt nonresidents from income and withholding tax requirements in the state in which they work, but do not live. For example, all nonresident employees performing services within Ohio are not subject to Ohio state income tax if they are residents of Indiana, Kentucky, Michigan, Pennsylvania, or West Virginia, and vice versa. [53] Similarly, Maryland has reciprocal agreements with the District of Columbia, Pennsylvania, Virginia, and West Virginia; [54] Michigan has reciprocal agreements with Illinois, Indiana, Kentucky, Minnesota, Ohio, and Wisconsin; [55] and Pennsylvania has reciprocal agreements with Indiana, Maryland, New Jersey, Ohio, Virginia, and West Virginia, [56] to name a few. [57] However, some states, such as California, Connecticut, Delaware, and New York, do not have any reciprocal exemption agreements, and businesses are responsible for income tax withholding on services performed within the state, irrespective of the employee's residency. [58]

States may assess penalties for the under-withholding of tax, the failure to timely remit withholding tax, and the failure to timely file periodic returns. [59] In addition, some states and localities impose negligence penalties on employers that fail to withhold tax. [60] Penalties are generally a percentage of the tax due, and therefore depend on the rate of withholding applicable in each state. [61] Under such circumstances, businesses may be able to mitigate their tax liability by participating in a state voluntary disclosure program, if one exists, for withholding taxes. For example, the voluntary settlement programs in Colorado, [62] Georgia, [63] New Jersey, [64] and Ohio [65]

apply to withholding tax but not unemployment insurance. [66] Businesses participating in the VCSP should check their local tax authority's website to see whether or not the state offers any relevant voluntary disclosure program.

Most states have established separate labor and employment agencies, i.e. the state Department of Labor or the Employment Development Department as it is known in California, to administer unemployment insurance and income tax withholding. In California, Colorado, New Jersey, and New York, for example, employers include unemployment insurance with withholding and wage reporting on quarterly returns filed with the state DOL or equivalent agency. Therefore, businesses filing delinquent W-2s and making additional payments for withholding in the course of the VCSP should also correct corresponding state unemployment insurance filings. Furthermore, state labor and employment agencies may impose additional penalties for worker misclassification beyond those codified under state tax codes and covered by state voluntary disclosure programs for withholding taxes described above. [67] Only a few states currently offer amnesty programs for the failure to pay unemployment insurance; these states include Michigan [68] and Texas. [69] Like other voluntary disclosure programs, the parameters of these amnesty programs vary and participating businesses should check with their local state agency to determine the features of the program offered, as well as the deadline for participating in the program. [70]

Participating businesses should keep in mind that the voluntary disclosure and amnesty programs described above are usually time-sensitive with strict expiration dates. At the same time, new settlement programs are being developed and offered by state taxing and labor authorities. Accordingly, it is important for participating businesses to check with their local agencies not just before deciding whether or not to participate in the VCSP, but also before they actually move forward with the VCSP as the settlement programs available or the parameters of those programs may have changed.

Conclusion

As described above, the “fresh start” offered under the VCSP is extremely limited, and participation in the program will expose businesses to a bevy of employee and state consequences not addressed under the VCSP. Until state taxing and labor authorities develop corresponding settlement programs, the cost of participation in the VCSP will remain fact-specific and depend on the tax compliance of a business's employees as well as the applicable laws of the state in which the business operates. Under the current climate, the real cost to businesses participating in the VCSP will vary widely depending on the facts and circumstances of each case.

1

See **Ann. 2011-64, 2011-41 IRB 503**; IR 2011-95, 9/21/11.

2

As of 5/11/12, the IRS had received 541 VCSP applications. See Breach, “ABA Meeting: Assessment by State Not a Bar to Entering VCSP,” *Tax Analysts,* 2012 TNT 03-28 (citing statements of senior technical reviewer, IRS Office of Associate Chief Counsel (Tax-Exempt and Government Entities)) (5/14/12).

3

Treasury Inspector General for Tax Administration, “While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed,” 2/4/09, www.treasury.gov/tigta/auditreports/2009reports/200930035fr.html.

4

Id.

5

See Memorandum of Understanding Between the Internal Revenue Service and the United States Department of Labor (9/19/11).

6

The IRS will provide the DOL with annual aggregate data relating to trends in worker misclassification, but the IRS will not share confidential federal tax information with the DOL unless disclosure is authorized under **Section 6103**.

7

The eleven states are Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, New York, Utah, and Wisconsin. See DOL Wage and Hour Division News Release 11-1373-NAT (9/19/11). Under the agreement between the IRS and the DOL, the IRS will share the employment tax referrals provided by the DOL with state and municipal taxing agencies authorized to receive such information under approved agreements with the IRS.

8

See IRS News Release 2007-184, 11/6/07; IRS Fact Sheet 2007-25 (November 2007).
9

See Employment Misclassification Prevention Act, H.R. 3178 (2011), Payroll Fraud Prevention Act, S. 770 (2011).
10

See "Worker Classification Issues Under Renewed Focus," 2012 ABATAX-CLE 0218078 (2/18/12).
11

See generally **Section 3509**.
12

See IRM 4.23.5.6, citing McGuire, **16 AFTR 2d 5458**, 349 F2d 644, 65-2 USTC ¶9616 (1965). Under limited circumstances, however, workers treated as independent contractors under the common law test may nevertheless be treated as employees by statute for certain employment tax purposes. See e.g., **Section 3121(d)** .
13

See **Regs. 31.3121(d)-1(c)**, **31.3306(i)-1(b)**, **31.3401(c)-1(b)**.
14

Id.
15

Department of Treasury, IRS, "Independent Contractor or Employee? Training Materials," Training 3320-102(10-96) TPDS 84238I, at 2-7 (10/30/96); see also IRM 4.23.5.6.1. The DOL uses a test similar to the common law test employed by the IRS in determining whether or not a worker is an employee, and examines the following six factors: (1) the degree of the business's right to control the manner in which the work is to be performed, (2) the business's opportunity for profit or loss depending on its managerial skill, (3) the business's investment in equipment or materials required for the task, or the employment of helpers, (4) whether the service rendered requires a special skill, (5) the degree of permanence of the working relationship, and (6) whether the service rendered is an integral part of the business. See Donovan v. DialAmerica Mktg., Inc., 757 F2d 1376 (CA-3, 1985).
16

Rev. Rul. 87-41, 1987-1 CB 296; see also Department of Treasury, IRS, "Independent Contractor or Employee? Training Materials," Training 3320-102(10-96) TPDS 84238I, at 2-3 (10/30/96).
17

IRM 4.23.5.6.1.
18

See VCSP Frequently Asked Questions (FAQ) No. 2, www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program-(VCSP)-Frequently-Asked-Questions.
19

Under the IRS's Classification Settlement Program (see below at note 22), if the business files the required Forms 1099 for some workers, but not for others, relief is available only for the workers for whom the Forms 1099s were filed. The VCSP FAQs, however, are silent on this particular scenario.
20

VCSP FAQ No. 23, www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program-(VCSP)-Frequently-Asked-Questions.
21

See generally **Ann. 2011-64, 2011-41 IRB 503**; IR 2011-95, 9/21/11.
22

See IRM 4.23.6.7 for a list of cases includable in the CSP.
23

See generally I.R.M. 4.23.6.
24

Breach, *supra* note 2.
25

VCSP FAQ No. 10.
26

VCSP FAQs Nos. 9 and 11.

[27]

VCSP FAQ No. 15.

[28]

Section 3509(a)(1) provides, as a general rule, that an employer who fails to withhold income tax from an employee's wages by reason of treating such person as not being an employee is liable for tax as if the amount required to be withheld were equal to 1.5% of the wages paid to such employee and 20% of the employee's share of FICA taxes. (Under **Section 3509**, employers are still responsible for the full amount of their share of FICA taxes.) When the employer acts with intentional disregard, the penalty is increased from 1.5% to 3% of the withholding tax and 40% of the employee's share of FICA taxes (**Section 3509(b)**).

[29]

IR 2011-95, 9/21/11.

[30]

VCSP FAQ No. 16.

[31]

VCSP FAQ No. 16; see also **Ann. 2011-64, 2011-41 IRB 503**.

[32]

VCSP FAQ No. 13.

[33]

VCSP FAQ No. 12.

[34]

The "safe harbor provision" under section 530 was initially scheduled to terminate at the end of 1979 but was extended permanently by the Tax Equity and Fiscal Responsibility Act of 1982. Subsequent changes were made to section 530 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, and the Pension Protection Act of 2006. The statutory language of section 530 of the Revenue Act of 1978, though not codified in the Code, can usually be found in the publisher's notes following **Section 3401**.

[35]

However, in April 2012, the Fair Playing Field Act was reintroduced before Congress in an effort to eliminate or curtail the section 530 harbor provision. See Fair Playing Field Act, S. 2145, H.R. 4123 (2012), which was first introduced in September 2010 (S. 3786, H.R. 6128 (2010)). If passed, the Act would continue retroactive relief under section 530 but eliminate all future relief under section 530, as well as eliminate the reduced tax under **Section 3509** when a taxpayer did not have reasonable basis for its worker classification. See "Worker Classification Issues Under Renewed Focus," 2012 ABATAX-CLE 0218078 (2/18/12).

[36]

See generally IRM 4.23.6.9.

[37]

See e.g. IRM 4.23.6.13.5.

[38]

Reg. 31.6205-1(b)(3).

[39]

Id.

[40]

See In re Eryurt, 142 Bkrptcy. Rptr. 999 (Bkrptcy. DC Fla. 1992) ("while an employer is required to deduct FICA taxes from wages paid to an employee, the employee is ultimately liable for payment of FICA taxes, regardless of whether taxes are collected by the employer." (internal citations omitted)); Roscoe, **TC Memo 1984-484**, PH TCM ¶84484, 48 CCH TCM 1078 ("[employees] remain liable for the taxes until they are discharged by [their] employer."); **Rev. Rul. 86-111, 1986-2 CB 176** (employee is "ultimately liable" for FICA taxes).

[41]

55 AFTR 2d 85-506, 84-2 USTC ¶9962 (DC Wis., 1984).

[42]

69 AFTR 2d 92-1207, 92-2 USTC ¶50393 (DC Ariz., 1992).

[43]

70 AFTR 2d 92-5900, 92-2 USTC ¶50520 (DC Ariz., 1992). The district court based it decision on Lewis v. Reynolds, **10 AFTR 773**, 284 US 281, 76 L Ed 293, 3 USTC ¶856, 1932-1 CB 130 (1932), which held that in tax refund cases, the taxpayer has the burden of

proving that his or her taxes were overpaid, and that the government may redetermine the taxes owed and retain any sums necessary to satisfy the taxpayer's total liability even if such new assessment would otherwise be statute barred.

44

72 AFTR 2d 93-5424 (DC Tex., 1993).

45

See **Section 6521(a)**; **Rev. Proc. 85-18, 1985-1 CB 518** (reclassified employee who incorrectly paid self-employment tax may file claim for refund, although the amount of the refund will be offset by employee's share of FICA tax); Compare. Casety, **TC Memo 1993-410**, RIA TC Memo ¶93410, 66 CCH TCM 616 (worker reclassified as employee not liable for self-employment tax); Laraway, **TC Memo 1992-705**, RIA TC Memo ¶92705, 64 CCH TCM 1503 (same).

46

Section 3509(d)(1) states that the employee's liability for tax is not affected by the assessment or collection of any additional income tax determined to be owing from the employer.

47

Lucas, TCM 2000 ; Grooms, TCM 1992 .

48

IRM 4.23.2.6.

49

Health Law & Compliance Update § 7.06 Proper Classification of Independent Contractors (2012).

50

See e.g. Ark. Code Ann. § 11-10-210; Conn. Gen. Stat. § 31-222; Del. Code Ann. tit. 19, § 3302; Ga. Code Ann. § 48-7-101; Ind. Code tit. 22, § 2-2-3; Me. Rev. Stat. Ann. tit. 26, § 1043; Mass. Gen. Laws ch. 151A, § 2; N.H. Rev. Stat. Ann. tit. 23, § 282-A: 9; N.J. Rev. Stat. § 43:21-19; N.M. Stat. Ann. § 51-1-42; Vt. Stat. Ann. tit. 21, § 1301; see also N.Y.S. A06793 (2009) (currently pending before the N.Y. Assembly Labor Committee).

51

See e.g. Cal. Rev. & Tax. Code § 18668; N.Y. Tax Law §§ 675, 685(f); N.C. Gen. Stat. Ann. § 105-163.8.

52

Id.

53

See Ohio Dept. of Tax. website, Frequently Asked Questions—Employer Withholding, FAQ. No. 21.

54

Md. Income Tax Admin. Release No. 37 (September 2009).

55

Mich. Rev. Admin. Bulletin 1988-17 (5/27/88).

56

See Penn. Dept. of Rev. website, Find Answers, Answer ID No. 268 (8/15/11).

57

Almost all states that have state tax reciprocal agreements have a form that an employee must complete to be exempt from income tax withholding in the state where he or she is employed; the exemption under a reciprocal agreement generally does not apply unless the nonresident employee timely completed and filed the reciprocal agreement form. See e.g., Ind. Form WH-47; Md. Form MW 507; Mich. Form MI-W4; N.J. Form NJ-165; Ohio Form IT 4NR; Pa. Form REV-419.

58

See Ca. Franchise Tax Bd. website, Nonresident Withholding; Conn. Dept. of Rev. website, Taxpayer Answer Center, Answer. ID No. 322; Del. Dept. of Finance, Div. of Rev. website, Withholding Rules and Regulations Booklet, § 11 (2/21/07); N.Y. Dept. of Tax. and Finance, Publication NYS-50, “Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax,” at p. 27 (October 2011).

59

See e.g., Ga. Code Ann. § 48-7-126 (imposing $10 penalty for failure to withhold tax for each employee on a quarterly basis); N.J. Stat. Ann. § 54:49-4 (imposing a late filing penalty of 5% of the tax due for each month or portion of a month the return is late (not to exceed 25% of the tax due), an additional penalty of $100 for each month the return is late, and a late payment penalty of 5% of the tax due, plus interest); N.Y. Tax Law § 685 (imposing a late filing penalty of 5% of the tax due for each month or portion of a month the return is late (not to exceed 25% of the tax due), and/or a late payment penalty equal to .5% of the unpaid tax for each month or

portion of a month the tax remains unpaid (not to exceed 25%), plus interest; if the failure is willful, the employer will be subject to an additional penalty equal to the total amount of tax evaded); N.C. Gen. Stat. Ann. § 105-236 (imposing a late payment of 10% of the tax due, and a late filing penalty equal to 5% of the tax due for each month or portion of a month the return is late (not to exceed 25% of the tax due)).

[60]

See Salam, "Businesses Feel the Pinch as Taxing Authorities Seek to Close the Employment Tax Gap," 20-SEP JMTAX 3, 46 (September 2010).

[61]

See e.g., Ga. Code Ann. § 48-7-101 (requiring withholding of state income tax at the rate of 6% of the amount of compensation paid); N.Y. Lab. Law § 518, N.Y. Dept. of Labor website, Unemployment Insurance, Current Employer Tax Rates (2012); "Worker Classification Issues Under Renewed Focus," 2012 ABATAX-CLE 0218078 (2/18/12) (New York requires withholding of up to 9.9% on the first $8,500 of annual wages).

[62]

See Co. Dept. of Rev. website, Voluntary Disclosure Program (under the program, businesses are required to pay back taxes and interest, and in return, the Department will usually waive liabilities older than three or four years and will usually waive any penalty assessment, except if the tax was collected; the program requires a four-year look-back period for income tax).

[63]

See Ga. Dept. of Rev. website, "Guide to Georgia's Voluntary Disclosure Program."

[64]

See N.J. Dept. of Treasury website, Voluntary Disclosure Program (under New Jersey's program eligible businesses will be subject to all back taxes and interest for the period covered, (New Jersey's program has a four-year look-back, three prior years and the current year), plus a 5% penalty on all taxes owed in lieu of all other applicable late filing and late payment penalties; the program has four eligibility requirements: (1) the employer was not previously contacted by New Jersey Division of Taxation or any of its agents; (2) the employer is not registered for the taxes they wish to come forward on; (3) the employer is not currently under any criminal investigation; and (4) the employer is willing to pay outstanding tax liabilities and file the prior year returns within a reasonable period).

[65]

See Ohio Dept. of Tax. website, Voluntary Disclosure of Employer Withholding Tax Liabilities (under the program, any employer is eligible for the program if the employer enters into and executes an employer withholding tax agreement before the state Department of Taxation contacts the employer about withholding taxes, income taxes, pass-through entity taxes, and/or corporate franchise taxes; employers are liable for tax due plus interest, and all penalties are waived).

[66]

See also N.Y. Dept. of Tax. and Finance website, Voluntary Disclosure Program; Pa. Dept. of Rev. website, Voluntary Disclosure Program.

[67]

See e.g. Ca. Labor Code § 226.8 (imposing steep penalties on employers who willfully misclassify their employees as independent contractors; under the new law, which took effect 1/1/12, businesses guilty of willful misclassification are subject to civil penalties between $5,000 and $25,000 per violation, and are also required to publicize a notice of their violation(s) on their company websites).

[68]

Mich. Dept. of Licensing and Regulatory Affairs website, Unemployment Insurance Agency, "Employer Amnesty Program Misclassification of Wages," Fact Sheet No. 148 (March 2012).

[69]

Tex. Comptroller of Public Accounts website, "Project Fresh Start" (2012).

[70]

Where applicable, participating businesses should consult local authorities as to whether any amnesty programs for unemployment insurance also extend to other required payments, such as disability insurance and workers' compensation.