

INDEPENDENT CONTRACTOR OR EMPLOYEE? IRS OFFERS NEW CLASSIFICATION SETTLEMENT PROGRAM WHILE FEDERAL AND STATE AGENCIES SIGN INFORMATION SHARING AGREEMENTS

September was a noteworthy month for developments pertaining to worker classification issues. Most notably, the IRS announced a new program that provides partial relief from federal employment taxes for eligible employers that agree to prospectively treat one or more classes of workers as employees. This new program, known as the Voluntary Classification Settlement Program, or VCSP, is a voluntary program that provides employers with an opportunity to reclassify their workers as employees for future periods with limited and reduced federal employment tax liability for the past non-employee treatment. In addition, the DOL signed several information sharing agreements with the IRS and multiple state labor agencies. These agreements are intended to improve efforts to identify and correct the misclassification of employees as independent contractors.

BACKGROUND

Much attention has been given to ways of reducing the federal deficit, and an option that is often discussed involves reducing the tax gap, which is generally thought of as the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time. The misclassification of workers as independent contractors (instead of employees) has been identified as a significant contributor to the tax gap. In fact, in 2006, the Government Accountability Office estimated that several billion dollars annually is lost from the understatement of federal taxes as a result of worker misclassification. Consequently, various efforts by federal agencies have been undertaken to address worker classification issues. For example, the IRS announced a national employment tax audit initiative in 2009 whereby the IRS would audit approximately 6,000 employers selected at random from 2010 through 2012 for issues involving worker misclassification, fringe benefits, officer compensation and expense reimbursements. It is clear that worker classification issues continue to be a focal point for federal and state agencies.

VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM ELIGIBILITY

IRS Announcement 2011-64, which can be accessed here: <http://www.irs.gov/pub/irs-drop/a-11-64.pdf>, provides an outline of the VCSP. To be eligible, an employer, which can include a tax-exempt organization, must satisfy the following requirements:

- The employer must have consistently treated the applicable workers as nonemployees;
- The employer must have filed all required Forms 1099 for the workers for the previous three years;
- The employer cannot currently be under IRS audit;
- The employer cannot currently be under audit concerning the classification of the workers by the DOL or a state government agency; and
- An employer who was previously audited by the IRS or the DOL concerning the classification of the workers will only be eligible if the employer has complied with the results of that audit.

To apply, an employer must complete and submit IRS Form 8952, Application for Voluntary Classification Settlement Program, which can be accessed here: <http://www.irs.gov/formspubs/article/0,,id=242970,00.html>

If an employer is eligible for the VCSP, then the following terms and conditions will apply with respect to the reclassified workers:

- The employer must prospectively treat the workers (or the class or group of workers) as employees for future tax periods.

- The employer will pay 10% of the employment tax liability that may have been due on compensation paid to the workers for the most recent completed tax year, determined under the reduced rates of section 3509 of the Internal Revenue Code.
- The employer will not be liable for any interest and penalties on the employment tax liability.
- The employer will not be subject to an employment tax audit with respect to the worker classification of the workers for prior years.
- The period of limitations on assessment of employment taxes will be extended from three years to six years for the first three years beginning after the date on which the employer agrees to begin treating the workers as employees.

FEDERAL AND STATE WORKER CLASSIFICATION INFORMATION SHARING

The information sharing agreements announced by the DOL outline plans for increased cooperation among the IRS, DOL and several state labor/employment agencies on worker classification issues. These information sharing agreements are intended to help prevent, detect and remedy worker misclassifications. The parties also anticipate that the information sharing agreements will improve the efficiency of the participating agencies in worker misclassification matters. As of September 19, seven states (Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah and Washington) had signed information sharing agreements with the DOL, and Hawaii, Illinois, Montana and New York were expected to sign similar agreements.


CONSIDERATIONS FOR EMPLOYERS

The combination of these announcements is a classic example of a "carrot" and "stick" approach in the context of worker classification issues. Many employers will view the VCSP as an enticing "carrot" because of the ability to prospectively reclassify workers at a reduced federal rate of tax without penalties, interest or having to address reporting and withholding issues for prior year(s). Meanwhile, the information sharing agreements could be viewed as a new "stick" that will allow the IRS, the DOL and participating state agencies to more easily learn of worker classification issues. This enforcement tool may persuade some employers to seek relief from federal tax exposure through the VCSP rather than waiting for a potential audit from one or more agencies.

While the VCSP may be appealing for federal tax purposes, it does not address other federal, state or local issues. For example, employers may still be subject to review by other federal agencies, such as the DOL (in minimum wage and overtime investigations), as well as state and local agencies for worker classification issues in prior years. Furthermore, the IRS has not addressed whether information disclosed under the VCSP will be confidential. With the announcement of the information sharing agreements described above, it is unclear whether participation in the VCSP could trigger audits from other agencies.

CONCLUSION

These announcements highlight the continued attention devoted to worker classification issues by the IRS, the DOL and various state agencies. If employers have not recently reviewed the classification of their independent contractors, then they should consider undertaking a review to determine if such treatment remains appropriate. Employers that believe reclassification is appropriate should then consider whether to utilize the VCSP. While the VCSP provides several valuable benefits such as reduced taxes and elimination of potential penalties and interest for prior years, employers should be aware that the VCSP does not resolve all issues and concerns associated with worker classification matters. Thus, employers considering the VCSP should carefully weigh all aspects of a decision to voluntarily reclassify their workers in light of these new developments.

Should you need assistance with your organization's evaluation of worker classification issues, including possible participation in the VCSP, please contact Calvin R. Chambers at (317) 977-1459  or cchambers@hallrender.com or your regular Hall Render attorney.