



irs says "let's make a deal" (regarding misclassified workers)

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by Jeffrey D. Davine

attorneys

Jeffrey D. Davine

practice areas

nonprofit organizations

This alert summarizes the salient terms of the voluntary classification settlement program ("VCSP") that was recently announced by the Internal Revenue Service. The VCSP gives employers who may have incorrectly classified workers as independent contractors a chance to "come in from the cold" without triggering a significant income and employment tax liability. Both nonprofit and for-profit entities are eligible to participate in the VCSP. In essence, the VCSP allows employers to obtain relief from past federal payroll taxes they may owe if they agree to prospectively treat workers as employees.

Background. The determination as to whether a worker should be classified as an employee or independent contractor depends on a number of factors. Generally speaking, if the recipient of the services has the right (regardless of whether that right is exercised) to control the details or the "manner and means" as to how the worker performs his or her services, it is likely that the worker is properly classified as an employee. On the other hand, if the recipient of the services does not have the ability to control the details or the manner and means as to how the worker performs his or her services, *i.e.*, the recipient of the services simply contracts for a finished product or task, it is likely that the worker may be properly classified as an independent contractor. Often, a worker's classification as an employee or independent contractor is not entirely clear. In other words, facts exist on both sides of the "ledger" in determining how the worker should be classified. Unfortunately, having facts that go both ways makes the determination more difficult and provides the government with an opportunity to "second-guess" a decision to classify a worker as an independent contractor.

Improperly Classifying a Worker Can Trigger a Significant Tax Liability.

Determining whether a worker is an employee or independent contractor is important because significant tax consequences may flow from the decision. Specifically, income and employment taxes must be withheld from the



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compensation that is paid to each worker who is an employee, and these amounts, together with certain employment taxes payable by the employer, must be remitted to the government. On the other hand, no withholding of income or employment taxes is required with respect to amounts paid to an independent contractor, and the recipient of the services is not subject to any employer-level taxes.

If an employer fails to withhold and remit the required taxes from compensation paid to a worker who is properly classified as an employee, the employer may be responsible for all the taxes that should have been withheld and remitted to the government. In addition, interest will be imposed on the amounts owed and penalties may also be assessed. Depending on the amount of compensation paid to the misclassified workers and the period of time during which the misclassification occurred, the employer could be faced with a significant tax liability.

Participating in the VCSP. For an employer that chooses to participate, the VCSP will allow the employer to escape what could be a devastating federal tax liability by paying only a fraction of what its actual past liability should be. In exchange for this forgiveness, the employer will be required to prospectively treat all of the workers who are the subject of the VCSP application as employees.

VCSP Eligibility Requirements. To participate in the VCSP an employer must satisfy certain eligibility requirements, submit a formal application to the IRS, and enter into a closing agreement with the IRS.

To be eligible, an employer must comply with the following requirements: (i) the workers that are the subject of the VCSP must have been consistently treated as independent contractors by the employer; (ii) during the previous three years, the employer must have filed all required IRS Forms 1099 for the workers (not later than six months after their due date); and (iii) the employer cannot currently be undergoing an examination by the IRS or be involved in an audit concerning the classification of the workers by the Department of Labor or by a state government agency. An employer that was previously audited by the IRS or the Department of Labor in which the classification of workers was in issue will only be eligible to participate in the VCSP if it has complied with the results of that audit.

An eligible employer must submit Form 8952 ("Application for Voluntary Classification Settlement Program") to the IRS. The Form 8952 must be submitted not less than 60 days prior to the time that the employer chooses to begin treating the workers as employees. It is not necessary to submit a payment with the Form 8952.

The agreement that the employer enters into with the IRS need not include all of the workers that the employer is treating as independent contractors. The employer, however, must agree to treat the workers who are covered by the VCSP, and all similarly situated workers, as employees prospectively.

Example: Company X is in the business of constructing office buildings. As part of its business it engages the services of a number of different types of workers, including architects, welders, plumbers, painters, carpenters, and electricians. In the past, Company X has treated all of these workers as independent contractors. Company X determines that it should have treated the painters as employees instead of as independent contractors and decides to participate in the VCSP with respect to the painters. Company X submits Form 8952 to the IRS with respect to its painters. The Form 8952 is accepted by the IRS, and Company X enters into a closing agreement with the IRS with respect to the painters. After the closing agreement is entered into, Company X will be required



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to treat all of its painters as employees for income and employment tax purposes. Company X, however, will not be required (by virtue of entering into the VCSP) to treat its other workers as employees.

Financial Consequences of Participating in the VCSP. If an employer chooses to participate in the VCSP, it will be required to pay 10% of the amount of the employment taxes that would otherwise have been due on compensation paid for the most recent tax year to the workers, calculated under the reduced tax rates of Section 3509 of the Internal Revenue Code. According to the IRS, an employer that is accepted into the VCSP will pay an amount roughly equal to about one percent (1%) of the wages paid to the reclassified workers during the prior year.

Aside from the limited payment described above, the IRS will not impose interest or penalties on the amount paid, and the employer will not be subject to an employment tax audit with respect to these workers for prior years. The employer, however, must agree to extend the statute of limitations on assessment of employment taxes for three years for the first, second, and third calendar years beginning after the date on which the taxpayer has agreed under the VCSP closing agreement to begin treating the workers as employees. In other words, the employer must agree to extend the usual three-year statute of limitations to six years for these tax periods.

Rejection of VCSP Application. One concern that has been expressed by employers who are contemplating whether to submit an application to the IRS to participate in the VCSP is whether a rejection by the IRS will stir up a hornet's nest by triggering an audit by the IRS (or result in some other "calamity"). According to an announcement published by the IRS, a rejection by the IRS of a VCSP application will not automatically trigger an audit of the employer. The employer could, of course, be audited other reasons, but (at least according to the IRS) not as a result of filing the VCSP application.

Another concern expressed by employers is whether the IRS will share information concerning VCSP applicants with the Department of Labor or with state income/employment tax agencies. According to the IRS, no information concerning VCSP applicants will be shared with other agencies (including the Department of Labor and state income/employment tax agencies).

Who Should Participate in the VCSP? Determining the potential benefit to a particular employer of participating in the VCSP requires some number crunching. However, as a rule of thumb, if an employer has treated a significant number of workers as independent contractors and it is clear that these workers should have been treated as employees, participating in the VCSP could provide a significant benefit. On the other hand, if an employer has classified only a small number of workers as independent contractors and the employer has a reasonable basis for the classification (such as a published court opinion, IRS ruling, written opinion from counsel, or similar authority), participating in the VCSP may not be in the employer's best interests. Before deciding whether to submit a VCSP application, an employer would be well advised to discuss the issue with counsel who is experienced in this area of the law.

If you have any questions regarding this alert, please contact the author or any other member of our Charitable Sector Practice Group.