WORKER MISCLASSIFICATION

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The Worker Misclassification area is a prime example of the enhanced tax enforcement climate we practice in. Major audit resources are being devoted by the IRS and State tax authorities, as well as the U.S. and State Departments of Labor, in reclassifying independent contractors as employees and these agencies are exchanging more and more audit information and the stakes on worker misclassifications are getting higher under the Affordable Care Act's 50 full time employee trigger for the employer insurance mandate. IRS will be looking at employer's worker classification issues to ensure that companies are complying with the ACA's provisions and worker misclassification may expose employers to severe penalties under the ACA. If that's not enough, plaintiffs' lawyers are even getting into the act by bringing class actions against businesses alleging worker misclassifications/failure to pay wages type causes of action under the Fair Labor Standards Act (FLSA).

By way of background, whether a worker is an independent contractor or employee generally is determined by whether the enterprise an individual works for has the right to control and direct the individual regarding the job he or she performs and how to do it. Under the common-law rules established by Court precedent, multiple factors are used to determine if an individual is a common-law employee.

Companies whose worker classifications are challenged by the IRS aren't necessarily out of luck though, they can fight for relief under section 530 of the Internal Revenue Code. Under section 530 qualified taxpayers can bar IRS from reclassifying contractors as employees in many cases. To qualify businesses must have filed forms 1099s' for the disputed workers and treated all similarly situated workers as contractors and had a reasonable basis for treating them as contractors and not employees which can be met by example by relying on a prior court decision or revenue ruling, a previous IRS no change employment tax audit or a long standing industry practice.

Even if a business doesn't qualify for section 530 relief, reduced penalties can apply when the worker misclassification is unintentional. The income tax withholding penalty is only 1.5% of wages – with no interest - far below the normal level, and the tax rate for the employee's share of FICA tax is 1.53% vs. 7.65%. These percentages are doubled if the business didn't file 1099 forms for the workers and there is no relief for the employer's share of the FICA tax – it remains at 7.65%.

Perhaps more importantly, the IRS has launched the Voluntary Worker Classification Settlement Program which permits eligible business owners, tax-exempt organizations and government entities to reclassify contractors as employees and make only a relatively small payment to cover past payroll or employment taxes, and avoid large penalties and interest that can result from an audit. This program can be utilized to help defuse situations where businesses facing lurking issues regarding the misclassification of employees as independent contractors can reclassify them and eliminate the tax exposure. In fact, the need for analysis and strategizing by business taxpayers for proactively managing this risk issue (rather than it being managed by tax authorities) have never been greater.

Employers who opt into the program will owe 10% of the tax liability that would have been due on the employees' compensation for the past year (about 1% of wages paid to reclassified workers in the past year), *without interest or penalties*. This payment would be made in lieu of facing back taxes, penalties and interest for usually three years of misclassification after audit. Equally important, the IRS has announced that no information under this settlement program will be shared with the States or the federal Department of Labor.

To be eligible, a business applicant must:

- consistently have treated the workers in the past as nonemployees (the taxpayer need not have had a reasonable basis for treating workers as non-employees);
- have filed all required Forms 1099 for the workers for the previous three years (much better than the IRC §530 reporting consistently requirement which must be met for all post 1978 tax periods) and
- not currently be under audit by the IRS, the Department Labor or a State agency concerning the classification of the workers.

The application process entails filing IRS form 8952 at least 60 days before the business wants to begin treating the workers as employees. There is no time deadline set forth for the settlement program to expire.

The program permits taxpayers to reclassify some or all of its workers. However, once a taxpayer chooses to reclassify certain workers as employees, all individuals in the same class must be treated as employees for employment tax purposes.

In return for the reduced tax/no interest or penalties break, and no employment tax audit for prior years, participating employers will be subject to a special six-year statute of limitations for the first three years under the program. The usual statute of limitations that applies to the assertion of employment tax deficiencies is three years. All the terms will be set forth in a closing agreement between the taxpayer and the IRS. Furthermore, successful participation in this settlement program would undoubtedly qualify as a voluntary disclosure under Internal Revenue Manual 9.5.11.9.3, and the participating taxpayers would avoid potential criminal employment tax prosecution in the most egregious situations.

Business employers who have any concerns as to the classification of independent contractors should be counseled to take advantage of this favorable settlement program, which provides certainty and relief to employers in this important area. Such employers should also consult with experienced tax counsel who can successfully navigate them through this process, and coordinate any State employment tax consequences by seeking relief under State voluntary disclosure policies.

The IRS Voluntary Worker Classification Settlement Program ("VCSP") is not subject to the IRS and the Department of Labor memorandum of understanding strengthening their joint enforcement efforts by increasing information sharing on their respective enforcement action (e.g., the Department of Labor will refer cases to the IRS to follow-up with further investigations). The memorandum of understanding also includes several States as parties to the agreement including New York, New Jersey, Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah, Washington, Hawaii, Illinois, Montana, with more States expected to sign on in the future. With these agencies exchanging information on employee misclassification,

companies must take greater care than ever to properly classify workers, because one agency investigation could easily trigger another. So the time to review worker classification is now.

Given the above, there are also steps that can be taken to help reduce the risk of misclassification in the workplace such as drafting and executing written agreements with all independent contractors; not imposing employment practices or work rules on independent contractors; not attempting to prohibit independent contractors from working for or with others; requiring all independent contractors to provide their own transportation, equipment, tools etc.; and requiring all independent contractors to be separately incorporated business entities.

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