

**Employment Tax Law Alert –
IRS Offers Employers A Break
On Misclassified Workers**

By Robert J. Alter¹

Against the backdrop of robust civil and criminal employment tax enforcement programs by the Internal Revenue Service (IRS) -- and potentially devastating liability consequences -- the IRS has created a settlement program that is extraordinarily favorable for business taxpayers. The program, which recently launched, 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) has never been greater. The stakes in many cases have become too high to do nothing if potential exposures exist.

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.

IRC §530 provides retroactive and prospective relief from employment tax liability for employers who misclassified workers as independent contractor using the common-law facts and circumstances in certain limited circumstances.

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In IRS Announcement 2011-64, 2011-41 Internal Revenue Bulletin, the IRS unveiled 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.

Employers who opt in to the program will owe 10 percent of the tax liability that would have been due on the employees' compensation for the past year (about 1 percent 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 consistency requirement which must be met for all post 1978 tax periods) and
- not currently be under audit by the IRS, the Department of 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 the 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 taxpayer 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 extremely 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 a recently announced IRS and the Department of Labor memorandum of understanding strengthening their joint enforcement efforts by increasing information sharing on their respective enforcement actions (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, 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 your worker classification is now. If you need help determining how to properly classify employees, please give us a call. We can help you decide whether you could benefit from the VCSP.