

IN PRACTICE

## TAX LAW

# IRS Offers Employers a Break on Misclassified Workers

Eligibility has been expanded for the Employment Tax Voluntary Classification Settlement Program

By Robert J. Alter

**B**usiness taxpayers operate in an enhanced employment tax enforcement climate — both civil and criminal — and in certain situations face potentially devastating liability from worker misclassification. The need for analysis and strategizing by business taxpayers for proactively managing the worker-misclassification risk issue (rather than it being managed by the tax authorities) has never been greater. The stakes in many cases have become too high to do nothing if potential exposures exist. Notably, in such a hostile climate for business taxpayers, the IRS has relaxed the eligibility requirements for its previously announced Voluntary Classification Settlement Program (VCSP). That program, which was launched in September 2011, has been utilized to help defuse situations where businesses faced lurking issues regarding the misclassification of

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*Alter is a partner at McElroy, Deutsch, Mulvaney & Carpenter in Morristown, and past chairman of the Section of Taxation of the NJSBA. He specializes in representing business and individual clients in civil and criminal tax disputes with state and federal tax authorities.*

employees as independent contractors and allowed their reclassification, thus minimizing or eliminating tax exposure.

In IRS Announcements 2012-45 and 2012-46, the IRS revised, relaxed and expanded eligibility for its VCSP.

Specifically, in Announcement 2012-45, the IRS took the following action. First, it agreed to permit taxpayers under audit — other than an employment tax audit — to participate in the program. Second, it clarified that the following taxpayers are not eligible to participate in the program: A taxpayer that is a member of an affiliated group under IRC § 1504(a), where another member of the group is under an employment tax audit, or taxpayers contesting in court the misclassification of its employees as a result of an IRS/Department of Labor audit of a prior tax period. Third, the IRS agreed to eliminate the requirement that taxpayers agree to extend the period of limitation governing assessment of employment taxes from three to six years, for the first five years under the program, as part of its VCSP closing agreement with the IRS.

In Announcement 2012-46, the IRS created a new, temporary initiative (available only through June 30, 2013) to allow taxpayers who were otherwise eligible for the VCSP, but had not filed

all required Forms 1099 for the previous three years with respect to reclassified workers, to qualify for a modified version of the VCSP — the VCSP Temporary Eligibility Expansion. This initiative provides such taxpayers with an opportunity to obtain the same benefits under VCSP for reclassifying their workers as employees for future tax periods, in return for limited federal employment tax liability for the past non-employee treatment.

Specifically, in order to obtain the same relief under the temporary expanded VCSP, participants are required to pay 25 percent (versus 10 percent) of the employment tax liability that would have been due on compensation paid to the reclassified workers during the prior year, determined under the reduced rates of IRC § 3509(b), and pay a reduced penalty for Forms 1099 that were not filed during the previous three years. The Form 1099 penalty is graduated based on the number of required Forms 1099 that were not filed:

- Up to 25 unfiled Forms 1099: \$50 each;
- 26 to 49 unfiled Forms 1099: \$74 each; and
- 50 or more unfiled Forms 1099: \$100 each.

Finally, participants have to certify

in the closing agreement that they have furnished to workers, and electronically filed with the IRS, Forms 1099 for the previous three years. An application (IRS Form 8952 marked "VCSP Temporary Eligibility Expansion") must be submitted on or before June 30, 2013, to request the foregoing relief. The IRS retains discretion as to whether to accept a taxpayer's application.

By way of background, the determination of whether a worker is an independent contractor or an employee is a question of control. Essentially, if the company has the right to say when, where and how the work has to be done, then the worker is under the company's control and is an employee. 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 contractors using the common-law facts and circumstances in certain limited situations.

The IRS VCSP permits eligible business owners, tax-exempt organizations and government entities to agree to prospectively reclassify contractors as employees for future tax periods, 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.

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 nonemployees);
- 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 VCSP 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.

Participation in the VCSP initiatives results in reduced tax/no interest or penalties, and no employment tax audit for prior years. All terms are to be set forth in a closing agreement between the taxpayer and the IRS. Furthermore, successful participation in these settlement programs 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 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 help them successfully navigate through this process, and coordinate any state employment tax consequences by seeking relief under state voluntary disclosure policies.

The IRS VCSP and its Temporary Eligibility Expansion are not subject to a recently announced IRS and 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 and 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 is now to review worker classification issues and whatever benefits are available from the VCSP initiatives. ■