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New IRS Voluntary Worker Reclassification Program

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The Internal Revenue Service (IRS) recently announced a new initiative – the Voluntary Classification Settlement Program (VCSP) – that provides partial relief from back federal employment taxes, penalties and interest to eligible taxpayers that agree to prospectively treat workers as employees. IRS Announcement 2011-64.

Overview

Terms of the Program

The business will pay the IRS a modest sum in comparison to the potential worst-case employment tax liability.

- The business pays 10% of the amount of employment taxes calculated under the rates of Internal Revenue Code (IRC) § 3509(a) for compensation paid for the most recently ended tax year to the workers being reclassified.
- The business has no liability for penalties and interest.
- The IRS will not audit the business for employment tax purposes for prior years with respect to the classification of those workers being reclassified.
- The business will extend the statute of limitations for assessment of employment taxes by three years for the first three calendar years after the date the business has agreed to the reclassification. Thus, the usual "three-year" statute is extended to six years.

If these terms are attractive, see if your business is eligible.

Eligibility Requirements

Employers may prospectively reclassify workers under VCSP if they meet the following criteria:

- Consistently treated the workers as nonemployees;
- Filed all required Forms 1099 for the workers for the previous three years; and
- Are not currently under audit by the IRS for any reason or by the Department of Labor or a state agency, with respect to the workers' classification.

Employers wishing to participate in the VCSP must apply to participate in VCSP, enter into a closing agreement with the IRS and promise to prospectively treat the class of workers as employees for ***all*** future tax periods.

VCSP Only Provides Relief for Back Federal Employment Taxes

If you find the program attractive and are eligible, your company should be aware that VCSP will not provide relief for the following situations:

- IRS. A VCSP closing agreement does not prevent the IRS from auditing a business with respect to the classification of workers who were not reclassified under the VCSP closing agreement.
- US Department of Labor. A VCSP closing agreement does not bind USDOL with respect to employment classification issues.
- Any State Agency. A VCSP closing agreement does not bind any state agency with respect to employment classification issues.
- Workers. A VCSP closing agreement does not prevent workers from bringing misclassification claims.

Employers have always had the opportunity to make the business decision, outside of a formal IRS program, to reclassify workers as employees. However, employers who participate in the VCSP will only incur minimal federal payroll tax liability and no interest or penalties for past nonemployee treatment, and will eliminate the risk of a potentially expensive employment classification audit with respect to the reclassified workers.

Discussion

Employers accepted into the program will pay approximately one percent of the wages paid to the reclassified workers for the past year[1] in full satisfaction of their federal payroll tax liability.

No interest or penalties will be due, and the employers will not be audited for employment tax classification purposes for prior years with respect to the workers. For the first three years of the program, participating employers will be subject to a special six-year statute of limitations (rather than the usual three years) for payroll taxes, meaning that the IRS will have six years to audit the employer's compliance with payroll tax matters for the first three years post-VCSP participation.

However, as discussed below, there are other potentially serious consequences that could arise through an employer's participation in the program. And even if an employer was audited by theIRS for worker classification issues, it might be able to avoid liability under an existing IRS program or pay reduced taxes under statute. Accordingly, an employer considering whether to participate in the VCSP should carefully consider the costs and risks of participation in VCSP against the incremental tax savings that could not be achieved through any other IRS program.

Example of Potential VCSP Savings *(for 100 misclassified workers earning $60,000 per year for three years)*	
Under IRS Audit for 2008-2011	Approx. Liability
Payroll Tax Liability	$ 2,500,000
Interest	$ 150,000
Penalties[2]	$ 500,000
Total Exposure on Audit	$ 3,150,000
Under VCSP[3]	$ 64,000
Total Exposure	

Other Issues

While the VCSP provides significant protection from potential federal employment tax liability, reclassifying independent contractors as employees often raises a whole host of issues that are not ameliorated by VCSP. For example, state and local taxes are not covered by the VCSP. Moreover, participation in the VCSP is not binding on any other governmental agency.

Consequently, employers that participate in the VCSP could be subject to claims for unpaid unemployment taxes and other governmental payments for individuals reclassified as employees. The agencies may assert that VCSP participation is an employer admission of misclassification. Most importantly, individuals reclassified as employees often bring claims for overtime, meal breaks, workers compensation, employee benefits and the like. While employee benefit claims often have been mitigated by careful plan drafting, many of these other obligations cannot.

Employers should also confirm that the tax savings purportedly obtained through the VCSP is not available through other means. The IRS already maintains a classification settlement program pursuant to Section 530 of the Tax Reform Act of 1978, whereby a worker will not be reclassified as an employee retroactively assuming that the service recipient meets certain requirements.[4] In addition, federal courts sometimes employ a more favorable classification analysis for workers employed in certain industries. And, IRC Section 3509 already provides for certain relief for failing to remit income and employment taxes if the taxpayer satisfies its requirements.[5]

Increased Enforcement Efforts

The VCSP is part of increased efforts by the Obama Administration to address a perceived widespread misclassification of employees as independent contractors.

In another step, on September 19, 2011, the IRS, the U.S. Department of Labor, and seven states (currently Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah and Washington) entered into a Memorandum of Understanding permitting the agencies and states to share information, which will allow increased enforcement efforts in pursuing employers for misclassification issues.

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[1] Ten percent of the amount of employment taxes calculated under the reduced rates of IRC 3509 for the compensation paid for the most recent tax year to the workers being reclassified under the VCSP.

[2] Assuming imposition of the negligence penalty under IRC §6662(b). Of course, the IRS also could assert the following penalties (among others) (i) penalty for failure to pay the required employment taxes is 5 percent per month of unpaid taxes, up to a 25 percent maximum, IRC §6651(a)(2), (ii) penalty for failing to file Forms W-2, (iii) penalty for failure to deposit employment taxes up to a maximum of 10%.

[3] This example compares potential tax liability as of April 15, 2012, and assumes that the employer has submitted the VCSP application during 2011 for worker reclassification as of January 1, 2012. This example also assumes that reduced rates under IRC § 3509 would be applicable even if the employer does not participate in VCSP.

[4] The requirements of Section 530 of the Tax Reform Act of 1978 are: (1) the service recipient generally does not treat the individual as an employee for any period; (2) the service recipient does not treat any other individual holding a substantially similar position as an employee for purposes of employment taxes for any period; (3) all required federal tax returns are filed by the service recipient on a basis consistent with the taxpayer's treatment of the individual as a nonemployee; and (4) the service recipient has a reasonable basis for not treating the individual as an employee. The VCSP is more liberal than relief afforded under Section 530 because, under section 530, an employer must have a reasonable basis for treatment of workers as independent contractors.

[5] The applicable requirements for IRC § 3509 are the information reporting requirements of IRC §§ 6041(a), 6041A, or 6051 that would be applicable consistent with the employer's treatment of the employee as a nonemployee. IRC § 3509(b)(2).