SUMMARY

- New IRS program offers limited amnesty to businesses that have been misclassifying workers as independent contractors.
- Qualifying businesses pay only about one percent of wages that were paid over the previous year to reclassified workers.
- To qualify, businesses must (a) have consistently treated the workers as non-employees, (b) have filed all 1099s for the previous three years and (c) not currently be under audit by a government agency.
- Independent contractor vs. employee is often a judgment call which may be made differently by the IRS and the business.

NEW IRS PROGRAM CAN BENEFIT BUSINESSES WHICH HAVE MISCLASSIFIED WORKERS

By Davis Goodman – October 2011

As part of the IRS' "Fresh Start" initiative, which is a series of efforts by the IRS to help taxpayers become compliant with their tax obligations, businesses can now enter into a Voluntary Classification Settlement Program ("VCSP") to reclassify non-employee workers (a/k/a "independent contractors") prospectively as employees. In exchange for this voluntary reclassification, the IRS will limit the federal employment tax liability for past non-employee treatment to approximately one percent of wages paid over the year preceding reclassification.

The line between independent contractor and employee is not always clear and, in the end, how a worker is classified is frequently a judgment call. If a business has been making the "wrong call" (at least as far as the IRS is concerned), the VCSP provides a limited form of amnesty.

Just days before the IRS announced the VCSP in late September, the United States Department of Labor initiated an aggressive new enforcement program designed to end what it calls the "widespread" practice of misclassifying employees. The new enforcement program includes sharing of information among the Department of Labor, IRS, other federal agencies and at least 11 states (California has not yet agreed to participate). In addition to this information sharing crack-down, somewhat of a cottage industry has sprung up among plaintiffs' attorneys looking for misclassified employees on whose behalf to file class actions seeking large sums of compensatory and statutory damages.

Participating in the VCSP, therefore, could prevent an IRS finding that past misclassification occurred and an employer's concomitant – potentially disastrous – liability to pay several years of back due payroll taxes, penalties and interest. VCSP participation could also head off an intrusive and expensive Department of Labor audit and, potentially, the filing of a class action lawsuit (although, at the present time, it remains unclear how the amnesty afforded by the VCSP will impact an employer's liability for civil damages.)

What's the Advantage of the Program for Me?

Under the VCSP, qualifying businesses will be able to pay an amount equal to just over one percent of the wages paid over the last year to those workers who are voluntarily reclassified with no interest or penalties. There are drawbacks, however. First and foremost, employers must pay 100% of all taxes due on payrolls for reclassified employees on a going forward basis. In other words, the forgiveness of tax liability is strictly retrospective, not prospective. Second, employers who sign up for the benefits of VCSP participation agree to have their going forward compliance subject to IRS review for six, as opposed to the normal three, years. Presumably, this is because the IRS wants to discourage "backsliding."

How do I Qualify for the Program?

To qualify for the program, a business must (a) have consistently treated its workers in the past as non-employees, (b) have filed all Forms 1099 for the previous three years, and (c) not currently be under audit concerning the classification of the workers by the IRS, the Department of Labor or a state agency.

Is my Worker an Independent Contractor or an Employee?

In the broadest terms, to determine whether a worker is an independent contractor or an employee, the IRS looks at whether the business has the *right to control* the details of how the worker's services are performed, regardless whether such control is actually exercised. More specifically, the IRS looks at three major categories of control to determine whether a worker is an employee or an independent contractor:

1. Behavioral Control
2. Financial Control
3. Type of Relationship

Each case will turn on its own facts, but the IRS does offer some guidelines for each of the three major categories that they review.

1. Behavioral Control.

The IRS looks at four categories to determine the degree of behavioral control:

(a) What type of instruction is given? Does the business tell the worker when and where to work, what tools to use, what workers to hire, what order to follow when performing the work, etc?

(b) What is the degree of and how detailed is the instruction? The key characteristic is whether the business has retained the right to control the details of the worker's performance or whether the worker has given up that right.

(c) What is evaluated? Does the business evaluate the details of how the work is performed or the end result?

(d) What kind of training is provided? Does the business train the worker or does the worker use his/her own methods?

2. Financial Control.

The IRS considers five indicia to determine how much the business controls the economic aspects of the worker's job.

(a) Who makes the investment in tools required for the job?

(b) Are expenses reimbursed?

(c) Does the worker have an opportunity to make a profit or loss? The IRS considers an opportunity for loss more significant that an opportunity for profit.

(d) Are the worker's services generally available to the market?

(e) How is the worker paid? A guarantee of a regular wage amount for an hourly, weekly or other period of time is indicative of an employee, for example.

3. Type of Relationship.

How do the business and the worker perceive their relationship with the other?

In general, the IRS considers four categories to determine how the relationship is perceived, though none by itself is determinative.

(a) Is there a written contract?

(b) Are there employee benefits?

(c) Is there a specific time involved? If the relationship is for a specific project or period, rather than for an indefinite time, the worker is more likely to be viewed as an independent contractor.

(d) Is the service provided a key aspect of the business? Workers providing a service that is a key aspect of the business are more likely to be considered employees, because the business is more likely to have the right to direct and control the worker's activities.

Should I Apply for the Program?

Because many businesses may not know whether their workers have been misclassified, it is best to seek the advice of counsel before volunteering for VCSP participation. While the IRS will require only a relatively small amount of previously unpaid payroll taxes as the price of participation, an employer's tax bill going forward will increase as all payroll taxes for all reclassified employees must be paid on a current basis. On the other hand, for employers currently operating in the "danger zone," the VSCP may well offer a desirable alternative.

Further Information

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