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IRS Launches Voluntary Compliance Settlement Program for Misclassified Workers

By William Hays Weissman

On September 21, 2011, the Internal Revenue Service (IRS) announced that it was launching a new Voluntary Compliance Settlement Program (VCSP) that will enable employers to resolve past worker classification issues by paying a small amount of tax in exchange for reclassification of contractors as employees on a forward-going basis. See IRS Announcement 2011-64.

According to IRS Commissioner Doug Shulman, "This settlement program provides certainty and relief to employers in an important area. This is part of a wider effort to help taxpayers and businesses to help give them a fresh start with their tax obligations."

The VCSP is available to private employers, tax-exempt organizations and government entities. To be eligible, an applicant must:

- Consistently have treated the workers in the past as nonemployees;
- Have filed all required Forms 1099 for the workers for the previous three years; and
- Not currently be under audit by the IRS, the Department of Labor, or a state agency concerning the classification of the workers at issue.

Employers apply by filing a new form, Form 8952, *Application for Voluntary Classification Settlement Program*, at least 60 days before they want to begin treating the workers as employees. The two-page form requests basic information about the employer, a description of the workers, and the amounts paid to them for the most recently completed tax year. The IRS will first determine whether the taxpayer is eligible, and, if so, will contact the taxpayer or its representative to complete the process. The IRS retains discretion to reject any taxpayer from the VCSP, including taxpayers that otherwise meet the basic eligibility criteria.

A taxpayer participating in the VCSP will agree to prospectively treat the class or classes of workers as employees for future tax periods. In exchange, the taxpayer:

- Will pay 10% of the employment tax liability that would otherwise have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of section 3509(a) of the Internal Revenue Code (IRC).
- Will not be liable for any interest and penalties on the amount; and
- Will not be subject to an employment tax audit with respect to the previous classification of the workers being reclassified under the VCSP.

Participating employers will, for the first three years under the program, also be subject to a special six-year statute of limitations, rather than the three-year limitation period that generally applies to payroll taxes.

In addition, while no payment is due with the application, full and complete payment will be due at the time the VCSP closing agreement is returned to the IRS.

Employers are not obligated to reclassify all independent contractors, but may elect specific workers. For example, a construction contractor that uses drywall installers, plumbers and electricians as independent contractors may decide to reclassify the drywall installers as employees. It can submit an application solely for the drywall installers without addressing the plumbers or electricians.

Because the taxpayer pays only 10% of the reduced rate of employment tax liability, which is 10.68% under IRC section 3509, participation in VCSP allows the employer to pay to the IRS about 1% of the compensation paid to the workers being reclassified. For example, a taxpayer paid \$1,000,000 in the most recently completed tax year to workers that are the subject of the VCSP. Under section 3509, the employment taxes applicable to \$1,000,000 would be \$106,800 (10.68% of \$1,000,000). Under the VCSP, the taxpayer pays 10% of \$106,800, or \$10,680.

Taxpayers that are not currently undergoing any audit and have questionable classes of workers should think carefully about whether participating in the VCSP makes sense. For example, by applying for the VCSP, taxpayers will be foregoing their rights to assert "safe harbor" relief under Section 530 of the Revenue Act of 1978 in the future, and thus potentially maintain independent contractor status for the workers (*See Littler's February 2010 ASAP, The Truth About Recent Attacks on the Independent Contractor Classification*). A taxpayer might also be concerned that, if the IRS does not accept its application, a roadmap has been provided to the IRS for a future audit, as it is unclear at present what happens to this information should the IRS, in its discretion, not accept a VCSP application. Of further concern, however, is that the three-year extension of the statute of limitations appears to apply to employment taxes generally, and not merely the classification of workers subject to the VCSP, which may be a deterrent to taxpayers agreeing to apply for the VCSP.

In addition, if a taxpayer is not currently under audit but has previously undergone an audit, they may still be eligible for the VCSP if they have followed the results of the audit. It is unclear whether, for example, a cursory investigation such as one by a state workforce development agency into a claim for unemployment benefits would constitute an audit for purposes of the VCSP.

It is anticipated that the IRS will provide some further clarification of how the VCSP will work, such as whether unemployment benefits audits constitute an audit or whether the three year statute extension applies to all employment taxes or only the particular classification at issue. Employers who have questions about the VCSP should contact experienced employment counsel to review the pros and cons of participating.

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