



Legal Alert: Employee Misclassification Relief?

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Executive Summary: The IRS recently announced a new "Voluntary Classification Settlement Program" (VCSP), which allows employers to correct worker classification errors and pay significantly reduced penalties, without having to go through either an examination or complicated administrative procedures.

Background

Proper classification of workers, as employees or independent contractors, is always an issue for both employers and the workers themselves. One of the major effects of classifying an individual as either an employee or a contractor is employment tax liability on the part of the "employer." An employer who finds that employees have been misclassified as contractors may wish to correct that error, but doing so will usually expose the employer to penalties with respect to employment taxes and withholding failures and the employer may not be willing to take on those liabilities, especially for prior years.

In limited circumstances, there have been ways of obtaining relief from the tax penalties. Section 530 of the Revenue Act of 1978 provided, and continues to provide, retroactive relief for employee misclassification if certain conditions exist, but those conditions include a reasonable basis for the misclassification based upon judicial precedent, IRS ruling or long-standing industry practice. Alternatively, the Internal Revenue Service has a Classification Settlement Program (CSP) that can be used to resolve employment tax issues with reduced sanctions for employers who are undergoing an employment tax audit. However, most employers, who have neither the good fortune to qualify for Section 530 relief nor the misfortune to be selected for audit, are left to deal with these matters on their own.

Voluntary Classification Settlement Program (VCSP)

Last week, the IRS issued the VCSP, which enables employers to voluntarily correct worker classification errors with significantly reduced penalties, without having to go through either an examination or complicated administrative procedures. Any business – including tax-exempt organizations and government entities – that has been treating workers (or a class or group of workers) as independent contractors or other nonemployees may prospectively elect to treat those workers as employees, so long as the employer:

- consistently treated the workers as nonemployees;

- filed all required Forms 1099 for the workers for the previous three years;
- is not under audit by the IRS, or by the Department of Labor (DOL) or a state government agency with respect to the classification of the workers; and
- has complied with the results of any prior IRS or DOL audit concerning the classification of the workers.

An employer who participates in the VCSP agrees to prospectively treat the workers in question as employees, and to pay 10 percent of the employment tax liability that would have been due on the workers' compensation for the most recent tax year, determined using the already-reduced rates of section 3509 of the Internal Revenue Code. The employer will not be liable for any interest or penalties on that tax liability, and will not be subject to an employment tax audit with respect to the classification of the workers for prior years. On the other hand, an employer participating in the VCSP must agree to extend by three years the period of limitations on assessment of employment taxes for the first three calendar years beginning after the date as of which the workers are treated as employees.

VCSP Penalty

Regarding the VCSP penalty, an employer who is subject to section 3509 of the Internal Revenue Code owes employment taxes equal to the sum of (i) the regular amount of employer-paid FICA, (ii) 20% of the otherwise-applicable amount of employee-paid FICA, and (iii) 1.5% of the employee's wages in lieu of income tax withholding. This totals 10.28% of compensation up to the Social Security wage base (for 2011, for which employee FICA rates were reduced), and 3.24% of compensation above the wage base. The VCSP penalty is 10% of that amount, or approximately one percent of the employees' compensation for the preceding tax year. This can be an extremely favorable result for the employer.

IRS Forms Implementing the VCSP

In order to implement the VCSP, the IRS also issued Form 8952, which is used to request relief under the program. The Form can be found at <http://www.irs.gov/pub/irs-pdf/f8952.pdf>, and the instructions at <http://www.irs.gov/pub/irs-pdf/i8952.pdf>.

Issues to Consider Before Agreeing to Participate in the VCSP

While the VCSP may seem appealing, before agreeing to participate in the program, employers should consider certain factors, including:

- ***Confidentiality:*** First, the extent to which the employers' voluntary submissions to the IRS will be subject to disclosure is not entirely clear. "Tax return information" is protected from disclosure, as are personal and financial data, with certain exceptions (such as state and municipal taxing authorities that have agreements with the IRS). However, last week the IRS and the DOL also entered into a Memorandum of Understanding regarding referrals and sharing of information concerning worker classification cases. The agencies agreed to refer matters to each other, and to state and local agencies, to the extent permitted by law. There is no agreement concerning any of the information becoming available to the public, but if information

were to become public, the settlements could easily be converted into wage hour class actions based on the employer's admissions that it misclassified employees.

- ***VCSP Does Not Resolve Other Potential Liability:*** Secondly, the VCSP is exclusively aimed at employment tax compliance. Many employers may believe that this program will absolve them of all liability related to their misclassified employees. The VCSP does not, however, relieve employers of liability under state tax laws, workers' compensation laws, federal or state wage and hour laws (overtime, minimum wage, meal breaks, termination payouts, etc.), ERISA, or other employment laws. After settling employment tax liabilities with the IRS, employers may find themselves having to deal with additional fines, penalties and other liabilities.

Employers' Bottom Line:

There are many factors to consider before participating in the VCSP. Employers who become aware that their employees are misclassified may be better off coming into compliance and taking a wait and see approach. However, the program will be a viable option for some employers.

If you have any questions regarding the new program or employee classification in general, please feel free to contact the authors of this Alert, Jeffrey Ashendorf, jashendorf@fordharrison.com, or Salvador Simao, ssimao@fordharrison.com, any member of Ford & Harrison's Employee Benefits Practice Group or the Ford & Harrison attorney with whom you usually work.