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LABOR & EMPLOYMENT ALERT

OCTOBER 2011

Three New Programs to Encourage Worker Reclassification Unveiled

By M. Christine Carty

Within the last few weeks, the Internal Revenue Service ("IRS"), the U.S. Department of Labor ("DOL") and 11 states have joined forces to launch a new set of initiatives to reduce the misclassification of workers.

On September 19, 2011, Hilda Solis, the U.S. Secretary of Labor, announced a joint effort between the DOL, the IRS and 11 states to share information and "coordinate law enforcement" among them with the goal to "end the practice of misclassifying employees in order to avoid providing employment protections." The participating states are Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, New York, Utah and Washington.

A few days later, on September 21, 2011, the IRS announced its Voluntary Classification Settlement Program ("VCSP"). According to the IRS[1], the VCSP allows companies that have applied for and been accepted into the VCSP to "reclassify their workers as employees for employment tax purposes for future tax periods with partial relief from federal employment taxes." Companies that receive VCSP treatment will: (i) pay ten percent (10%) of their employment tax liability for the reclassified workers for the most recent tax year; (ii) pay no interest or penalties; and (iii) not be subject to employment tax audits for prior years regarding classification of the workers being reclassified. To be eligible for the VCSP, a company must have consistently treated the workers as independent contractors, including filing Forms 1099, for the last three years, and not be under a classification audit by the DOL or a state government entity. If a company[2] is granted VCSP treatment it must agree to extend the three-year statute of limitations for employment tax issues for three (3) years for each of the first three years after the VCSP closing agreement. Thus, a company that participates in the VCSP beginning in 2011 must agree to a six year statute of limitations for employment tax audit purposes for the calendar years 2012, 2013 and 2014 activities. The consequence of this extension is that these tax years will not be closed for six years until after the end of 2018, 2019 and 2020 and back taxes, penalties and interest could be assessed for six, rather than the current three, years retroactively.

These two programs are the latest efforts of the Obama Administration to reduce the classification of workers as independent contractors. In this year's Fiscal Year 2012 Revenue Proposals (the "2012 Revenue Proposal"), the Administration announced its intent to "permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law" and "to issue generally applicable guidance on the proper classification of workers." The full text of the 2012 Revenue Proposal addressing classification makes clear that President Obama seeks the repeal of the safe harbor found in Section 530 of the Internal Revenue Act of 1978 ("Section 530 Safe Harbor"). The Safe Harbor[3] prevents the IRS from reclassifying workers as employees if certain criteria are met, including: (i) the consistent treatment of the workers as non-employees; (ii) the filing of Forms 1099 for the preceding three years for the workers in question; and (iii) the existence of a "reasonable basis" for clas-

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1. See IRS Announcement 2011-64.
2. Nonprofit organizations are eligible for the VCSP.
3. The Section 530 Safe Harbor was previously described in our Labor and Employment Alert dated September 2, 2011.

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sifying the workers as non-employees. Section 530 provides that a "reasonable basis" can include a prior classification audit of the same category of workers, a court decision, industry practice, and/or the opinion of a qualified attorney or an accountant. Section 530 also prohibits the IRS from issuing revenue rulings and other similar guidance concerning classification and requires the IRS, before conducting a classification audit of a company, to determine first if that company is eligible for Section 530 Safe Harbor treatment.

The 2012 Revenue Proposal also advocates reduced penalties for misclassification, but only if a company voluntarily reclassifies workers before being contacted by the IRS and is fully compliant in making its Form 1099 filings. According to the 2012 Revenue Proposal, "after enactment, new enforcement activity would focus mainly on obtaining proper worker classification prospectively."

The first step in implementing the classification goals of the 2012 Revenue Proposal was the introduction of the Payroll Fraud Prevention Act ("PFPA") in April 2011. As reported in our September 2, 2011 Alert, the PFPA would create a new class of workers — non-employees — who are covered by the Fair Labor Standards Act. It also would require companies to provide notices to workers of their classification status[4] and rights and refer them to a newly created DOL website. If enacted, the PFPA *would not* affect the Section 530 Safe Harbor for federal employment tax purposes. The PFPA, S. 770, has been referred to the Senate Health, Education, Labor and Pension Committee ("Senate Committee") where no action has been reported to date.

4. The DOL announced some time ago that it intends to promulgate a rule, expected before the end of 2011, that would require such notices to be provided by employers to all workers who they classify as independent contractors or as exempt from overtime under the FLSA.

5. The 2010 budget for the DOL Wage and Hour Division increased sufficiently to permit it to hire 140 full time investigators to focus largely on misclassification, held steady in 2011 and seeks an increase of $12 million in 2012 to hire an additional 95 agents.

The two new programs — the VCSP and the joint DOL/IRS/state misclassification effort — implement two other stated goals of the 2012 Revenue Proposal. The VCSP provides for voluntary reclassification and 90 percent amnesty for back employment taxes and full amnesty for penalties and interest. The joint DOL/IRS/state efforts focus on enforcement of classification statutes, not only for employment tax purposes, but also under numerous other statutes, including the Fair Labor Standards Act ("FLSA"), the Occupational Safety and Health Act ("OSHA") and the Employees Retirement Income Security Act ("ERISA") and state workers' compensation, unemployment and disability laws, which protect employees but not independent contractors.

The three initiatives could be characterized as the "two sticks and a carrot" approach to classification. The "sticks" are the threat of increased numbers of IRS, DOL or state agency audits under the new DOL/IRS/state enforcement program,[5] coupled with efforts to enact the PFPA and a stated intent to attempt repealing the Section 530 Safe Harbor. Together or separately, these may present substantial concerns and uncertainty for companies. As a result, companies may favorably consider the "carrot" of the VCSP now being offered by the IRS to eliminate uncertainty and the potential cost of one or more audits, potential penalties, interest and back employment taxes. At least, it appears that the IRS, the DOL and the Administration hope for this outcome.

It is too early to project with confidence whether the PFPA will be enacted or Section 530 will be repealed. The legislation to repeal Section 530 has not yet been introduced and the PFPA remains in the Senate Committee. It is likely, however, that the Republican-controlled House of Representatives will not favor either piece of legislation. Nonetheless, even if Section 530 remains in place and the PFPA is not enacted, employers are likely to experience an increased number of audits at both the state and federal levels, particularly in targeted industries of construction, child care, home health care, grocery stores, janitorial, business services, landscaping and poultry/meat processing.

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In weighing whether circumstances make the VCSP's mitigation of tax liability an attractive option, employers should carefully consider the possible collateral consequences of admitting to past misclassification under other laws, such as state statutes, FLSA, OSHA and ERISA. This is especially important given the DOL's new enforcement program and heightened cooperation with the IRS and the states.[6] It is important to note in this regard that a pending classification audit by *either* a state agency or the DOL will disqualify a company from VCSP treatment. This means that a classification audit arising from a state unemployment, workers' compensation or disability application can be a disqualifier.[7] And, when considering applying for VCSP treatment, a company should recognize that, if granted, it will most likely no longer be eligible for the Section 530 Safe Harbor since it will have switched the workers from non-employees to employees, thereby ending its ability to satisfy the Section 530 requirement of consistent treatment as non-employees. In short, upon entering the VCSP, there will be no turning back, at least under the current law. It is also worth noting that the benefits claimed by the IRS to be conferred by the VCSP are illusory to companies covered by the Section 530 Safe Harbor. Since the VCSP, by its terms, only has prospective effect, if a company seeks and receives VCSP treatment for a class of workers covered by the Section 530 Safe Harbor, there is no legal basis to assess any employment taxes, penalties, or interest for prior years. Such a company would be paying 10 percent of employment taxes for a year that it does not owe and, in addition, agreeing to leave its books open for IRS audit for employment taxes for twice the usual limitations period for the three years after it opts for VCSP treatment.

We will continue to watch worker classification developments carefully and report on them as they emerge. ◆

6. Apart from whether a state has joined the new DOL/IRS/state enforcement program, the PFPA, if enacted, also would create an incentive to states to cooperate with the DOL's efforts regarding misclassification because states will be required to establish administrative penalties for misclassifying employers for unemployment compensation purposes as a condition to receiving Federal Unemployment Tax Act ("FUTA") funds.

7. A Form 990 series examination of an exempt organization also is a disqualifying audit according to IRS issued guidance.

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