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ACT NOW ADVISORY

IRS Announces Voluntary Classification Settlement Program

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On September 21, 2011, the Internal Revenue Service ("IRS") announced a new program that will give businesses the opportunity to resolve prior worker classification issues by voluntarily reclassifying their non-employee workers (such as consultants, freelancers, and independent contractors) as employees for federal employment tax purposes. Officially called the "Voluntary Classification Settlement Program" ("VCSP"), this program is part of a larger "Fresh Start" initiative at the IRS to aid taxpayers and businesses in addressing their federal tax liabilities.

As you are likely aware, for federal tax purposes, payments to employees are subject to income tax and employment tax withholding, while payments to independent contractors are not. Distinguishing employees from independent contractors can be challenging, and misclassifications can lead to IRS audits, among other things, which often result in determinations requiring the payment of back taxes, interest, and penalties.

The VCSP allows employers to avoid IRS audits and obtain substantial relief from federal payroll taxes they may have owed in the past if they agree to treat their non-employee workers as employees prospectively. Employers that participate in the VCSP will pay 10 percent of the employment tax liability that may have been due on compensation paid to those workers for the most recent tax year, but will be required to treat those workers – and all other workers in that "class" of employment – as employees, and withhold taxes on their wages, going forward.

Participating employers will not be subject to interest or penalties on past-due employment tax liabilities attributable to those workers and will not be subject to an IRS audit with respect to those workers (but *only* those workers – the employer may still be subject to audit with respect to all other worker classifications). During the first three years following the reclassification, however, participants in the VCSP will be subject to a special six-year statute of limitations ("SOL"), rather than the standard three-year SOL, on tax liability actions. In other words, during this three-year period, the IRS will be permitted to look back six years, not three, when determining whether to assess employment tax penalties against the employer for tax liability with respect to its employees (aside from those just reclassified under the VCSP).

To be eligible to participate in the VCSP, an employer 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 *[NOTE: If the company has been in existence for fewer than three years, or any worker in the classification has been working in that classification for three years, the company may still participate in the VCSP, so long as IRS Forms 1099 have consistently been filed for workers in the classification. A company would not, however, be eligible to participate if, within the last three years, one or more of the workers in the classification was issued an IRS Form W-2 by the employer*.]
- Not currently be under audit by the IRS, the U.S. Department of Labor ("DOL"), or a state agency concerning the classification of these workers *[NOTE: Employers under "SS-8 review" are not considered to be subject to an audit and are, therefore, eligible to participate in the VCSP. An "SS-8 review" – a process initiated by the filing of an IRS Form SS-8 by either a worker or a company – involves seeking an IRS determination as to the classification status of a worker.]*

Application for the VCSP will be made by filing Form 8952 with the IRS at least 60 days before the employer proposes to reclassify the workers as employees. Employers whose application has been accepted will enter into a closing agreement with the IRS to finalize the terms of the VCSP, and will simultaneously make full and complete payment of any amount due under the closing agreement.

Interestingly, the VCSP was announced only days after the IRS and DOL entered into a Memorandum of Understanding ("MOU"), in which those two agencies pledged to improve interagency communications with respect to worker misclassification issues. In addition, seven states have also recently signed MOUs with the DOL on this same topic. Although New York has not yet signed, the DOL has announced an agreement to enter into an agreement with the New York Attorney General's Office.

Importantly, although the MOU does not indicate that information regarding VCSP participation will be shared between agencies, there is no guarantee that it will not be shared. That is, although a participating employer will shield itself from IRS audits regarding the reclassified positions, this does not preclude (i) IRS audits with respect to other positions, (ii) audits by state taxing authorities, or (iii) federal or state labor authority (*i.e.,* DOL) audits.

What Employers Should Do Now

- Review your workforce to see whether there are any workers, or a groups of workers, who may have previously been, and continue to be, misclassified as independent contractors;

- Contact your employment counsel to discuss:

    - Whether the workers in question would likely be deemed "employees," if challenged;
    - Whether reclassification will affect your obligations regarding other regulatory agencies;

- What the ramifications of reclassifications will be, because an employer may be required to reclassify an entire class of workers and will remain open to audit in other areas and by other agencies; and
- Whether the VCSP will ultimately benefit you.

For more information about this Advisory or for assistance in addressing any potential worker misclassification concerns at your organization, please contact:

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