

## **IRS Creates New Voluntary Classification Settlement Program Providing Companies the Opportunity to Reclassify Independent Contractors and Limit Liability**

**October 18, 2011**

The Internal Revenue Service (IRS) has released details regarding its new Voluntary Classification Settlement Program (VCSP) in Announcement 2011-64.<sup>1</sup> The VCSP provides taxpayers a new opportunity to reclassify as employees workers that have been incorrectly treated as independent contractors for employment tax purposes, with partial relief from back federal employment taxes. Unlike the current Classification Settlement Program (CSP), the VCSP does not require that a company currently be under audit by the IRS.

### **Overview**

The VCSP supplements the IRS's existing CSP, expanding eligibility to voluntarily correct misclassified workers. The current CSP is available to resolve federal employment tax issues related to worker misclassification if certain criteria are met. The CSP permits the prospective reclassification of workers as employees, with reduced federal employment tax liabilities for past nonemployee treatment. The CSP allows business and tax examiners to resolve the worker classification issues as early in the administrative process as possible, thereby reducing taxpayer burden and providing efficiencies for both the taxpayer and the government.

If a company discovers a potential misclassification, but is not currently under audit, the company cannot take advantage of the CSP. In that instance, the company would face significantly higher employment tax liabilities than the reduced rates available under the CSP. Moreover, the company may be subject to penalties and interest on the liabilities. Finally, such a reclassification could itself trigger an audit. Recognizing these potential obstacles to properly classifying workers, the IRS created the VCSP to facilitate voluntary reclassification and achieve increased tax compliance and certainty for taxpayers and the government. However, although the VCSP does not require the company to be currently under audit and offers more favorable tax settlement rules, its eligibility restrictions are more restrictive than those in the CSP.

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1. View the full announcement online at <http://www.irs.gov/pub/irs-drop/a-11-64.pdf>.

## **Eligibility for the VCSP**

The VCSP is available to companies who currently treat a worker or group of workers as independent contractors or other nonemployees and want to prospectively treat the workers as employees. To be eligible, companies must have consistently treated the workers they wish to reclassify as nonemployees or independent contractors for tax purposes. This means the company must have filed Forms 1099 for each of the workers for the previous three tax years. In addition, the company cannot be under audit by the IRS, Department of Labor, or state government agency. A taxpayer who was previously audited by the IRS or the Department of Labor concerning the classification of the workers (or class of workers) in question will only be eligible if the taxpayer has complied with the results of that audit.

## **VCSP's Reduced Employment Tax Liability**

Under the VCSP, if a taxpayer agrees to voluntarily reclassify a worker (or class of workers), the company will pay 10% of the employment tax liability that may have been due on compensation paid to the worker for the most recent tax year as determined by Internal Revenue Code Section 3509.<sup>2</sup> The taxpayer will not be liable for any interest and penalties on the liability, and will not be subject to an employment tax audit with respect to the worker classification of the workers for prior years.

If a company wishes to enter into the VCSP, it must complete the appropriate application with the IRS. Companies that are accepted by the IRS into the VCSP will enter into a closing agreement with the IRS and simultaneously make full and complete payment of any amount due under the closing agreement.

## **Identifying Potentially Misclassified Workers**

While there are many factors that assist in the determination of whether a worker is an employee or independent contractor, there is no clear definition of what constitutes an independent contractor. Whether a worker is performing services as an employee or as an independent contractor depends upon the facts and circumstances and is generally determined under the common-law test of whether the service recipient has the right to direct and control the worker as to how to perform the services. Understandably, companies sometimes misclassify workers as independent contractors as they attempt to navigate through the current rules.

## **Implications**

Companies should review their independent contractor arrangements to determine if they have properly classified their workers. If a company believes that workers are improperly classified, the IRS's new VCSP may be an option in lieu of full relief under the safe-harbor provisions of Section 530 of the Revenue Act of 1978, which provides that, if certain requirements are met, an employer may treat an individual as an independent contractor for employment tax purposes. Reclassifying workers through the VCSP or other means, however, can have additional nontax ramifications that should also be considered, whereas reliance on Section 530 relief would not require altering the worker's independent contractor classification status.

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2. Like the CSP, the VCSP provides relief only with respect to federal payroll tax liability but does not include relief from Federal Unemployment Tax Act (FUTA) liabilities.

If you have any questions or would like more information on the classification of your workers or the IRS's VCSP, please contact any of the following Morgan Lewis attorneys:

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