THE
NATIONAL LAW REVIEW

New IRS Voluntary Initiative Aims to Provide Significant Tax Relief to Employers with Employee-Independent Contractor Misclassification Issues

Article By
G. Michelle Ferreira
Scott E. Fink
Courtney A. Hopley
Barbara T. Kaplan
Greenberg Traurig, LLP

- Law Office Management
- Tax
- Labor & Employment
- Administrative & Regulatory

- All States
- All Federal

Sunday, October 2, 2011

Two developments announced by the **Internal Revenue Service (IRS)** in the last few days show the continuing commitment of the **IRS and the Department of Labor (DOL) to enforce the worker classification laws aggressively and to encourage businesses to properly determine and withhold employment taxes**.

In the first development, the **IRS entered into a Memorandum of Understanding with the DOL and 11 states on September 19, 2011, which will help facilitate information sharing between the two agencies and the states regarding employee classification**. In the second development, on September 21, 2011, the IRS announced a new program that will enable eligible employers to resolve their worker misclassification issues by allowing the reclassification of its workers as employees in exchange for significant relief from past employment taxes,

penalties and interest and the avoidance of an IRS audit. This *GT Alert* discusses these developments.

It is no secret that the IRS has focused on the enforcement of employment tax noncompliance for some time. In September of 2009, the IRS announced a national research project to evaluate the level of compliance with employment tax laws among a wide range of companies, including small and large businesses, government entities and non-profit organizations. The IRS promised to perform comprehensive audits of 6,000 employers from 2010 through 2012 in an effort to gain information on where the employment tax abuses really were. In particular, the IRS focused on the following compliance issues: (i) worker misclassification; (ii) executive compensation; (iii) fringe benefits; and (iv) compliance with return filing obligations (i.e. W-2s, 1099s, 940s and 941s.) In addition to gathering data regarding employment tax gap, the purpose of the national research project was to identify tax returns with the greatest risk for noncompliance and to increase enforcement efforts in employment tax reporting.

From a tax perspective, **there is a financial incentive for employers to classify workers as independent contractors instead of employees because businesses do not have to withhold federal income tax or pay Social Security, Medicare or Federal Unemployment taxes on payments made to independent contractors**. The IRS is cracking down on abuses in involving employment tax non-compliance and it is intent upon closing the tax gap by specifically increasing its employment tax audits. Under the Memorandum of Understanding, the DOL has agreed to provide the IRS with information obtained from Wage and Hour Division investigations that may raise employment tax compliance issues. The information sharing between the DOL and the IRS is likely to lead to more employment tax audits on a wide range of taxpayers — small- and mid-size businesses, large businesses and international companies, charitable organizations and governmental entities. Although IRS Commissioner Douglas Shulman stated that the **Memorandum of Understanding is "unrelated" to the new Voluntary Classification Settlement Program (VCSP),** it is clear that the IRS is focused on targeting worker classification underreporting.

The VCSP is designed to allow businesses to become compliant with its worker classifications at a significantly reduced cost to the taxpayer. The VCSP came within two days of the announced agreement between the DOL and the IRS to share information regarding employee misclassification and within one year into the employment tax audits of 6,000 random U.S. employers by the IRS. (See previous *GT Alert*, Are You Ready for an IRS Employment Tax Audit?)

The new VCSP provides an opportunity for eligible employers to become compliant with employment tax laws at a reduced cost before they are detected by the IRS. The determination of whether a worker is performing services as an employee or independent contractor is complicated and depends on the facts and circumstances of each case. Eligible employers that have misclassified workers in the past or are uncertain of the proper classification can apply for the relief under the VCSP. To be eligible for the VCSP, an employer must have consistently treated workers as non-employees in the past and filed all required Forms 1099 for the workers for the previous three years. Additionally, there cannot be a dispute between the employer

and the IRS, the DOL or a state agency regarding the classification of its workers, or the employer will not be eligible to participate in the VCSP.

An employer that participates in the VCSP must agree to prospectively treat their workers (or a class or group of workers) as employees for future tax periods. In exchange for the reclassification of its workers to employees, the employer: (i) will only be required to pay 10 percent of the employment tax liability that may have been due on compensation paid to the workers for the past year; (ii) will not be liable for any interest and penalties on that liability; and (iii) will not be subject to an employment tax audit with respect to the worker classification issue for the past years. Under the VCSP, the resulting liability would be approximately one percent of the compensation paid to workers for the most recent full calendar year.

To participate in the program, eligible taxpayers must submit an application to the IRS at least 60 days from the date the taxpayer wants to begin treating its workers as employees. Those taxpayers that are accepted into the VCSP will be required to: (i) extend the statute of limitations on assessment of employment taxes from three to six years; (ii) enter into a closing agreement with the IRS; and (iii) make full payment of any amount due under the agreement upon the signing of the closing agreement.

Employers who have misclassified their workers for some time face significant tax and penalty consequences if they fail to participate in the VCSP and are instead audited as part of the IRS's increased focus on employment tax non-compliance. For example, the reclassification of a taxpayer's workers from independent contractors to employees not only increases the taxpayer's tax liability, but potentially also exposes the taxpayer to penalties for failure to file Forms W-2, failure to deposit taxes, failure to furnish Forms W-2, late payment penalties, negligence penalties and significant interest on all tax and penalties assessed. The complete waiver of all of these penalties, as well as a reduction in the employment taxes due under the VCSP program, may be an attractive incentive for employers to correct their previous non-compliance in worker classification by participating in the new VCSP initiative. However, this reduction in federal employment taxes must be weighed against any additional costs that may arise as a result of the reclassification under state law.

The VCSP comes on the heels of unprecedented IRS success in two voluntary disclosure initiatives involving offshore accounts and assets and shows that the IRS finds the tool of voluntary disclosures to be useful in obtaining increased compliance in various areas, including that of employment taxes. Moreover, the IRS's new trend in announcing voluntary disclosure programs, such as the VCSP, will likely encourage significant participation by employers with misclassified workers who wish to eliminate their audit and penalty exposure. It is expected that the VCSP will provide significant added revenue to the IRS.

Employment tax audits are on the rise and we expect them to continue into the indefinite future. Now that the IRS has added access to DOL information, it is expected the IRS will gain new leads to taxpayers who have employment tax noncompliance issues. Because determining whether a worker is an independent contractor or an employee is complex under federal law, it requires serious consideration and analysis by experienced tax professionals.

Source URL: https://www.natlawreview.com/article/new-irs-voluntary-initiative-aims-to-provide-significant-tax-relief-to-employers-employee-in