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Recent IRS Efforts Focusing on Misclassification of Independent Contractors Offer Benefits But Also Present Risks for Employers

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The improper classification of an employee as an independent contractor (or other non-employee) can expose an employer to significant tax and non-tax liabilities. In the last week, there have been two important developments for employers regarding this issue. First, the Internal Revenue Service (IRS) launched the Voluntary Classification Settlement Program (VCSP) (found here). The VCSP provides eligible employers the opportunity to prospectively reclassify workers erroneously classified as independent contractors or other non-employees as employees, and significantly reduces the tax liability related to the worker misclassification for prior years. Second, the IRS and U.S. Department of Labor (DOL) entered into an information-sharing arrangement in order to coordinate enforcement of worker classification (found here). Further detail on these developments can be found below.

Although the economic benefits of the IRS VCSP are appealing, because of the new information-sharing agreement between the IRS and DOL and the lack of an amnesty program for the non-tax liabilities associated with reclassifying workers, employers may ultimately find the VCSP unattractive. Employers who reclassify workers *prospectively* for tax purposes under the program could be required to reclassify workers *retrospectively* for DOL and state agency purposes. Thus, employers may increase the risk of liability for failure to provide workers' compensation and unemployment insurance; for violations of employment discrimination and immigration laws, overtime requirements, and pension plans; and for failure to provide certain benefits, such as paid vacation, sick time, contributions to pension plans and grants of equity that are otherwise provided to employees.

Voluntary Classification Settlement Program

Under the VCSP, employers wishing to voluntarily reclassify their workers may participate in this optional program if they meet certain eligibility requirements. Specifically, employers must have consistently treated the class of workers to be reclassified as non-employees and filed all required Forms 1099 for each of the workers to be reclassified for the previous three years. In addition, employers may not be under audit by the IRS at all or under audit by DOL or a state agency

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specifically with respect to the classification of the workers. An employer who has previously been audited by the IRS or DOL concerning the classification of workers is only eligible for the program if the taxpayer has complied with the results of the audit. Eligible employers who wish to participate in the VCSP must file an application with the IRS on new Form 8952 at least 60 days before the date the employer wants to begin treating its workers as employees.

Once accepted into the VCSP, an employer will enter into a closing agreement with the IRS pursuant to which the employer agrees to: (1) treat the class or classes of workers it wishes to reclassify as employees for future tax periods; (2) pay 10% of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year, as determined from the already reduced rates available for reclassification; and (3) for the first three calendar years after the year in which the agreement is signed, be subject to a special six-year statute of limitations on the assessment of employment taxes, instead of the three-year period that would otherwise generally apply. In exchange for agreeing to these conditions, the employer will not be liable for any interest or penalties on the employment tax liability amount paid under the agreement and will not be subject to an employment tax audit with respect to worker classification of the reclassified workers for prior years.

Additional information regarding eligibility requirements, application materials and a set of FAQs on the program, is available on the IRS website here.

IRS/DOL Memorandum of Understanding

Two days prior to the IRS announcing the VCSP, the IRS and DOL entered into a memorandum of understanding, under which the two agencies will share information with each other and coordinate enforcement efforts to fight worker misclassification. Additionally, agencies or attorneys general from 11 states (Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, New York, Utah and Washington) have signed similar memoranda of understanding with the DOL.

The memorandum of understanding between the IRS and DOL specifically allows DOL to provide to the IRS data that DOL believes may raise tax compliance issues related to misclassification. For its part, the IRS may share with DOL any information (other than taxpayer return information) that could constitute a violation of any federal criminal law that DOL enforces. The IRS also may share data relating to misclassification trends, unless the data otherwise qualifies as confidential federal tax information. Other types of information the IRS may share with DOL include tax training materials and annual statistics summarizing achievements based on DOL referrals. Significantly, because the memorandum of understanding does not expressly exempt information gained by the IRS from the VCSP, information gleaned by the IRS from a VCSP application could be shared with DOL.

In light of these initiatives and the growing focus on worker misclassification, we encourage employers to evaluate their worker classifications and to contact counsel to understand the full implications of participating in the VCSP for their company.

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