

MP&S TAX ALERT: IRS EXPANDS RELIEF PROGRAM FOR EMPLOYERS WITH MISCLASSIFIED WORKERS

In 2011, the IRS launched the Voluntary Classification Settlement Program (VCSP) that allows eligible employers to voluntarily reclassify workers as employees, rather than independent contractors, for future tax periods. In exchange, the employers' liability for past payroll tax obligations is slashed to only a minimal payment. The program is intended to increase tax compliance and reduce the tax and administrative burdens on employers with misclassified workers.

Now the IRS has modified the VCSP to, among other things, allow employers under IRS audit (other than an employment tax audit) to participate. It also *temporarily* further expands eligibility — through June 30, 2013. But while the expansions may seem like a win-win option for employers, participating isn't without risk.

Employee vs. independent contractor issue

Classifying workers as independent contractors instead of employees can benefit employers in several ways. For example, employers aren't required to pay payroll taxes, withhold taxes, pay benefits, or comply with most wage and hour laws for independent contractors. Independent contractors also are easier to terminate and usually won't qualify for unemployment compensation. If the IRS determines that employees have been improperly classified as independent contractors, though, the employer can be subject to significant back taxes, interest and penalties.

According to the IRS, a worker isn't an independent contractor unless the employer has the right to control or direct *only the result* of the work — as opposed to also controlling the details of how the work is performed. To determine whether a worker is an employee or an independent contractor, the IRS considers three categories of factors related to the degree of control and independence:

- 1. Behavioral.** Does the employer control, or have the right to control, what the worker does and how the worker does his or her job?
- 2. Financial.** Does the employer control the business aspects of the worker's job? For example, is the worker paid a salary? Does the employer reimburse the worker's expenses? Does the employer provide the tools or supplies to do the job?
- 3. Type of relationship.** Does the worker receive employee-type benefits? Will the relationship continue after the work is finished? Is the work a key aspect of the employer's business?

The IRS has acknowledged that the determination of the proper classification under these factors may not always be clear.

Initial terms of the program

When the VCSP was introduced, it allowed voluntary reclassification to prospectively treat workers as employees, outside of the audit process and without the need to go through normal administrative correction processes. It was available to employers that currently treated their workers, or a class or group of workers, as independent contractors or other nonemployees.

To be eligible, the employer had to have consistently treated the workers as nonemployees and filed required Form 1099s for the workers for the previous three years. The employer couldn't currently be under any audit by the IRS or under audit concerning the classification of workers by the Department of

Labor (DOL) or a state governmental agency. Employers that were previously audited by the IRS or DOL on classification issues were eligible for the VCSP only if they complied with the audit's results.

The employer wasn't required to reclassify all of its nonemployee workers as employees. But after an employer chose to reclassify some of its workers, all workers in the same class had to be treated as employees.

In return for reclassifying workers, an employer would be liable for only 10% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year. It wouldn't be liable for any interest or penalties, or be subject to an employment tax audit regarding the classification of the workers being reclassified for prior years. The potential savings, therefore, were significant.

Recent changes to the VCSP

Most of the initial program terms outlined above continue to apply, but the IRS has amended the VCSP to:

- Allow an employer under IRS audit (except an employment tax audit) to participate,
- Clarify that an employer that is a member of an affiliated group isn't eligible to participate if any member of the group is under employment tax audit, and
- Clarify that an employer isn't eligible if it's contesting in court the classification of the class or classes of workers from a previous audit by the IRS or DOL.

In addition, the IRS has eliminated the requirement that an employer agree to extend the statute of limitations on the assessment of employment taxes. Previously, employers had to agree to a special six-year statute of limitations on the assessment of additional employment taxes for the first three calendar years following the reclassification, as opposed to the usual three years. As a result, the IRS would have had twice as much time to audit the employer and assess additional employment taxes for those first three years than it would otherwise have.

Temporary eligibility expansion

The IRS has also announced a Temporary Eligibility Expansion (TEE) that provides a modified VCSP for employers that would be eligible for the standard VCSP except for the fact that they haven't filed all of the required Form 1099s.

The payment due under the TEE is greater than that under the regular VCSP (25% of employment tax liability vs. 10%), but the other benefits are the same. TEE employers also must pay a reduced, graduated penalty for unfiled Form 1099s for the previous three years for the workers being reclassified.

To participate, an employer must meet certain eligibility requirements, apply by June 30, 2013, and enter into a closing agreement with the IRS. If deemed eligible to participate, the employer then must furnish to the reclassified workers, and electronically file with the IRS, all required Form 1099s for the previous three years.

Worth the risk?

Employers must bear in mind that participation in the VCSP won't shield them from potential liability to state tax agencies, workers' compensation carriers (for unpaid premiums on misclassified employees) or the misclassified employees themselves (for wage and hour claims and employee benefits). By entering the program, you may be essentially admitting liability for those costs. We can help you determine whether the benefits of the VCSP are worth the risks.

MP&S TAX PLANNING GUIDE

To facilitate ongoing access to the latest tax rules and regulations, MP&S offers an [online tax guide](#) that is updated on an ongoing basis.

FOR MORE INFORMATION



If you have questions about anything you read in this alert or in the MP&S tax guide, please contact an [MP&S tax advisor](#) or [Steven Eliach](#), JD, LLM, the Principal-in-Charge of the MP&S Tax Practice, by phone at 212.503.6388 or by email at seliach@markspaneth.com.

IRS CIRCULAR 230 DISCLOSURE

Treasury Regulations require us to inform you that any Federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

© Marks Paneth & Shron LLP 2013 | www.markspaneth.com

MANHATTAN | LONG ISLAND | WESTCHESTER | CAYMAN ISLANDS

[Privacy Policy & Legal Disclaimer](#)