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Information Memo

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IRS Offers Favorable Settlement Terms for Employers Resolving Worker Misclassification Issues; IRS and DOL Team-Up to Combat Worker Misclassification

Voluntary Classification Settlement Program

In late September, the IRS established the Voluntary Classification Settlement Program ("VCSP") which allows employers, upon application and acceptance into the program, to prospectively reclassify, as employees, those workers that they may have erroneously treated as independent contractors. Employers accepted into the VCSP will receive substantial relief from federal payroll taxes that they may owe for prior years and will not be audited on payroll taxes related to those workers for prior years.

Eligibility – To be eligible, an employer must have consistently treated the misclassified workers as independent contractors or nonemployees and must have filed all required Forms 1099 within six months of their due date for those workers for the three years prior to applying for the program. In addition, the employer (including any parent or subsidiaries) cannot currently be under audit by the IRS, the DOL or a state agency concerning the classification of those workers. If the employer was previously audited by the IRS or the DOL about the classification of those workers, the employer will only be eligible for the VCSP if it has complied with the results of that audit.

VCSP Agreements – The VCSP allows employers to reclassify some or all of their workers as employees. However, once an employer chooses to reclassify certain workers, all workers in the same class must be treated as employees for employment tax purposes. Employers accepted into the VCSP will agree to prospectively treat the class of workers as employees for future tax periods. In exchange, the employer:

1. Will pay 10% of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of IRC § 3509 (which is roughly 1% of the wages paid to the reclassified worker for the most recent tax year);
2. Will not be liable for any interest or penalties on the liability;
3. Will not be subject to an employment tax audit with respect to the worker classification of those workers for prior years; and
4. Will agree to extend the statute of limitations on assessment of employment taxes for three years for the first, second and third year after the date on which the employer has agreed under the VCSP closing agreement to start treating the workers as employees.

Other Considerations – There are several other issues that should be considered prior to applying for the VCSP. For example, employees are covered by the Fair Labor Standards Act (FLSA) and state wage and hour laws and nondiscrimination laws. Among other things, these laws require employers to pay employees a minimum hourly wage and time-and-a-half for time worked in excess of 40 hours per week. In addition, employees may be eligible for other statutory and fringe benefits (e.g., unpaid leave under the Family Medical Leave Act; COBRA benefits; health insurance, etc.).

Also, reclassification may put some small businesses over the minimum employee threshold that triggers certain statutory benefits for all employees. Employers should also consider whether participation in the VCSP will have any state tax or ERISA implications. Lastly, it is important to note that while participation in the VCSP limits federal employment tax liabilities, it does not prohibit lawsuits which seek damages for an employer's failure to comply with federal and state wage and hour laws and nondiscrimination laws.

Memorandum of Understanding between the Department of Labor and IRS

In an effort to reduce the incidence of employee misclassification and improve compliance with federal labor law, the IRS and the Department of Labor ("DOL"), on September 19, 2011, entered into a Memorandum of Understanding ("MOU") to share information and collaborate on the issue of employees who have been misclassified as independent contractors.

Under the MOU, the DOL, at its discretion, will refer to the IRS any data that it believes may raise IRS employment tax compliance issues related to misclassification. The IRS will evaluate and classify employment tax referrals provided by the DOL and, at the IRS's discretion, conduct examinations to determine compliance with employment tax laws. The IRS will also, at its discretion, share the DOL employment tax referrals with state and municipal taxing agencies that are authorized to receive tax return information under approved agreements with the IRS. With respect to information pertaining to VCSP applicants, the IRS advised that it will not share such information with the DOL or state agencies.

New York is expected to sign a similar MOU with the DOL. Colorado, Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, Utah and Washington have already entered into similar MOUs with the DOL.

ACTION SUGGESTED: Given the IRS's increased efforts to combat employee misclassification and the extremely favorable settlement terms offered under the VCSP, employers should evaluate whether their independent contractors and nonemployees should actually be classified as employees. If so, the employer should consider the nontax implications of participating in the VCSP before applying for the program.

If you have any questions about the VCSP or this memorandum, including questions as to whether applying for the VCSP is advisable in light of your circumstances, please contact Frank C. Mayer in our Albany office (518.533.3219, fmayer@bsk.com), Courtney A. Wellar in our Syracuse office (315.218.8365, cwellar@bsk.com) or any of the members of our Tax Practice Group listed below:

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