

IRS Implements Voluntary Program for Reclassifying Workers

by Peter J. Hunt

On September 21, the Internal Revenue Service (IRS) issued Announcement 2011-64, describing a new “Voluntary Classification Settlement Program” (VCSP) that will allow employers to reclassify independent contractors as employees for employment tax purposes on a prospective basis. Under the VCSP the employer will pay a fixed settlement amount in satisfaction of prior year employment tax liabilities for the reclassified workers, and the IRS will agree not to audit the employer’s prior year employment tax returns with respect to those workers.

New Program Builds on Current Classification Settlement Program

For several years the IRS has maintained a “Classification Settlement Program” (CSP) under which an employer undergoing an IRS employment tax audit is offered the opportunity to reclassify workers from independent contractor status to employee status on a prospective basis. As part of the CSP, the IRS typically proposes a settlement amount which, if paid by the employer, would resolve the employer’s potential liability for the prior years under audit. The employer is not required to accept the IRS’s offer.

Under the current CSP, the amount of the IRS’s settlement offer for prior years depends on a number of factors. Liability for multiple tax years may be involved. Section 3509 of the Internal Revenue Code (Code) provides for reduced employment tax rates for certain cases involving retroactive worker classification, and the IRS settlement offer will take such rates into account. In addition, the IRS may reduce the amount of the settlement payment (or eliminate the payment entirely) depending on the extent to which the employer has satisfied the conditions for relief under Section 530 of the Revenue Act of 1978 (Section 530). See our [Advisory](#) dated July 26, 2010 on the requirements for, and potential challenges to, Section 530 relief.

VCSP Will Allow Employers to Reclassify in Advance of IRS Audit

The new VCSP will allow employers to reclassify their workers as employees on a prospective basis in advance of an IRS audit. An employer whose application for VCSP is accepted will enter into a closing agreement with the IRS to pay a fixed amount, described below, to settle the prior years' employment tax liability for the reclassified workers. Eligibility for Section 530 relief will not affect the amount of the settlement payment.

The settlement payment will equal 10% of the employment tax liability (for income tax withholding, and the employer and employee portions of the Social Security and Medicare taxes) that would have been due on the compensation paid to the reclassified workers for the most recent tax year. No penalties or interest would be payable. The employment tax liability on which the settlement is based will be determined using the reduced tax rates of Section 3509 of the Code.

For example, an employer seeking to implement a VCSP settlement in 2012 would calculate the employment tax liability for 2011 for the reclassified workers using the Section 3509 rates in effect for 2011. The maximum Section 3509 tax rates for 2011 are 10.28% for compensation up to the Social Security wage base, and 3.24% on compensation above the Social Security wage base. The settlement payment would be 10% of 2011 employment tax liability for the reclassified workers determined using these rates, with no penalties or interest due.

The VCSP closing agreement will provide that the IRS will not audit prior year employment tax returns with respect to the reclassified workers in question. However, the closing agreement also will require the employer to extend for three years the period of limitations on assessment of employment taxes for the first, second and third calendar years beginning **after** the date on which the employer has begun treating the reclassified workers as employees under the VCSP. As the normal period of limitations is three years from the due date of each quarterly employment tax return, this would effectively give the IRS a 6-year period to audit the employer's employment tax returns, and assess additional taxes and penalties, for each of the first three calendar years beginning after the VCSP reclassification.

Eligibility for the VCSP

To be eligible for the VCSP, the employer must have consistently treated the workers as nonemployees, and must have filed all required Forms 1099 for the workers for the previous three years. The employer cannot be under any audit by the IRS, and cannot be under audit covering worker classification by the U.S. Department of Labor (DOL) or any state government agency. An employer who was previously audited by the IRS or DOL concerning worker classification will only be eligible if the employer has complied with the results of that audit.

Participation in the VCSP does not require that the employer treat all of its workers as employees—the employer can specify a particular class of workers that the VCSP will apply to. However, the IRS has indicated that it will expect the employer to treat all future workers who belong to the same class as employees.

Application Process

Eligible employers can submit an application to the IRS on Form 8952 to participate in the VCSP. The application should be submitted at least 60 days prior to the date on which the employer will begin treating the workers in question as employees. The IRS will contact the employer or its authorized representative

once it has reviewed the application and verified the employer's eligibility. Once the IRS accepts an employer's application, the employer and IRS will execute a closing agreement and the employer will pay the settlement amount.

The IRS retains discretion whether to accept or reject an employer's application. We assume the IRS will use its discretion to reject applications only if the applications are submitted by ineligible employers or are not properly completed, but we will need to monitor the actual implementation of the VCSP to verify this. Employers will want assurances that the IRS will not arbitrarily reject VCSP applications in order to identify targets for employment tax audits.

Questions for Employers to Consider

Employers who have classified workers as independent contractors should consider the availability of the VCSP. Before deciding to apply under the VCSP, employers should consult with counsel and consider a number of questions, such as:

- What is the employer's federal employment tax liability exposure for prior years for nonemployees? Is Section 530 relief available for those prior years, and for future years? How does the VCSP settlement amount compare to the employer's employment tax exposure for prior years?
- What will be the additional cost of treating the workers as employees for future years? Note that this often includes more than additional employment tax costs. Employers will need to consider whether the workers in question should be reclassified as employees not only for employment tax purposes but also for workers' compensation, the Fair Labor Standards Act (e.g., overtime), benefit plan eligibility and other purposes.
- Is the employer comfortable with giving the IRS an extended period of time to audit the employer's employment tax returns for the first three tax years that begin after workers are reclassified under the VCSP?
- Does the employer meet all of the VCSP eligibility requirements? For example, has the employer consistently used Form 1099 to report compensation paid to the workers in question, and is the employer currently under audit by the IRS on any tax matters, or by the DOL or a state authority on worker classification matters? Large employers that are subject to regular IRS audits may have difficulty finding a period of time in which they are eligible to use the VCSP.
- Does the employer have significant exposure for state and local employment taxes with respect to independent contractors? While the VCSP will settle past federal employment tax liabilities, it will not be binding on state and local tax authorities. It is not clear to what extent the IRS will share information about VCSP applications with state and local tax authorities.
- Could the employer be required to provide employee benefits to reclassified workers for prior years? A VCSP settlement will not prevent the IRS or DOL, or the reclassified workers themselves, from claiming that the workers should have been provided benefits for prior years. Whether such claims have any merit is a complex question, requiring careful review of the plan documents and applicable laws.

To discuss the pros and cons of applying for the VCSP, please contact the Pillsbury attorney with whom you regularly work, or any of the following members of Pillsbury's Employment Tax Audit Task Force.

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