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Independent Contractors Misclassification

IRS Voluntary Compliance Settlement Program

The Internal Revenue Service (IRS) has implemented a new program to allow taxpayers who have misclassified workers as independent contractors to voluntarily reclassify the workers as employees with minimal tax liability. This is a voluntary program. To be eligible, a taxpayer must have consistently treated the workers as non-employees; have filed all required Forms 1099 for the past three years; cannot currently be subject to an audit by the IRS, the Department of Labor (DOL) or a state government agency; and, if previously audited by the IRS or DOL on this issue has complied with the results of that audit.

To participate in the Voluntarily Compliance Settlement Program (VCSP), the taxpayer must complete an application which will be reviewed by the IRS for verification of eligibility. The taxpayer must agree to prospectively treat the workers as employees for future tax periods and agree to a three-year extension of the statute of limitations on an assessment of employment taxes during the first three years (resulting in a six-year statute of limitations). The taxpayer will be required to pay 10% of the employment tax liability (calculated at reduced rates) for the most recent tax year only and will not be required to pay interest or penalties. The taxpayer will not be subject to audit with respect to worker misclassification for prior years. The taxpayer must enter into a closing agreement with the IRS to finalize the terms of the VCSP and pay any amount due.

Keep in mind that this program does not affect other potential liabilities of an entity that has misclassified workers as independent contractors rather than employees. The California Employment Development Department (EDD) may still impose tax liability under California law for misclassification. Additionally, there may be overtime that was not paid or other violations of federal or state employment laws. There may also be liability or other consequences if it is determined that these workers should have been included in pension or health and welfare benefit plans.

IRS/DOL Memorandum of Understanding

At the same time, the IRS and DOL have entered into a Memorandum of Understanding (MOU) by which the DOL Wage and Hour Division will share information and other data with the IRS that relates to misclassification issues. This could lead to increased IRS audits of entities with independent contractors – which could result in assessments of employment

taxes payable (without the discount provided by the VCSP), penalties and interests. The MOU also provides for information-sharing agreements between the IRS and state and local taxing agencies. [California has not currently entered into such an agreement.] The IRS and DOL will also coordinate education of taxpayers/employers and other outreach efforts on the misclassification issue. One of the stated goals is to provide a “level playing field” for law-abiding taxpayers and employers.

The VCSP and IRS/DOL Memorandum of Understanding are essentially “carrot and stick” efforts by the federal government to promote taxpayer compliance with regard to misclassification of employees as independent contractors which would result in increased federal employment tax revenues. There may be significant federal tax savings for employers who currently have employees misclassified as independent contractors. Any employer in this situation should consider applying for the VCSP. However, since there may be other liabilities as a result of reclassification, employers should consult with counsel before proceeding with this process.

New California Law on Misclassification

This new law makes willful misclassification, defined as avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor, unlawful. It is also unlawful to charge such an individual for equipment, materials, etc. for which it would be a violation of law (because the employer would be required to provide the items) if the individual were not misclassified. Civil penalties for such violations range from \$5000 – \$15,000 and then \$10000 - \$25,000 if there is a pattern and practice of such violations. Anyone who is found to have violated these provisions will be required to display a notice that enumerates the violations and notifies anyone who believes he/she is misclassified with information for contacting the Labor and Workforce Development Agency. The notice must be signed by an officer and be posted for one year.



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