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## *IRS Announces Voluntary Worker Classification Settlement Program*

Last week, the Internal Revenue Service (“IRS”) announced a new settlement program that may be of interest to certain businesses, particularly emerging companies that elected to treat a group of workers as independent contractors rather than employees. The program allows businesses to resolve past worker misclassification issues at fairly low cost.

In recent years, the IRS, the federal Department of Labor (the “DOL”) and their state equivalents have increasingly scrutinized whether employers classify their workers as “employees” or “independent contractors.” In fact, the IRS, the DOL and agencies from seven states (including Connecticut) recently entered into a memorandum of understanding to coordinate efforts to crack down on worker misclassifications. Last year, the Connecticut Department of Labor publicized an initiative to make misclassification a priority. With Connecticut now imposing successor liability for withholding taxes, we suspect the Connecticut Department of Revenue Services may begin increasing employment tax audits, bringing its attention to misclassification, as well.

From a tax perspective, by classifying workers as independent contractors instead of employees, businesses avoid the administrative expense of payroll withholding and the financial burden of the employer’s share of payroll taxes (e.g., Social Security, Medicare and unemployment). The consequences of misclassifying workers as independent contractors can be expensive - the employer will be held liable for the payroll taxes due (without the benefit of having withheld) plus penalties and interest.

The test for worker classification depends on the context (whether for purposes of labor laws, workers’ compensation statutes or payroll taxes, etc.). All tests turn primarily on whether the business has the right to control the worker’s manner and means of performance. The IRS has collapsed a 20-factor common law test into three main elements.

- **Behavioral Control.** The first element is whether the business has the right to direct or control the way in which the worker performs the job. The issue is not whether the business actually exercises control, but whether the business has the *right* to control. The IRS will consider the degree of instructions given, the type of evaluation system and the existence of training. The more detailed the instructions regarding how the work is to be performed (as opposed to the result to be achieved), the more likely the worker will be classified as an employee. A performance-based evaluation system suggests the worker is an employee, while a results-based evaluation system suggests the worker is an independent contractor. Training is evidence of the exercise of control over the worker, favoring an employee classification.
- **Financial Control.** The second element is whether the business has the right to control the economic aspects of performance. A worker is more likely to be classified as an independent contractor if he must make a significant financial investment in the means of performance (such as purchasing equipment or hiring his own workers), incurs unreimbursed business expenses or has an opportunity to realize a profit or loss. In practice, the IRS frequently classifies a worker as an employee if the worker performs

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services solely for the taxpayer. A worker who performs services for multiple customers or actively markets his services is less likely to be classified as an employee. The method of payment is relevant, as well. Independent contractors are more likely to be paid a flat fee while employees are more likely to be paid hourly.

- **Type of Relationship.** The last element is how the parties characterize their relationship, which is evidence of the parties' intent concerning control. The existence of a written agreement establishing an independent contractor relationship is relevant but not determinative. The provision of employee benefits favors an employment relationship. Also relevant is the permanency or indefiniteness of the relationship and how integral the services are to the taxpayer's regular course of business.

All factors are viewed in the context of the type of work performed. As with many IRS tests, the answer depends on the facts and circumstances, leaving some taxpayers uncertain as to whether they are correctly classifying their workers.

Through the Voluntary Classification Settlement Program ("VCSP"), a taxpayer agrees to reclassify its workers (or a class of workers) from "independent contractors" to "employees." The eligibility requirements are:

1. The taxpayer must currently be treating the class as independent contractors and consistently have done so;
2. The taxpayer must have properly filed all Forms 1099 for the past three years; and
3. The taxpayer cannot currently be under audit by the IRS, the DOL or a state equivalent.

The benefits to the taxpayer are threefold.

1. The taxpayer will pay only 10% of the liability it would otherwise have owed for the most recently closed tax year, with the liability calculated at the lowest possible rates. For compensation paid in 2010, without the VCSP, a taxpayer's liability would be 10.68% of compensation paid below the Social Security wage base (\$106,800 in 2010) and 3.24% of compensation paid above the Social Security wage base. Under the VCSP, the taxpayer's liability will be only 1.07% of compensation below the Social Security wage base and 0.32% of compensation above the Social Security wage base. For example, if a taxpayer paid a total of \$1,500,000 in 2010 to a class of workers (all of whom were below the Social Security wage base), the employer's potential liability would be \$160,200 (10.68% of \$1,500,000). Under the VCSP, the taxpayer would pay only \$16,020 (10% of \$160,200).
2. The taxpayer will pay no penalty or interest. Without the program, penalties could be as much as 20% of the liability and current interest rates range from 3% to 5%. In the example above, without the VCSP, the taxpayer could be liable for as much as \$40,050 in penalties and interest in addition to the \$160,200 actual liability.

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3. The IRS will not conduct a payroll tax audit for prior years with respect to the reclassified workers. The IRS guidance does not clarify whether this audit benefit applies with respect to past workers or only those individuals currently being reclassified. Presumably, it applies to past workers within the reclassified class if the taxpayer includes their compensation in the liability calculation. A taxpayer should ensure such a clarification be contained in the settlement agreement.

In return, the taxpayer agrees, for the next three years, to extend the three-year statute of limitations to six years.

Taxpayers must apply for acceptance into the program by filing Form 8952, Application for Voluntary Classification Settlement Program. The application requires the taxpayer determine its liability for the past-due payroll taxes. Thus, a taxpayer will know its actual liability before applying. The IRS recommends submitting the application at least 60 days prior to the desired reclassification date and will notify the applicant of acceptance or rejection.

The program is available to for-profit companies, tax-exempt entities and government entities.

The VCSP is not a business's sole remedy for misclassification for tax purposes. If, upon examination, the IRS determines that a business misclassified its workers, the business may still be able to obtain relief if it had a "reasonable basis" for classifying its workers as independent contractors and consistently treated that class of workers as independent contractors. A "reasonable basis" includes reasonable reliance on judicial precedent, an IRS revenue ruling or long-standing industry practice. Before applying to the program, a business may wish to seek legal advice regarding whether it likely has a "reasonable basis" for its current classification.

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