

IRS Introduces New Settlement Program for Worker-Classification Issues: Putting the Latest Employment Tax Offer into Perspective

By Hale E. Sheppard

Hale Sheppard analyzes the choices available to companies that could be facing worker-classification disputes with the IRS in the near future.

Introduction

Let's begin with some context: The difference between what taxpayers should pay and what they actually pay the IRS is called the "tax gap." A significant portion of the tax gap is attributable to noncompliance with employment tax laws, including worker misclassification; The IRS is currently conducting a three-year research project, which entails an additional 6,000 random employment tax audits. This research will inevitably lead to the conclusion that worker misclassification is rampant and deprives the federal government of billions of dollars in tax revenues each year; Therefore, the IRS likely will deem it necessary to dedicate significantly more resources to enforcement of employment tax laws in the future.

Against this backdrop, the IRS announced in September 2011 a new voluntary classification settlement program (VCSP), which is designed to entice companies into reclassifying their workers from independent contractors to employees. The VCSP may seem appealing at first blush, but further analysis reveals that participation in this pseudo-

amnesty program may not be the best decision for many companies. Of course, the challenge is that many companies grappling with this critical issue lack a complete picture of the options and their true implications. These companies and/or their advisors have, as they say, just enough information to be dangerous.

Option 1: Stay the Course and Prepare for Potential IRS Attack

Overview of the Defenses

A company with potential worker-classification issues has two major options. One is to analyze the strength of its legal position, and, if it has a high probability of success, stay the course and prepare for IRS scrutiny. Once the IRS initiates a worker-classification audit, a knowledgeable company probably would raise a variation of the following argument:

The company meets all the requirements of Act Sec. 530; therefore, the IRS must immediately discontinue its worker-classification examination, and the company should be allowed to continue treating the workers as independent contractors in the future, regardless of whether

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the workers should be characterized as employees under applicable law. Even if the company were to somehow fail to qualify for Act Sec. 530 relief, it is still entitled to a favorable resolution under the IRS's standard classification settlement program (CSP). Participation in the CSP is optional for the company, not mandatory. Accordingly, if the company were to decline the CSP offer from the IRS, the company nonetheless should *not* be subject to employment tax deficiencies, penalties, or interest, and should be entitled to continue treating the workers as independent contractors because it would persuade the Tax Court at trial that such workers are not employees.

The preceding argument, while familiar to tax practitioners who regularly engage in employment tax disputes with the IRS, is dense and replete with alternative positions. Therefore, it is helpful to break it down into manageable pieces, as seen below.

Act Sec. 530 Relief

Brief History of Act Sec. 530

Act Sec. 530 is the Holy Grail of worker-classification cases; the company that satisfies all the criteria to warrant so-called Act Sec. 530 relief obtains two major benefits. First, the IRS may not assess any back employment taxes (including federal income tax withholding, FICA taxes or FUTA taxes), penalties or interest charges against the company.¹ Second, and perhaps more importantly, the IRS cannot obligate the company to reclassify the workers in question as employees, regardless of the fact that applicable law supports reclassification. The company gets a free pass, if you will, for past *and* future behavior. It looks innocuous enough, but the general rule of Act Sec. 530 is powerful:

If, for purposes of employment taxes, the [company] did not treat an individual as an employee for any period, and ... all Federal tax returns (including information returns) required to be filed by the [company] with respect to such individual for such period are filed on a basis consistent with the [company's] treatment of such individual as not being an employee, then, for purposes of applying such taxes for such period with respect to the [company], the individual shall be deemed not to be an employee unless the [company]

has no reasonable basis for not treating such individual as an employee.²

Given its importance in the employment tax arena, one could write entire books on the history, impact and nuances of Act Sec. 530. This is well beyond the scope of this article, though. Suffice it to understand a few key points.

Congress introduced Act Sec. 530 over 30 years ago, in the Revenue Act of 1978, in an effort to counter aggressive IRS worker-classification audits on small businesses.³ According to the legislative history, the congressional relief provided to companies by Act Sec. 530 was appropriate because the IRS had dramatically increased enforcement of employment tax laws, many of the positions that the IRS began taking were contrary to those adhered to in earlier years, and the forced reclassifications often resulted in double payment of the same taxes because companies were obligated to pay federal income tax liabilities and FICA taxes (which the company did not withhold and remit to the IRS) for workers, even though such workers may have already paid their own income and self-employment taxes.⁴

Congress initially contemplated a short-term reprieve for companies, the proverbial "time out" while studies were conducted to analyze the scope of the problem and potential solutions. The relevant legislative history described it in the following manner:

The [Senate Finance] Committee believes that it is appropriate to provide *interim relief* for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed reclassifications of workers, until the Congress has adequate time to resolve the many complex issues involved in this area.⁵

These initial thoughts notwithstanding, Act Sec. 530 has remained in effect for over 30 years. The law has been amended during this period three times, with each occasion further strengthening the rights of those companies invoking Act Sec. 530 relief.⁶ For instance, the law and IRS policies have evolved to ensure that the IRS, not the company under attack, has the duty of broaching the issue of potential relief. Act Sec. 530(e)(1), enacted in 1996, states that IRS personnel conducting a worker-classification audit

“shall” provide the company with written notice of the existence and terms of Act Sec. 530 “before or at the commencement of” the audit.⁷ The Internal Revenue Manual contains additional detail in this regard, stating the following:

Section 530 is a relief provision that *must* be considered as the *first step* in any case involving worker classification. Relief is available to taxpayers or employers that are under examination or involved in administrative (including Appeals) or judicial proceedings with respect to assessments based on employment status reclassification ... It is not necessary for the taxpayer to claim section 530 relief for it to be applicable. In order to correctly determine tax liability, the examiner must first explore the applicability of section 530 even if the taxpayer does not raise the issue.⁸

Criteria to Satisfy Act Sec. 530

The law generally provides that, if a company treated a worker as an independent contractor for certain tax periods, then the worker *shall* be deemed to be an independent contractor for such periods, provided that the company meets the following three criteria:

- The company timely filed information returns in a manner consistent with the worker’s status as an independent contractor; that is, the company filed annual Forms 1099 with the IRS reporting all “non-employee compensation” paid to the worker (“Reporting Consistency”).
- The company treated other workers holding substantially similar positions as independent contractors (“Substantive Consistency”).
- The company had a “reasonable basis” for treating the worker as an independent contractor (“Reasonable Basis”).⁹

With respect to the third component, a company has a Reasonable Basis for treating a worker as an independent contractor if it reasonably relies on *any* of the following four safe harbors:

- Court decisions or published IRS rulings, regardless of whether they relate to the particular industry or business in which the company is engaged, as well as technical advice, a private letter ruling, or a determination letter from the IRS pertaining to the specific company in question (“Precedent Safe Harbor”).
- A past IRS audit in which there was no assessment attributable to the treatment, for employment tax

purposes, of workers holding positions substantially similar to those of the workers whose status is currently at issue (“Prior Audit Safe Harbor”).

- A longstanding recognized practice of a significant segment of the industry in which the worker is engaged (“Industry Practice Safe Harbor”).
- Some other reasonable basis for treating the workers as independent contractors (“Other Reasonable Basis Safe Harbor”).¹⁰

It is clear that the last component (*i.e.*, the Other Reasonable Basis Safe Harbor) should be broadly interpreted to favor the company.¹¹ Moreover, Congress stated that reasonable reliance on a qualified, informed tax professional suffices:

Under case law, reliance on the advice of an attorney or an accountant may constitute a reasonable basis for treating a worker as an independent contractor. The IRS appears to agree with this position, provided there is a showing that the attorney or accountant was knowledgeable about the law and facts in rendering the advice.¹²

Likewise, the IRS has acknowledged the reasonable-reliance defense in its own INTERNAL REVENUE MANUAL, which contains the following guidance:

Reliance on an attorney or accountant may constitute a reasonable basis. The taxpayer need not independently investigate the credentials of the attorney or accountant to determine whether such advisor has any specialized experience in the employment tax area. However, the taxpayer should establish at a minimum, that it reasonably believed the attorney or accountant to be familiar with taxpayer’s tax issues and that the advice was based on sufficient relevant facts furnished by the taxpayer to the adviser.¹³

In addition to reasonably relying on a qualified tax professional, Congress has also recognized that a taxpayer can meet the Other Reasonable Basis Safe Harbor by showing that the company reviewed the common-law standards and concluded, albeit incorrectly, that the workers in question did not fall into the “employee” category. According to a congressional report, “[t]axpayers generally have argued successfully that reliance on the common-law test can constitute a reasonable basis for purposes of applying Section 530.”¹⁴

Classification Settlement Program

Background on the Classification Settlement Program

Based on the preceding description of Act Sec. 530, one might infer that reaching the Holy Grail is a straightforward, manageable task. This should be the case, but problems often arise from the fact that the Revenue Agent—surprise, surprise—disagrees about whether the company meets all three criteria under Act Sec. 530. The first two, Reporting Consistency and Substantive Consistency, are rarely a point of contention. It does not, as they say, require a rocket scientist to determine whether a company filed its Form 1099 with the IRS or treated all workers of a particular class in the same fashion. The fight, therefore, usually focuses on the third criteria, Reasonable Basis.

A company generally believes that all its business-related decisions are inherently reasonable, including its decision to treat certain workers as independent contractors. The Revenue Agent, on the other hand, tends to be more cynical. He may well believe that the company's decision to treat certain workers as independent contractors was reasonable from an economic perspective. Indeed, there is not much room to argue with the following logic: A company's main goal is to make money. Treating workers as nonemployees reduces operational costs for a number of reasons; therefore, the company is more profitable by treating workers as independent contractors.

The issue, though, is that there is "reasonable" from a business perspective, and then there is "reasonable" for purposes of Act Sec. 530. Revenue Agents often conclude during an audit that the company's decision to treat the workers as independent contractors was unreasonable because, say, the published rulings or cases on which the company relied were factually distinct from the company's situation, the industry of which the company believes it is a part is too narrowly defined for purposes of Act Sec. 530, or the tax professional on whom the company supposedly relied was unaware of all the relevant facts, did not specialize in employment tax law, or was otherwise unqualified to give dependable advice. Whichever the reason, the result is the same: the Revenue Agent is unwilling at the audit level to grant Act Sec. 530 relief. Thus enters the IRS's standard classification settlement program (CSP).

Many people have at least heard of Act Sec. 530, but general unawareness of the CSP seems to be the norm. This is probably attributable to the obscure materials in which details about the CSP appear. In 1996, the IRS issued a news release announcing the CSP and identifying it as a two-year trial program.¹⁵ At the end of this initial period, in 1998, the IRS decided to extend the CSP indefinitely because both an internal review and public comments indicated that it was achieving its goal of resolving worker-classification cases at an early stage.¹⁶ Details about the CSP are somewhat challenging to find because they derive primarily from a Field Service Advisory in 1996, as restated and expanded in the INTERNAL REVENUE MANUAL.¹⁷ The description of the CSP, below, comes from these two sources.

In cases where it appears that a company may have misclassified a worker, the Revenue Agent must fully develop the issue and determine, among other things, whether a misclassification occurred under applicable law, whether the company is eligible for Act Sec. 530 relief, and, if not, whether the company is entitled to a CSP offer.¹⁸ If the Revenue Agent and his superiors conclude that a CSP offer is in order, they must decide which of two "graduated settlement offers" the IRS will make.

In situations where the company had Reporting Consistency, but clearly lacked either Substantive Consistency or Reasonable Basis, then the CSP offer entails assessment of 100 percent of the employment tax liability for the one tax year under audit, computed using the special rates under Code Sec. 3509, if applicable ("One-Year-100-Percent Offer"). The second offer is better. In cases where the company had Reporting Consistency and a "colorable argument" that it also had Substantive Consistency or Reasonable Basis, the CSP offer contemplates assessment of just 25 percent of the employment tax liability for the one tax year under audit, computed using the special rates under Code Sec. 3509, if applicable. ("One-Year-25-Percent Offer").¹⁹ Under either scenario, the company must agree to reclassify the workers in question as employees going forward, starting the first day of the quarter following the date of the Closing Agreement.²⁰

IRS personnel are instructed to consult the "CSP Analysis Chart" depicted in Table 1 in making determinations in worker-classification cases.²¹

Visualizing the thought process may help some readers comprehend the IRS's decision-making tree. (Please refer to Table 1.)

To truly appreciate the benefit of the two CSP offers, one must look beyond the INTERNAL REVENUE MANUAL to the two important, yet obscure, provisions in the tax code: Code Sec. 3509 and Code Sec. 6205.

Analysis of Reduced Tax Rates Under Code Sec. 3509

In 1982, Congress realized that three "major problems" existed with the forcing a company to reclassify its workers as employees: (i) The company could be assessed income taxes, FICA taxes and FUTA taxes for all years still open under the statute of limitations; (ii) overpayments of federal income taxes may occur if the company were obligated to pay these amounts in situations where workers personally paid these amounts earlier *via* estimated tax payments or with their individual income tax returns; and (iii) overpayments of FICA taxes could occur, too, if the company were required to pay these amounts in cases where the workers already did so through self-employment taxes.²² Congress understood that, in the case of a forced reclassification, the IRS generally would adjust/lower assessments for the company's failure to withhold, provided that the company could furnish certificates, signed by those workers who were reclassified, showing that the workers had personally paid the taxes.²³ However, Congress underscored the practical challenges associated with this supposed clemency by the IRS: Obtaining certificates would be a "difficult burden" and a "serious retroactive tax burden" on a company in cases involving jobs with high turnover rates, or where workers were numerous, uncooperative, and/or poor record-keepers.²⁴

In light of this reality, Congress enacted Code Sec. 3509, which was designed to substantially simplify the law, reduce burdens on companies, approximate the average tax liability of a company after assuming certain levels of tax compliance by individual workers who were reclassified, and punish the company for its violations.²⁵ The legislative history contains a clear statement on the purposes of enacting Code Sec. 3509:

Table 1.

Are the Workers Employees?	Were Forms 1099 Timely Filed?	Is Taxpayer Entitled to Code Sec. 530 Relief?	Type of CSP Offer
Yes	No	No	None
Yes	Yes	No	1 year tax + CSP
Yes	Yes	Maybe	25% tax + CSP

Although these fractional amounts [of income taxes and FICA taxes paid by the company under Section 3509] are set at levels reflecting assumed levels of taxpayer compliance, the committee believes that the amounts also reflect appropriate sanctions for an employer's erroneous failure to withhold taxes from compensation paid to an employee, regardless of the actual level of taxpayer compliance in any particular case. Accordingly, the committee believes that the assessment of these amounts will serve the dual function of deterring non-compliance on the part of employers, and compensating the Treasury for the revenue loss typically associated with employer non-compliance with wage withholding.²⁶

Let's see how Code Sec. 3509 functions. As mentioned above, both the One-Year-100-Percent Offer and the One-Year-25-Percent Offer indicate that the employment tax liability for the year in question might be calculated under the special rates found in Code Sec. 3509. When a company incorrectly treats an "employee" as an independent contractor, the company is liable for the employee's federal income tax withholding and the employee's share of FICA taxes, not to mention the company's share of the FICA taxes and unemployment taxes.²⁷ Assuming that the company did not intentionally disregard its duty to withhold, Code Sec. 3509 sets forth two different levels of payback. In situations where the company filed annual Forms 1099 for the workers, the company must pay (i) income tax withholding calculated as 1.5 percent of the worker's wages,

Table 2.

Code Sec. 3509(a) Example	Percentage
Company's share of FICA	7.65%
20% of employee's share of FICA ($0.20 \times 4.2\% + 0.20 \times 1.45\%$)	1.13%
Total FICA	8.878%
Income Tax Withholding	1.50%
Total Code Sec. 3509(a)	10.28%

(ii) 20 percent of the employee’s share of FICA, and (iii) 100 percent of the company’s share of FICA.²⁸ Table 2 is an example from the IRS using the FICA rates for 2011.²⁹

The economic outcome is slightly worse for a company that failed to file Forms 1099 for the workers. In such cases, the company must pay (i) income tax withholding calculated as three percent of the worker’s wages, (ii) 40 percent of the employee’s share of FICA, and (iii) 100 percent of the company’s share of FICA.³⁰ Table 3 is an example from the IRS using the FICA rates for 2011.³¹

Table 3.

Code Sec. 3509(b) Example	Percentage
Company’s share of FICA	7.65%
40% of employee’s share of FICA ($0.40 \times 4.2\% + 0.40 \times 1.45\%$)	2.26%
Total FICA	9.91%
Income Tax Withholding	3.0%
Total Code Sec. 3509(b)	12.91%

Possible Interest-Free Payments Under Code Sec. 6205

As explained above, a company agreeing to resolve a worker-classification case under the CSP limits its exposure to the one year under audit by the IRS, avoids penalties and, depending on the circumstances, enjoys the reduced rates under Code Sec. 3509 related to the federal income taxes and FICA taxes that it failed to withhold from its workers and remit to the IRS. Settling under the CSP (or even later) could trigger one more benefit for a company, interest waiver. The intricacies of the relevant provision, Code Sec. 6205, far exceed the scope of this article, but it is important to be aware of its existence and basic function. Code Sec. 6205 and the regulations thereunder contain rules allowing for “interest-free adjustments” under certain circumstances.³² Importantly, these rules have been liberally interpreted by the IRS for decades, thereby allowing companies that concede worker-classification cases to avoid interest charges.³³

Actions Once the IRS Makes a CSP Offer

The company has two main courses of action once the IRS presents a CSP offer: accept it or reject it. Things are straightforward when the company simply accepts the offer; the parties execute the

appropriate Closing Agreement whose terms cannot be modified, the company makes the appropriate payment related to the one tax year under audit, and the company begins treating the relevant workers as employees starting the following quarter.³⁴ If a company rejects the initial CSP offer, then the Revenue Agent will expand the audit to cover all open years and issue an “unagreed” audit report. The company then has the right to file a protest letter disputing the audit report, thereby elevating the issue to the IRS Appeals Office.³⁵ In many contexts, including tax disputes, cooler heads often prevail. Cases often sit for several months before being worked by the IRS Appeals Office. During this period, a company may reexamine the strengths and weaknesses of its case and ultimately decide to accept the CSP offer. Provided that the Revenue Agent was properly doing his job, the company would be cognizant of its ongoing right to do so. According to the INTERNAL REVENUE MANUAL, the company “should be advised that if the CSP offer is not accepted at the examination level, the CSP offer will remain available throughout the appeal process.”³⁶

Litigate the Case in Tax Court

A description of the CSP by a former high-ranking IRS representative identifies and emphasizes the types of companies for which participation in the CSP is, for lack of a better phrase, a no-brainer:

To some extent, the CSP is a recognition of the position that the IRS Appeals had already adopted, *i.e.*, a willingness to concede most proposed back tax assessments in exchange for prospective treatment of workers as employees. In the past, taxpayers frequently settled worker classification cases under terms similar to or even a little better than those in the new CSP. The settlement program is intended to replicate what happens when an employer goes through the entire [worker] classification dispute process and obtains relief at the appellate or judicial level. The CSP goes right to the bottom line—reclassify the workers as employees for future years and pay some minimum tax for past years. While not exactly an amnesty, since there are qualifying conditions, *the CSP permits a taxpayer with obvious misclassifications to resolve the problem with minimal exposure for back tax liability.*³⁷

It would behoove a company with flagrant worker misclassifications to accept a CSP offer. As long as the company filed timely Forms 1099 for such workers, and as long as its failure to withhold taxes was not due to an intentional disregard of the rules, its worst fate would be the One-Year-100-Percent Offer. And, if the company treated all workers the same and managed to persuade the Revenue Agent that it at least had a colorable argument for independent contractor treatment, a One-Year-25-Percent Offer just might appear. Either way, this would be a positive resolution for the company.

By contrast, a company that has a strong case for Act Sec. 530 relief and/or a strong case that the workers should be treated as independent contractors under applicable law might not be so inclined to settle under the CSP. Instead, the company could, after unsuccessfully battling with the Revenue Agent and the Appeals Officer, elevate the case to the Tax Court. This would occur in the following manner. The Appeals Officer would issue a Notice of Determination of Worker Classification, in response to which the company would seek review by the Tax Court by filing a timely "Petition for Redetermination of Employment Status Under Code Section 7436."³⁸

One little-known advantage for taxpayers in worker-classification disputes before the Tax Court is that the IRS may have a significant burden of proof. In 1996, Congress modified Act Sec. 530 to expressly state that if a taxpayer establishes a *prima facie* case that it was reasonable to treat the workers as independent contractors, and the taxpayer fully cooperated with reasonable requests from the IRS during the audit, then the burden of proof with respect to the classification issue shall be on the IRS.³⁹ Citing the high incidence of worker-classification disputes, the fact that many of these disputes involve small businesses without adequate resources to challenge the IRS, and the "costly litigation" resulting from the disputes, Congress further clarified its reasons for placing the onus on the IRS:

[I]n light of the unique nature of the legislative history to Section 530 which provides it should be construed liberally in favor of taxpayers, the Committee believes that *the burden of proof should generally be on the IRS once the taxpayer establishes a prima facie case that it was reasonable not to treat the worker as an*

employee and provided the taxpayer full cooperates with reasonable requests for information by the IRS.⁴⁰

Option 2: Participate in the Voluntary Classification Settlement Program

The second main option for a company with potential worker-classification issues is to be proactive and participate in the new VCSP, which was announced with considerable fanfare in September 2011. Given the relative newness of the VCSP, the guidance thus far is somewhat limited. Information derives primarily from three sources, Announcement 2011-64, a set of Frequently Asked Questions (FAQs) issued by the IRS, and Form 8952 (*Application for Voluntary Classification Settlement Program*).

The IRS acknowledges the existence and purpose of the standard CSP in Announcement 2011-64 and then explains the rationale for the VCSP: "[T]he IRS has determined that it would be beneficial to provide taxpayers with a program that allows for voluntary reclassification of workers as employees *outside of the examination context* and without the need to go through normal administrative correction procedures applicable to employment taxes."⁴¹

In terms of eligibility, Announcement 2011-64 states that a company must have consistently treated the workers as nonemployees and must have filed all the requisite Forms 1099 for the workers for the past three years.⁴² Harkening back to the discussion earlier in this article about Act Sec. 530, this sounds as if the company must have Substantive Consistency and Reporting Consistency.⁴³ It goes on to further limit the companies that are eligible for the VCSP, expressly excluding those currently under audit by the IRS, as well as those presently subject to a worker-classification audit by the U.S. Department of Labor or a state government agency.⁴⁴

With respect to the settlement terms, Announcement 2011-64 indicates that an interested company must (i) properly apply for the VSCP, (ii) pay 10 percent of the employment tax liability due on compensation paid to the workers for the most recent year, as determined under the special rates in Code Sec. 3509 (*i.e.*, One-Year-10-Percent Offer), (iii) treat the relevant class of workers as employees for future tax

periods, (iv) voluntarily extend the assessment period on employment taxes by three years for the first, second, and third calendar years after the company begins treating the workers as employees, and (v) execute a closing agreement to finalize the terms of the VCSP and make full tax payment at that time. In exchange, the IRS agrees not to assert penalties, waive all interest charges, and forego a worker-classification audit of the relevant workers for prior years.⁴⁵

The FAQs issued at this stage have added very little, though the IRS anticipates expanding this guidance in the near future.⁴⁶ The existing FAQs clarify, among other things, that a company can choose to reclassify some or all of its workers, tax-exempt organizations are generally eligible to participate in the VCSP, certain state and local government agencies are also eligible, a company should file its Form 8952 at least 60 days before it plans to begin treating its workers as employees, and full payment is due from the company at the time the VCSP closing agreement is executed and remitted to the IRS.⁴⁷

The illustration and examples regarding amounts due under the VCSP are perhaps the most interesting information provided by the IRS so far. FAQ #16 indicates that the amount due is calculated based on the compensation that the company paid to the workers in the most recently closed year at the time of the application. Thus, as shown in Table 4, the 10.68-percent effective rate applies to VCSP agreements in 2011 because the most recently closed year is 2010, and the 10.28-percent rate applies to VCSP agreements in 2012 because the most recently closed year is 2011.⁴⁸

FAQ #16 clarifies that the One-Year-10-Percent

Offer would apply to the percentages above. The following examples in FAQ #16 further elucidate this point:

In 2010 you paid \$1,500,000 to workers that are the subject of the VCSP. All of the workers that are the subject of the VCSP were compensated at or below the Social Security wage base (e.g., under \$106,800 for 2010). You submit the VCSP application on October 1, 2011 and you want the beginning date of the quarter for which you want to treat the class or classes of workers as employees to be 1/01/2012. You look to amounts paid to the workers in 2010 for purposes of calculating the VCSP amount, since 2010 is the most recently completed tax year at the time the application is being filed. Under section 3509, the employment taxes applicable to \$1,500,000 would be \$252,000 (10.68% of \$1,500,000). Under the VCSP, your payment [under the One-Year-10-Percent Offer] would be 10% of \$252,000, or \$25,200.⁴⁹

The facts are the same as in the example above, except that some of the workers that are subject of the VCSP were compensated above the Social Security wage base in the amount of \$250,000. Under section 3509, the employment taxes applicable to \$1,250,000 would be \$133,500 (10.68% of \$1,250,000) and the employment taxes applicable to the other \$250,000 would be \$8,100 (3.24% of \$250,000). Under the VCSP, your payment would be 10% of \$141,600 (\$133,500 plus \$8,100), or \$14,160.⁵⁰

Table 4.

Description	Code Sec. 3509 Percentage in 2011 (for compensation paid in 2011 up to the Social Security wage base)	Code Sec. 3509 Percentage in 2010 (for compensation paid in 2010 up to the Social Security wage base)	Code Sec. 3509 Percentage in 2010, 2011, and 2012 (for compensation paid in 2010, 2011, and 2012 above the Social Security wage base)
Income Tax Withholding	1.5	1.5	1.5
Employee Social Security Tax	.84	1.24	0
Employer Social Security Tax	6.2	6.2	0
Employee Medicare	.29	.29	.29
Employer Medicare	1.45	1.45	1.45
Total	10.28	10.68	3.24

Comparing the Options

For most companies facing a potential worker-classification issue, the decision of how best to proceed will be difficult, with various factors to consider.

Pros and Cons of Awaiting IRS Scrutiny

If the company can demonstrate that it had Reporting

Consistency, Substantive Consistency, and a Reasonable Basis with respect to the workers in question, then the IRS cannot advance the audit, cannot assess any employment taxes, penalties or interest against the company, and cannot force the company to reclassify the workers as employees going forward. Stated differently, if the company is confident in its ability to prove that it timely filed Forms 1099 for the workers, treated all the workers holding similar positions as independent contractors, and had a justification for taking these actions (e.g., relying on published guidance by the IRS, a prior worker-classification audit by the IRS, the general practice of a significant segment of the industry in which the company operates, or advice from an informed tax professional), then the company should be able to drink from the Holy Grail of employment tax, Act Sec. 530. The principal downside to this approach, of course, is the short-term cost. Companies will incur internal and external costs associated with defending themselves during an audit, appeal and/or litigation.

Even if the Act Sec. 530 argument were unsuccessful, a palatable option remains. Namely, the companies might be candidates for the CSP. Companies that had Reporting Consistency but lacked Substantive Consistency or a Reasonable Basis might be eligible for the One-Year-100-Percent Offer, while those that had Reporting Consistency and a colorable argument that they had Substantive Consistency or a Reasonable Basis should see the One-Year-25-Percent Offer. Additionally, depending on facts, the tax amounts to which these two percentages apply could be significantly reduced thanks to the special rates in Code Sec. 3509. The interest charges might be waived, too, under Code Sec. 6205. Timing is also an issue. Companies accepting a CSP offer must reclassify the workers in question as employees, but they are not required to start doing so until the first day of the quarter after the execution of the Closing Agreement. Therefore, if the IRS does not initiate an employment tax audit for several years, and if the audit and appeals process takes many months, companies can continue deriving the economic benefits of treating workers as independent contractors for a considerable period. Time, in this case, is certainly money. The main drawbacks to accepting a CSP offer are the fees associated with battling and negotiating with the IRS, payment of the small amount of back taxes for one year, and

the biggie, classification of workers as employees going forward.

Costs associated with having employees, as opposed to independent contractors, can be considerable. Depending on the company, they could include portions of FICA taxes, FUTA taxes, state unemployment insurance amounts, overtime wages, retirement plan matching contributions, training costs, insurance premiums, off-the-clock pay (such as vacation pay, holiday pay, sick pay), and so on. Additionally, classifying a worker as an employee triggers various laws regulating the professional relationship, including, but certainly not limited to, the Fair Labor Standards Act, Family and Medical Leave Act, Employee Retirement Income Security Act, Title VII of the Civil Rights Act and Occupational Safety and Health Act. Adherence to such laws results in compliance costs and potential lawsuits. Due to the competitiveness of the industries in which they operate or their small margin of profitability, some companies simply cannot afford to reclassify workers as employees, as doing so would place them on the fast track to bankruptcy. Therefore, accepting a CSP offer, be it the One-Year-100-Percent Offer or the One-Year-25-Percent Offer, is unfeasible. They must fight the issue in Tax Court.

A victory in Tax Court would yield results akin to those under Act Sec. 530: The company could dodge back employment taxes, penalties and interest, and continue treating the workers as independent contractors in the future. By contrast, a defeat in Tax Court would be devastating: The company likely would owe back employment taxes for three years (as opposed to one year), penalties and interest, and it would be obligated to treat the workers as employees going forward. It is also important to note that, regardless of the outcome of the litigation, the company would incur significant legal fees because properly handling a Tax Court case (including drafting initial pleadings, conducting pre-trial discovery work, coordinating with IRS counsel on the requisite Stipulation of Facts, filing any appropriate Motions, preparing pre-trial and post-trial briefs, participating in the trial, etc.) generally is an expensive endeavor.

Pros and Cons of Approaching the IRS

The advantages of proactively approaching the IRS and settling the matter under the VCSP are

fairly clear: companies get the One-Year-10-Percent Offer, the IRS waives all penalties and interest, professional fees to deal with the IRS are minimized, the IRS agrees not to conduct a worker-classification audit of prior years, and, from a planning perspective, certainty about potential tax exposure is achieved. The shortcomings of and the open questions about the VCSP might not be as obvious, though, particularly to those who are not regularly engaged in employment tax issues. They are listed below.

First, a company participating in the VCSP must *immediately* reclassify the workers, which deprives it of the ability to delay the event (as with companies accepting a CSP offer during a future audit or appeal) or avoid the event altogether (as with companies obtaining Act Sec. 530 relief at any time).

Second, ambiguity exists as to whether the reduced rates under Code Sec. 3509 will *always* apply to companies participating in the VCSP. As mentioned above, Announcement 2011-64 specifies that an eligible company must have Reporting Consistency and Substantive Consistency, but it does not demand Reasonable Basis. From this confusion is born. Code Sec. 3509(c) provides that the special tax rates will not apply where the employment tax liability is due to the company's "intentional disregard" of the tax withholding requirement, yet IRS guidance about the VCSP is silent on this precise issue.⁵¹ Announcement 2011-64 simply states that the company will pay the One-Year-10-Percent Offer "determined under the reduced rates of section 3509 of the Internal Revenue Code." Given the IRS's deliberate omission of Reasonable Basis as a prerequisite to participating in the VCSP, one might assume that all companies will be embraced, irrespective of their motives for the prior employment tax noncompliance. However, the IRS could clarify this issue by announcing in its next round of FAQs that, say, all taxpayers will pay the One-Year-10-Percent Offer, as determined under the general rule of reduced tax rates found Code Sec. 3509(a).

Third, participating in the VCSP may expose a company to additional employment tax problems down the road. As a condition to participating in the VCSP, a company must voluntarily extend the assessment period on employment taxes by three years for the first, second and third calendar after the company begins treating the workers as employees. In other words,

the company must grant the IRS six years, instead of the ordinary three years, to pursue *any type* of employment tax issues. Thus, while the IRS is prohibited from conducting a worker-classification audit of past years, it is free to initiate broader employment tax audits in certain future years. This is achieved by the Form 8952 (*Application for Voluntary Classification Settlement Program*), which obligates the company to make various representations under penalties of perjury, including the following:

The Taxpayer understands that by participating in the VCSP, Taxpayer agrees to extend the period of limitations on assessment of employment taxes for 3 years for the first, second, and third calendar years beginning after the date Taxpayer elects to begin treating the workers as employees under the VCSP closing agreement. Taxpayer has the right to refuse to extend the period of limitations on assessment or to limit the extension to particular issues or to a particular period of time. However, if Taxpayer refuses to extend the period of limitations on assessment or provides only a limited extension, the IRS will not execute the VCSP closing agreement.

Fourth, although a participating company is only required to pay the One-Year-10-Percent Offer, as computed under the reduced rates of Code Sec. 3509, it still must pay something to the IRS upon execution of the Closing Agreement. The VCSP is not a complete amnesty program, which can have significance if the case involves a large number of well-compensated workers.

Fifth, companies are concerned that the IRS will provide information that it gathers through the VCSP to the U.S. Department of Labor and/or state tax authorities. This fear was stoked by the fact that two days before the debut of the VCSP the U.S. Department of Labor and the IRS entered into a "Memorandum of Understanding" whose stated aims include "reducing worker misclassification" and increasing collaboration between the two agencies such that they can "leverage existing resources and send a consistent message to employers about their duties to properly pay their employees and to pay employment taxes."⁵² High-ranking officials have repeatedly denied any connection between the Memorandum of Understanding and the VCSP, despite their proximity.⁵³ They have also tried to

assure taxpayers at recent conferences that the IRS would not be disseminating taxpayer data acquired through the VCSP, making statements like “the IRS would not share reclassification information with other federal agencies or the state, because doing so would violate information disclosure laws,”⁵⁴ and “[t]here has been a decision that we’re not sharing the VCSP with the states because it is not coming from an audit.”⁵⁵

Sixth, participating in the VCSP might be construed as an admission by the company that could be used to its detriment by third parties. As explained above, each participating company must submit an application to the IRS, *i.e.*, Form 8952 (*Application for Voluntary Classification Settlement Program*). This document requires the company to make various representations, such as “[t]here is no dispute between Taxpayer and the Internal Revenue Service as to whether the workers are non-employees or employees for federal income tax purposes.” To be clear, the Form 8952 does not indicate that the parties disagree about the proper worker-classification but have chosen to resolve the issue without addressing the merits in an effort to conserve limited resources. Instead, it essentially forces the company to admit, under penalties of perjury, that the workers at issue are employees for these purposes, period.⁵⁶ Taxpayers may take some comfort in the fact that the representation narrows the concession to “federal income tax” issues; however, this may be of little value when the

company later faces scrutiny by a state tax agency, the U.S. Department of Labor, a plaintiff attempting to sue the company for negligent actions by one of its “employees,” a claim for certain benefits by a present or former “employee,” *etc.*

Conclusion

Increased worker-classification audits by the IRS are just a matter of time, and many companies are woefully unprepared for the onslaught. They are unfamiliar with the intricacies of the traditional avenues for resolving disputes over worker status, including Act Sec. 530 relief, the standard CSP, and Tax Court litigation. They lack a profound understanding of the new VCSP, too. This type of ignorance impairs their ability to make solid business decisions regarding their employment tax issues ahead of time and it places them at a strategic disadvantage when they encounter a formidable adversary, like a dogged Revenue Agent hell-bent on concluding that certain workers should have been treated as employees instead of independent contractors. Given the complexity of worker-classification issues, the large amounts of money regularly at stake, and the ambiguities associated with the recent VCSP, taxpayers would benefit from consulting an experienced tax practitioner to determine what, if any, actions they need to take in this current environment.

ENDNOTES

- ¹ For purposes of this article, the term “employment taxes” refers to three items: (i) The federal income taxes that an employer is required to withhold from an employee; (ii) amounts under the Federal Insurance Contributions Act (FICA), consisting of Social Security taxes and Medicare, which are paid partly by the employer and partly by the employee; and (iii) amounts under the Federal Unemployment Tax Act (FUTA), which are paid solely by the employer.
- ² Act Sec. 530(a)(1).
- ³ Revenue Act of 1978 (P.L. 95-600), Act Sec. 530.
- ⁴ S. REP. NO. 95-1263, 95th Cong. 2d Sess. (1978), at 209–11.
- ⁵ S. REP. NO. 95-1263, 95th Cong. 2d Sess. (1978), at 201 (emphasis added).
- ⁶ See P.L. 95-600, Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), Tax Reform Act of 1986 (P.L. 99-514), and Small Business Job Protection Act of 1996 (P.L. 104-188).
- ⁷ Act Sec. 530(e)(1); Act Sec. 1122 of P.L. 104-188.
- ⁸ IRM §4.23.5.2.1 (Feb. 1, 2003) (emphasis in original).
- ⁹ Act Sec. 530(a)(1); Rev. Proc. 85-18, 1985-1 CB 518.
- ¹⁰ Act Sec. 530(a)(2); Rev. Proc. 85-18, *supra*.
- ¹¹ Rev. Proc. 85-18, *supra* note 9, at §3.01.
- ¹² S. REP. 104-281, 104th Cong., 2nd Sess., at 24 (1996).
- ¹³ IRM §4.23.5.2.2.7 (Feb. 1, 2003).
- ¹⁴ S. REP. 104-281, 104th Cong., 2nd Sess., at 24 (1996).
- ¹⁵ IRS News Release 96-7 (Mar. 5, 1996).
- ¹⁶ Notice 98-21, 1998-1 CB 849.
- ¹⁷ FS-96-5; IRM §4.23.6.
- ¹⁸ FS-96-5; IRM §4.23.6.11 (Mar. 1, 2003).
- ¹⁹ FS-96-5; IRM §4.23.6.13.1 (Oct. 30, 2009).
- ²⁰ FS-96-5; IRM §4.23.6.13.1 (Oct. 30, 2009).
- ²¹ IRM §4.23.6.13.3 (Oct. 30, 2009). The author removed inapplicable portions of the chart for the sake of clarity.
- ²² S. REP. 97-494(I), 97th Cong., 2d Sess. (1982), at 1103.
- ²³ S. REP. 97-494(I), 97th Cong., 2d Sess. (1982), at 1104.
- ²⁴ S. REP. 97-494(I), 97th Cong., 2d Sess. (1982), at 1103–04.
- ²⁵ S. REP. 97-494(I), 97th Cong., 2d Sess. (1982), at 1104.
- ²⁶ S. REP. 97-494(I), 97th Cong., 2d Sess. (1982), at 1104.
- ²⁷ The legislative history leaves no doubt that, even if the company is entitled to the reduced rates under Code Sec. 3509 for taxes not withheld and remitted to the IRS on behalf of the workers, the company remains fully liable for its own employment tax obligations. The relevant Congressional report states that “[e]ven if this procedure applies, the employer still will be liable for the employer’s share of FICA taxes and FUTA taxes.” S. REP. 97-494(I), 97th Cong., 2d Sess. (1982), at 1105.
- ²⁸ Code Sec. 3509(a); IRM §4.23.8.5.1 (June 7, 2011).

²⁹ IRM §4.23.8.5.1 (June 7, 2011).

³⁰ Code Sec. 3509(b); IRM §4.23.8.5.1 (June 7, 2011).

³¹ IRM §4.23.8.5.1 (June 7, 2011).

³² Code Sec. 6205; Reg. §31.6205-1.

³³ Rev. Rul. 75-464, 1975-2 CB 474, *obsoleted* by Rev. Rul. 2009-39, IRB 2009-52, Dec. 10, 2009. The regulations and IRS pronouncements clarify that a company that refuses to accept the CSP offer can still have an “interest-free adjustment,” provided that it makes a cash bond deposit before receiving a Notice of Determination. See Reg. §31.6205-1(a)(6)(ii) and Rev. Rul. 2009-39.

³⁴ IRM §4.23.6.13.8 (Oct. 30, 2009).

³⁵ IRM §4.23.6.13.9 (Mar. 1, 2003).

³⁶ IRM §4.23.6.13.6 (Oct. 30, 2009).

³⁷ Phil Brand, *IRS’s Worker Classification Program—An Inside Look at New Ways to Resolve the Problems*, 85 J. TAX’N 1 (July 1996) (emphasis added).

³⁸ Code Sec. 7436; Tax Court Rules 290–94; Notice 2002-5, 2002-1 CB 320.

³⁹ Act Sec. 530(e)(4)(A).

⁴⁰ S. REP. 104-281, 104th Cong., 2nd Sess., 26 (1996) (emphasis added).

⁴¹ Announcement 2011-64, IRB 2011-41, 503 (Sept. 21, 2011) (emphasis added).

⁴² *Id.*

⁴³ FAQ #20 clarifies that the Reporting Consistency requirement will be more lax in the con-

text of the VCSP, confirming that somewhat late Forms 1099 will not present a hurdle to companies desirous of participating. FAQ #20 states that “the IRS will consider you eligible for the VCSP if you filed the required Forms 1099 within 6 months of their due date (including extensions), assuming that you meet the other eligibility requirements.”

⁴⁴ Announcement 2011-64, *supra* note 41. FAQ #20 clarifies that companies amid a Form SS-8 (*Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*) determination process are still eligible for the VCSP because such process is not considered an IRS audit.

⁴⁵ Announcement 2011-64, *supra* note 41.

⁴⁶ David Van de Berg, *More FAQs on Worker Classification Program Likely*, 2011 TNT 224-2 (Sept. 21, 2011); Shamik Trivedi, *VCSP Applications Trickling In, Additional FAQs Coming, IRS Officials Say*, 2011 TNT 206-7.

⁴⁷ *Voluntary Classification Settlement Program (VCSP) Frequently Asked Questions*, 2011 TNT 186-78 (Sept. 21, 2011).

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ S. REP. 97-494(I), 97th Cong., 2d Sess. (1982), at 1105. The legislative history elaborates on this point, explaining that “[i]

n order to deter intentional non-compliance with the wage withholding requirements, these provisions do not apply if the employer treats the employee as a non-employee with intentional disregard of the law.”

⁵² Memorandum of Understanding Between the Internal Revenue Service and The U.S. Department of Labor, Sept. 19, 2011.

⁵³ Amy S. Elliott, *IRS Not Sharing VCSP Applicant Data with States*, 2011 TNT 223-5 (Nov. 18, 2011); Shamik Trivedi, *New IRS Voluntary Compliance Program Aimed at Worker Misclassification*, 2011 TNT 184-2 (Sept. 22, 2011).

⁵⁴ Trivedi, *supra* note 46.

⁵⁵ van den Berg, *supra* note 46. FAQ #18 and FAQ #19 also state that the IRS will not share information about VCSP participants with the U.S. Department of Labor or state agencies.

⁵⁶ FAQ #22 tries to allay concerns by stating that the VCSP concerns future years only and that the IRS “is not making any determination with regard to prior years and [the company] is not may any representation as to the workers’ proper status for prior years for federal employment tax purposes.” This guidance seems dubious given that, as part of the VCSP, the company must pay one year of back taxes (at the special rates under Code Sec. 3509) for prior misclassifications.

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