

Federal Tax Relief for the Misclassification of Workers

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Many employers have chosen to cut costs by classifying workers into non-employee categories in the hopes of avoiding expenses such as healthcare and retirement coverage, overtime pay, and withholding taxes for Social Security, Medicare and unemployment insurance. Many employers, including nonprofit institutions such as colleges and universities, tailor their workforce specifically to avoid these costs.

If it works, hiring an independent contractor is much cheaper than hiring an employee. However, the classification of a worker is governed by law, and is not an option of an employer. When a worker is misclassified, the law can impose very stringent penalties on the employer such as back taxes, interest and penalties, reimbursement for compensation and benefits that should have been paid, and penalties enforced by the courts under state law that can include recovery of treble damages and attorneys' fees.

The IRS announced on September 20, 2011 a Voluntary Classification Settlement Program (VCSP) that provides partial, but substantial relief from federal employment taxes for employers that agree to treat workers prospectively as employees. (Ann. 2011-64)

If it has a misclassification issue, an employer should consider entering this program if it qualifies, as VCSP can substantially cut off the employer's potential federal tax liability. Other possible liabilities for misclassification that an employee can pursue in the state courts are not covered by

the IRS program, although if the client corrects the misclassification and makes the employee whole, the risk of litigation is effectively eliminated.

New IRS Relief for Misclassification of Workers

VCSP, which is an optional program, applies to employers that currently treat workers incorrectly as non-employees and want to correct the classification. To be eligible, the employer must:

- have consistently treated the workers in question as nonemployees,
- filed all required Forms 1099 for the workers for the previous 3 years,
- not be currently under IRS, DOL or a state government audit,
- have complied with the results of any prior audit if the employer had previously been audited by IRS or DOL over a misclassification issue.

Under VCSP, the employer:

- must 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 federal law;
- will not be liable for any interest and penalties on the liability;
- will not be subject to an employment tax audit for prior years with respect to the misclassified workers; and
- must agree to extend the period for assessing employment taxes for three years for the first, second and third calendar years beginning after the date

on which the employer has agreed under the closing agreement to begin treating the workers in question as employees.

Burns & Levinson LLP is available to help an employer assess and remedy any worker misclassification issues it may have and take advantage of the new IRS program to limit the tax, penalties and interest that an employee might otherwise incur.

For questions regarding this Client Update, please contact the following attorney:

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