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IRS Announces New Voluntary Worker Classification Program

The Internal Revenue Service announced a new Voluntary Classification Settlement Program yesterday. This program will allow employers to avoid costly IRS audits over classification of their workers as employees or independent contractors by voluntarily reclassifying their workers (or classes of workers) as employees for federal employment tax purposes and paying a portion of the prior year's employment tax. This follows on the heels of a joint announcement by the IRS and the Department of Labor earlier this week that both departments would be working more aggressively to prevent, detect, and remedy employee misclassifications. For federal tax purposes, payments to employees are subject to income tax and employment tax withholding, while payments to independent contractors are not. The determination of whether a worker is an employee or a contractor is based on all the facts and circumstances, and it is often difficult to make this distinction. This state of affairs has led to numerous IRS audits and high-stakes disputes with employers over the proper classification of their workers. The new Voluntary Classification Settlement Program allows employers to avoid IRS audits and obtain substantial relief from federal payroll taxes they may have owed in the past if they agree to treat their workers (or a class of workers) as employees prospectively. Employers who participate in the program will pay 10 percent of the employment tax liability that may have been due on compensation paid to those workers for the most recent tax year but will have to treat those workers as employees and withhold taxes on their wages going forward. Participating employers will not be subject to interest or penalties on past-due employment tax liabilities attributable to those workers and will not be subject to an IRS audit with respect to those workers. In addition, participants in the program will have to agree to extend the statute of limitations for assessments of employment taxes for the following three years. To be eligible for the Voluntary Classification Settlement Program, an employer must

- Consistently have treated the workers in the past as contractors, not employees;
- Have filed all required Forms 1099 for the workers for the previous three years; and
- Not currently be under audit by the IRS, the Department of Labor, or a state agency concerning the classification of these workers.

Application for the program will be made by filing Form 8952 with the IRS at least 60 days before the employer proposes to reclassify the workers as employees. The new Voluntary Classification Settlement Program (IRS form available here) may offer some employers welcome relief from the risk of an IRS audit and a potential significant liability for prior years' withholding taxes. Employers thinking of entering the program, however, should study the FAQs that the IRS will publish on its website so that they can be sure they understand all the federal employment tax ramifications of voluntarily entering this program. Employers should also consider other possible ramifications of entering into this program, including state employment tax liabilities, state unemployment insurance liabilities, exposure to income taxes in other states, the potential impact on employee benefit plans and nontax legal concerns. The reclassification of an independent contractor as an employee under this program is likely to result in classification of the individual as an employee for all legal purposes. As a result, once such reclassification occurs, the employee will be subject to the protection of federal and state wage and hour laws, anti-discrimination laws, unemployment compensation benefit laws and other laws and regulations applicable to employees.