



Tax Alert

IRS Voluntary Classification Settlement Program

OCTOBER 2011

The IRS recently announced a new voluntary settlement program for employers that have misclassified their employees as independent contractors or other nonemployees. The Voluntary Classification Settlement Program (VCSP) offers employers a significantly reduced penalty framework, as well as audit protection for previous years, in exchange for agreeing to prospectively treat the misclassified workers as employees. VCSP is being described by employment tax experts as an extremely generous deal for businesses to set things straight on reclassify workers as employees in return for very limited federal employment tax liability on the past nonemployee treatment.

Worker classification. To properly treat compensation for services rendered, a business must determine the relationship it develops with an individual engaged to perform the services. The worker performing the services must be classified as an employee or independent contractor. Additionally, individuals who would not normally be considered employees may be treated as employees by law (so-called statutory employees).

Classification has important federal tax consequences. Employers generally withhold and pay federal income tax and

employment taxes (FICA and FUTA) on wages paid to employees. In contrast, an independent contractor is solely responsible for the payment of taxes on his or her earnings. Because an employer is required to withhold employment taxes from the wages of employees, failure to do so can result in liability for unpaid withholding, FICA and FUTA taxes as well as penalties.

VCSP. The IRS has opened the VCSP to employers currently treating their workers, or a class or group of workers, as independent contractors or other nonemployees and that want to prospectively treat the workers as employees. The IRS requires that the employer consistently treated the workers as nonemployees, and filed all required information returns such as Forms 1099 for the workers for the three preceding calendar years. Under VCSP, an employer qualifies whether or not the misclassification was the result of a close call in judgment or a more clear cut misinterpretation of the law.

Employers currently under audit by the IRS (or under audit concerning worker classification by the U.S. Department of Labor (DOL) or a state government agency) are ineligible to participate in the VCSP. However, an employer previously audited by the IRS or DOL concerning worker classification may request to participate in

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the VCSP if the employer has complied with the results of that audit. A tax-exempt employer may be eligible to participate unless it is under a Form 990 series examination.

Reduced penalty and audit protection. In exchange for agreeing to prospectively treat the workers as employees, employers will pay only 10 percent of the employment tax liability that may have been due on compensation paid to the workers in the most recent year, as determined under the already reduced rates under Code Sec. 3509 of 1.5 percent of wages and 20 percent of employee social security taxes. Employers also will not pay any interest and penalties on the liability, and will not be subject to an employment tax audit with respect to the classification of the workers for prior years.

The IRS also requires participating employers to agree to extend the period of limitations on assessment of employment taxes for three years for the first, second and third calendar years beginning after the date on which the employer agrees to begin treating the workers as employees. In most cases, this is an inconsequential concession. An employer may refuse to extend the period of limitations but refusal will preclude the employer from participating in the VCSP.

Form 8952. The IRS has developed *Form 8952, Application for Voluntary Classification Settlement Program*, to request to participate in the VCSP. The IRS has advised employers to file Form 8952 at least 60 days from the due date that the employer wants to begin treating its workers as employees.

The IRS will review Form 8952 and determine if the employer is eligible to participate in the VCSP. If the employer is eligible for the VCSP, the IRS will contact the employer to enter into a VCSP closing agreement. An employer that receives a rejection notification may reapply to participate in the VCSP.

The IRS announced the VCSP in September 2011. The IRS has not given the VCSP an end-date as of this time. While the VCSP is welcome news and is business friendly, there remain a number of open questions such as the state tax treatment and impact on retirement and benefits plans of participating in the VCSP. Please contact your Wilkin & Guttenplan advisor for more information.

Any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

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