Got Amnesty? New IRS Deal Converts Independent Contractors

By Robert W. Wood

The Internal Revenue Service has several "voluntary disclosure" programs under its belt aimed at encouraging foreign income and bank account reporting and compliance. Now, the IRS has turned its attention to another bone of contention: the age-old line between independent contractor and employee. There's good reason.

Everyone in business knows it's cheaper to pay independent contractors. You don't have to withhold taxes or pay the employer portion of Social Security tax. You don't have to pay benefits, unemployment or workers' compensation, and you can bypass liabilities from accidents and injuries to discrimination. Virtually everything is cheaper — far cheaper — with independent contractors.

But labels aren't enough. The IRS (and other federal and state agencies) police this line vigorously. If you label someone as an independent contractor but treat them as an employee, you can face crippling tax and other liabilities.

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What's more, it's terribly difficult to apply the mishmash of facts and circumstances that go into determining who is a bona fide independent contractor. The IRS uses 20 factors, but the overall issue is whether the employer has the right to control the worker, not only as to end result of their work, but also as to their method and means. Fortunately, there's now some relief.

IRS Announcement 2011-64 unveils the Voluntary Classification Settlement Program, which allows you to prospectively reclassify your independent contractors as employees. Why is that a good deal? After all, it involves *giving up* on the independent contractor classification that may be saving you millions.

The attraction is the IRS' commitment — in a binding IRS closing agreement — that it will not audit you for the past no matter what. The tax dollars for failure to withhold income and Social Security taxes can run in the millions. Holding your breath and hoping you're not audited can be stressful. And the mix of factors is so fact-intensive that outcomes are hard to predict. Even if you win, disputes are expensive.

To be eligible, you must: have consistently treated the workers as independent contractors; have filed all required IRS Forms 1099 for workers for the previous three years; not currently be under audit by the IRS; not currently be under audit by the Department of Labor or a state government agency concerning worker classification; and if you were previously audited by the IRS or the Department of Labor concerning the classification of the workers, you will only be eligible if you complied with the results of that audit.

The IRS has discretion whether to accept you, but once it does, you will pay only 10 percent of the employment tax liability that would have been due on what you paid your workers for the most recent year. That comes out to about 1 percent of the pay given to those workers for the prior year. There are no penalties and no interest. If you have a weak case for contractor treatment, that may be a good deal.

Although this program is a very good deal for some, it won't be for others. Consider your facts and exposure carefully. Of all the variables to consider, employers feeling they have a virtual lock on Section 530 relief may be least likely to sign up. Section 530 relief allows some companies who have misclassified their workers not only to avoid tax and penalty liabilities for their past misclassifications, but it actually allows them to continue it. For details of Section 530 relief, see Wood, "*Revenue Service Cracks Down on Independent Contractor Misclassification*," *Los Angeles Daily Journal* (Aug. 30, 2011), p. 5.

Another significant issue is state law. Although the IRS issues a closing agreement for the past, it's not yet clear if California will conform. California has a history of not conforming to such initiatives. The IRS program only protects you from the IRS. If California fails to conform, it's worth wondering whether California might view participation in the IRS program as a kind of red flag that there were misclassifications in the past.

Another concern is how reclassified workers may react. Some may conceivably have objections to being reclassified from independent contractors to employees. Moreover, with their new employee status, some workers might consider whether they have a claim against the employer (for benefits, etc.) for the past.

There could be tort and agency liabilities to consider as well. An employer reclassifying its workers is likely to do so for *all* purposes, not merely with the IRS. The company would therefore begin paying unemployment insurance, workers' compensation premiums, etc. Liability issues could muddy the analysis.

For example, suppose your "independent contractor" driver was in an accident and a lawsuit is brewing. If he's truly an independent contractor, he is liable but you are not. But if he's your employee, you have joint liability for his actions. You may be protected from IRS liability as part of this program. However, the state law liability issue may be worrisome. Treating the driver as an employee (even prospectively) could look a little like erecting a fence around a swimming pool after a drowning accident.

The IRS program can be a very good deal for some and not so good for others. Every client should examine the whole picture before deciding. Get some advice about how strong or weak a case for independent contractor treatment you have, about what your chances of Section 530 relief would be if you ran into trouble, and about what non-IRS liabilities and issues are lurking. That way you can make a fully informed decision so you hopefully won't be lamenting having jumped the wrong way in the face of oncoming traffic.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.