IRS expands independent contractor amnesty program

By Robert W. Wood

Virtually every company with employees and independent contractors is aware that the Internal Revenue Service can reclassify independent contractors. In fact, the IRS would like it if *all* workers were employees. After all, IRS statistics show that independent contractors don't always pay their taxes.

Even if they do, the IRS receives withheld taxes quicker and more reliably from employers. What's more, withholding includes payroll taxes. Although independent contractors are supposed to pay self-employment tax, it is notoriously under-collected. Yet determining exactly who is a true independent contractor is notoriously difficult. The IRS has an amorphous 20-factor test to address it, but there is no litmus test.

It isn't just the IRS that polices the line between contractors and employees. California's Franchise Tax Board and Employment Development Department scrutinize it too. They are often tougher on employers than the IRS. That often means that employers are staring down the barrel of gun and worrying about how to address an expensive and protracted dispute over worker classification.

Employers can face crippling back taxes and penalties when workers are reclassified. Owners can face *personal* liability, too. That's why some companies have taken the IRS up on its amnesty offer. It essentially involves voluntarily turning your independent contractors into employees for the future. So far, nearly 1,000 employers have applied for this Voluntary Classification Settlement Program.

More employers may want to do so now that the IRS has expanded it. To be eligible for the IRS program, an employer must: (1) currently be treating some workers as independent contractors; (2) consistently have treated them as independent contractors, including filing IRS Forms 1099 reporting the payments to them; and (3) not currently be under audit on payroll tax issues by the IRS. In addition, the employer cannot currently be under audit by the U.S. Department of Labor or a state agency concerning the classification of these workers, nor can the employer be contesting the classification of the workers in court.

Companies that meet these criteria can convert independent contractors to employees prospectively without fear of IRS audit for the past. Employers accepted into the IRS program generally pay an amount that usually works out to approximately 1 percent of the wages paid to the reclassified workers for the past year. Amazingly, there are no penalties and no interest. What's more, the employers will not be audited on payroll taxes related to these workers for prior years.

Anyone who has faced the costs and stress of a reclassification audit, administrative dispute or litigation over these issues can appreciate how good a deal this is. That's especially true for companies that have a weak case for upholding independent contractor classification in the long term. And now the IRS has sweetened the pot in several key respects.

Under the IRS's recent liberalized program rules, even employers under IRS audit can qualify for the program as long as the audit is not specifically over employment taxes. Furthermore, employers who are accepted into the IRS program will no longer be subject to a special six-year statute of limitations that has previously applied. Instead, the usual three-year statute of limitation applies, as is normally true for payroll taxes.

These and other permanent modifications to the program are described in IRS Announcement 2012-45 and in the Voluntary Classification Settlement Program Frequently Asked Questions section of the IRS website. The IRS has also eased up on the basic conditions employers must meet to enter the IRS program. As noted, employers must normally have issued all required Forms 1099 to independent contractors who will be converted to employees. Now, however, even employers who failed to file the Forms 1099 can still participate in the program.

But this liberalized Form 1099 allowance has a limited time — only until June 30, 2013. Details on this temporary change are in Announcement 2012-46. Employers applying for the temporary relief program available for those who failed to file Forms 1099 will pay a slightly higher amount than other participants in the program. They also will pay some penalties, and will need to file the delinquent Forms 1099 for the workers they are reclassifying as employees. Even so, this is a significant liberalization of the IRS program that opens it up to a vastly larger group of employers.

Many employers worry that they cannot participate if they are involved in filing or responding to an IRS SS-8 determination request. An SS-8 is a simplified ruling procedure for determining worker status that any worker or any company can initiate. Most are filed by current or former workers, and they can seem like an audit.

Fortunately, though, the IRS has confirmed that such a proceeding — even if it is pending — does not prevent participation in the IRS program. Another common concern is whether the IRS will share information about companies that participate in IRS amnesty with other agencies, like the U.S. Department of Labor. The IRS has confirmed that it *will not* share the data.

In fact, the IRS has even gone so far as to say that it will also not share the data it collects about who is participating in the amnesty program with state agencies. It is well known that the IRS, DOL and many state agencies have swapped information readily in the past — and still do. Thus, the fact that the IRS has said that this amnesty program is off limits from its normal information-sharing practices is remarkable.

Some companies worry about applying for IRS amnesty and, for some reason, being rejected. If they are rejected, companies worry that having stepped forward to apply for the program will trigger an audit. Again, the IRS has helpfully nipped this concern in the bud. If an application to the program is rejected it will not automatically trigger an IRS audit.

Finally, many companies worry that by taking advantage of the IRS program and converting workers from independent contractors to employees for the future, they will prejudice their position on those workers for the past. If fixing a swimming pool after an accident can be construed as an admission of liability, isn't reclassifying workers? The IRS has confirmed that by taking advantage of the IRS amnesty there is no admission of liability or admission of any wrongdoing relating to worker classification for the past.

Despite its many advantages, the IRS program is not for everyone. Indeed, it is not even for every group of workers within a company. Companies can pick and choose, reclassifying some workers prospectively as employees without prejudicing the company's treatment of other groups of independent contractors which the company wants to keep treating as independent contractors. Again, this is remarkable.

Nevertheless, the IRS program has not been as widely embraced by employers as many advisers thought it would be. One reason may be that many companies both large and small may be viewing their independent contractor classifications through rose-colored glasses. Yet especially now that the IRS has materially expanded and liberalized this limited form of amnesty, it is time to reflect. More and more companies should view their liabilities in the increasingly messy worker classification area with a clear and critical eye.

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