Is the IRS Independent Contractor Settlement Program a Good Deal?

By Robert W. Wood


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The IRS voluntary classification settlement program for prospective reclassification of workers from independent contractors to employees appears straightforward. Wood examines the program and its potential ramifications, finding that the decision whether to participate is likely to take into account a wide range of legal and tax issues.

When the IRS says "voluntary" it can sound scary. The IRS is unlikely to use the term unless the potential liability is serious. Recent examples of serious liabilities addressed in that way include the 2009 offshore voluntary disclosure program (OVDP)[1] and the just-ended 2011 offshore voluntary disclosure initiative (OVDI).[2] Through those voluntary programs, the IRS is collecting billions of dollars and getting many taxpayers back into compliance with our federal income tax system.

Voluntary programs may also be characterized as limited amnesties. They can even bring the IRS some good press, resolving tough issues in a way that may suggest new strategies for old problems. A voluntary program can be delivered using a carrot and stick approach. The details of the program can provide certainty and can even be seen as a good financial deal for some, a carrot.

Yet the program can also be announced with a warning, as IRS Commissioner Douglas Shulman did with his "last best chance" comments about the OVDI. In effect, those who choose not to participate in the program will face rigorous enforcement, a stick. That method can encourage participants to come forward and help the IRS achieve greater collections of tax.

On September 21, the IRS announced a newly minted voluntary relief program for worker status termed the voluntary classification settlement program (VCSP).[3] Unlike the foreign account programs, the VCSP appears to have no deadline and no announced date of termination. The IRS will presumably see how it goes and decide later whether it should remain in effect.

Fundamentally, the new program involves taxpayers voluntarily giving up independent contractor status for their workers prospectively in exchange for immunity for the past. The prospective voluntary reclassification need not be for all workers, but must cover a class or type of workers. Within the confines of the program, an employer cannot have similarly situated workers working as employees while others continue as independent contractors.

There are two attractive carrots to the VCSP. First, there are no penalties and no interest, and there is only a nominal tax payment involved — 10 percent of the payroll taxes that would have been payable for the covered workers for the prior year. As we will see, that payment can be nominal indeed when one considers the stakes. Second, the IRS signs a closing agreement committing that there will be no audit for past worker classification.

Participants in the program will relinquish their independent contractor classifications prospectively without implicating the past. How many companies will take advantage of this program? How many will at least consider and evaluate it? Perhaps they will do so in the context of a legal review of their worker status practices.

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[1] *See* http://www.irs.gov/newsroom/article/0,,id=206012,00.html.

[2] *See* http://www.irs.gov/newsroom/article/0,,id=234900,00.html.

[3] *See* Announcement 2011-64, 2011-41 IRB 1, *Doc 2011-20066*, *2011 TNT 184-9*; IR-2011-95, *Doc 2011-20067*, *2011 TNT 184-13*.

It is too soon to say how many companies will participate, how broadly across their worker pools they will participate, and how they will analyze the numbers. But it seems logical for a large segment of the American workforce to evaluate whether it makes sense to participate in the VCSP. One question is how.

The nominal tax payment that amounts to the entry fee for the VCSP is unlikely to matter to most companies. It is in some respects like a teaser rate on a mortgage loan that later escalates to higher rates. The minor finite tax payment is a cost, of course, but it is not the major cost of the VCSP.

The major cost will be in the future. Prospective participants should compare the projected cost of operating with employees with that of independent contractors. Some companies may fail to seriously consider the VCSP, viewing it as involving a fundamental shift of policy from how they now do business. It might be, but there should be a way of analyzing the economics and factoring in the risks.

If one does not consider the risk of forced re-characterization by the IRS, using independent contractors in the future will almost certainly be more cost-efficient than using employees. For that reason alone, volunteering for the program would not seem to make sense. However, companies should consider the extent to which they may face scrutiny by the IRS and the Department of Labor over their use of independent contractors, the anticipated cost of defending themselves, and the likelihood that they will prevail.

This will often be a complex analysis. It may vary from one group of workers to another within the same company. Companies that monitor their independent contractor usage and are aware of the risks and costs of re-characterization battles may already have some idea how much their costs will increase with employees. However, most companies will have to fine-tune their projections. Estimates should help companies determine whether participating in the VCSP would be prudent, and if so, for precisely which group or class of workers currently treated as independent contractors.

Evaluating one's exposure is rarely an easy or dispassionate process. It will likely be especially difficult here, given the uncertainties pervading the entire worker status regimen. Murky legal and factual distinctions must be made when evaluating whether workers are employees or independent contractors. Regardless, companies should use the VCSP as a chance to consider their exposure and identify the areas in which they need to improve if they are to keep using independent contractors on a large scale. That means companies will also need to see how their own fact patterns, documentation, and actual use of independent contractors stack up to the law.

Worker Status Playing Field

Who is an independent contractor and who is an employee? We know it matters, and we know disputes over that fundamental divide occur frequently. The distinction between independent contractors and employees has been mired in controversy for decades. On virtually all sides, no one is entirely happy.

Companies that accurately denote their independent contractors no doubt feel threatened. Workers who prefer working independently may feel discriminated against. The IRS and other agencies of the federal and state governments see many putative independent contractor relationships that are laughably inadequate. Many cannot withstand scrutiny. Yet audits are time consuming, expensive, and can have unique procedural difficulties.

Despite all this, separating the wheat from the chaff is terribly time consuming and subjective. Perhaps for those reasons, section 530 relief has long been relied on as a way around the rules.[4] Section 530 relief has itself endured significant controversy, with various attempts to modify or repeal it.[5] Many employers are rescued by section 530 relief from what would otherwise be certain defeat. It has long been a major stumbling block for the IRS's enforcement efforts.

The liabilities lurking in independent contractor versus employee controversies are large. They are not limited to federal tax matters, or even to tax matters. But our awareness of and concern over the specific types of liabilities and the potential exposure varies widely, from ignorance to near paranoia. Some businesses naively assume that slapping an ''independent contractor'' label on a worker's name badge resolves the question.

The more sophisticated among us know a nice moniker is not enough, and we strive to accurately classify our employees and independent contractors. If we are careful, that should bring a measure of certainty and protection from liability. Yet almost nothing is risk free. Even the most cautious and carefully constructed working relationships and written agreements can go awry. Wherever one fits along this spectrum, there is risk of re-characterization. For tax and other purposes, the IRS and others may come along and make an assessment.

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[4]*See* section 530 of the Revenue Act of 1978 (P.L. 95-600).

[5]*See* the Taxpayer Responsibility, Accountability, and Consistency Act of 2009, H.R. 3408 (2009); the Fair Playing Field Act of 2010, S. 3786 (2010), H.R. 6128 (2010).

Hiring employees means paying wages, withholding taxes, offering employee benefits, bearing liability for employees' acts of negligence during their employment, and enduring the scrutiny of state and federal law regarding nondiscrimination, discipline, and termination. Independent contractors, however, are classically one-time workers doing a job for a fixed price and often working for multiple companies. Axiomatically, one cannot control independent contractors with detailed direction, and they bring no tort, contract, or tax liabilities to the employer's doorstep.

That may make the dichotomy between employee and contractor seem obvious and uncontroversial. But nothing could be further from the truth. There are many subtle characteristics that make the spectrum of workers largely homogeneous. It is often not easy to say in which category a particular worker or class of workers belongs, partly because obvious incentives exist for companies to attempt to use independent contractors rather than employees. That has led to an epidemic of arguably bogus independent contractors who do not necessarily function as they are supposed to.

Intentional blurring of the lines between independent contractors and employees produces controversy about what is — and is not — possible with independent contractors. It also undermines the circumstances in which companies lawfully and legitimately can use independent contractors rather than employees.

Wheat From Chaff?

How does one tell who is who? Whether using the IRS's 20 factors[6] or its more modern three areas of control,[7] the overall issue is control. Does the employer have the right to control the worker not only regarding the end result but also regarding method and means? The mix of factors is fact intensive and outcomes are unpredictable. Even if you win, disputes are expensive.

Traditionally, the IRS uses 20 factors, a kind of hit list of what to look for in determining a worker's status. It is based on the common law right-of-control test that is so prevalent in tax and nontax alike. More recently, the IRS thought it might be easier for people to consider three factors defining the relationship between businesses and workers: behavioral control, financial control, and the type of relationship.[8]

You can use either approach, although for most taxpayers, I find the old 20 factors superior because they invite scrutiny into more concrete issues:

1. *Instructions*. The more instructions the worker is given, the more likely it is that he is an employee.

2. *Training*. The more training the worker is given, the more likely it is that he is an employee.

3. *Integration*. The more closely integrated the work is with the employer's business, the more likely it is that the worker is an employee.

4. *Services rendered personally*. If the worker must personally do the work, it is likely he is an employee.

5. *Hiring, supervising, and paying assistants*. A person who hires, supervises, and pays his own assistants is likely to be an independent contractor.

6. *Continuing relationship*. The longer the term of the arrangement, the more likely it will be viewed as employment.

7. *Set hours of work*. A worker assigned set hours is more likely to be considered an employee.

8. *Full time required*. A worker required to work full time is more likely to be considered an employee.

9. *Doing work on employer's premises*. A worker regularly working on the employer's premises is more likely to be viewed as an employee.

10. *Order or sequence set*. Being required to perform services in a particular order or sequence is more likely to suggest employee status.

11. *Oral or written reports*. Rendering regular reports to an employer tends to suggest that the worker is an employee.

12. *Payment by hour, week, or month*. Payment by the hour, week, or month rather than by the job tends to suggest employee status.

13. *Payment of business and traveling expenses*. If an employer pays a worker's business and travel expenses, it suggests employee status.

14. *Furnishing of tools and materials*. The employer's furnishing of significant tools, materials, and other equipment suggests employee status.

15. *Significant investment*. A worker's own significant investment tends to indicate he is an independent contractor.

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[6]62 Stat. 468 (1948).

[7]*See* "IRS Tax Topic 762 — Independent Contractor vs. Employee," *available at* http://www.irs.gov/taxtopics/tc762.html.

[8]*Id.*

16. *Realization of profit or loss*. A worker's potential to realize a profit or suffer a loss suggests he is an independent contractor.

17. *Working for more than one firm at a time*. Working for more than one firm at the same time suggests independent contractor status.

18. *Making service available to the general public*. That a worker regularly and consistently makes his services available to the general public suggests independent contractor status.

19. *Right to discharge*. The right to discharge a worker suggests he is an employee.

20. *Right to terminate*. A worker's right to terminate the relationship without incurring a liability suggests the worker is an employee.

Despite this list, there is no litmus test, no number of factors pointing one way that provides certainty. Conversely, there is no one fatal fact that spells doom. Worker status involves a mosh pit of facts and circumstances. Even disciplined businesspeople and practitioners can find this daunting.

Moreover, despite the dizzying array of facts to take into account, there are many points even these factors don't address. Does one need a written agreement? It is hard to imagine an independent contractor relationship standing up without one. Yet a written agreement is 1 of the 20 factors.

We Need Volunteers

A potential way out of the maze, Announcement 2011-64[9] unveils the IRS's VCSP allowing taxpayers to voluntarily reclassify independent contractors as employees for the future. For taxpayers who qualify, tax exposure for the past is limited.

To be eligible, the taxpayer must:

1. have consistently treated the workers in question as independent contractors;

2. have filed all required Forms 1099 for the workers for the previous three years;

3. not currently be under audit by the IRS;

4. not currently be under audit by the Department of Labor or a state government agency concerning worker classification; and

5. have complied with the results of any previous IRS or Department of Labor audit.

The IRS has discretion to accept applicants into the program. Once a taxpayer is accepted, the taxpayer must pay the IRS 10 percent of the employment tax liability that would have been due on income the taxpayer paid the affected workers for the most recent year, but determined under the reduced rates of section 3509(a). The IRS estimates that this 10 percent payment will equal just over 1 percent of the income the employer paid to its reclassified workers for the prior year.[10]

There are no interest charges or penalties. Moreover, the IRS agrees (in a binding closing agreement) not to audit the taxpayer regarding payroll taxes related to these workers for prior years. The taxpayer must consent to a special six-year statute of limitations, rather than the three years usually applicable to payroll taxes.

To apply to the program, an employer must file Form 8952, ''Application for Voluntary Classification Settlement Program (VCSP).'' The IRS asks prospective participants to file the application at least 60 days before the taxpayer wants to begin treating the affected workers as employees. The taxpayer must also submit contact details for the taxpayer's representative on a Form 2848, ''Power of Attorney.''

One of the most scrutinized issues is likely to be the computation of the VCSP payment using the reduced rates of section 3509. Under section 3509, the effective tax rate for compensation up to the Social Security wage base is 10.68 percent in 2010 or 10.28 percent in 2011, and 3.24 percent for compensation above the Social Security wage base.

The amount due under the VCSP is calculated based on compensation paid in the most recently closed tax year determined when the VCSP application is filed. In 2011 the 10.68 percent effective rate applies because the most recently closed tax year was 2010. For 2012, the 10.28 percent effective rate applies because the most recently closed tax year at that point will be 2011. The 3.24 percent rate applies to compensation above the Social Security wage base for both 2011 and 2012 submissions.

The effective rates constitute the sum of the rates as calculated under section 3509, and are made up of the following, which are shown in the table on the next page.

Under the VCSP, the taxpayer then pays 10 percent of the amount calculated under section 3509. Consider the following examples.

Example: In 2010 you paid $1.5 million to independent contractors you now want to reclassify. They were all below the Social Security wage base of $106,800 for 2010. You submit a VCSP application on October 1, 2011, and want to pay those workers as employees

[9]*See* Announcement 2011-64.

[10]To see how this payment is computed, see VCSP FAQ 16, *Doc 2011-20234, 2011 TNT 186-78*; *see also* ''Instructions to Form 8952'' (Sept. 2011), *available at* http://www.irs.gov/pub/irs-pdf/i8952.pdf.

Description	Section 3509 Percentage in 2011 (for compensation paid in 2011 up to the Social Security wage base)	Section 3509 Percentage in 2010 (for compensation paid in 2010 up to the Social Security wage base)	Section 3509 Percentage in 2010, 2011, and 2012 (for compensation paid in 2010, 2011, and 2012 above the Social Security wage base)
Federal Income Tax Withholding	1.5	1.5	1.5
Employee Social Security Tax	0.84	1.24	0
Employer Social Security Tax	6.2	6.2	0
Employee Medicare Tax	0.29	0.29	0.29
Employer Medicare Tax	1.45	1.45	1.45
Total	**10.28**	**10.68**	**3.24**

commencing January 1, 2012. The most recently completed tax year is 2010, and under section 3509 the employment taxes applicable to $1.5 million would be $160,200 (10.68 percent of $1.5 million). Your required VCSP payment is 10 percent of $160,200, or $16,020.

Example: The facts are the same, except that some of the workers you are reclassifying were compensated above the Social Security wage base (a total of $250,000). Under section 3509, the employment taxes applicable to $1.25 million would be $133,500 (10.68 percent of $1.25 million), and the employment taxes applicable to the other $250,000 would be $8,100 (3.24 percent of $250,000). Under the VCSP, your payment would be 10 percent of $141,600 ($133,500 plus $8,100), or $14,160.

Section 530 and More

Of all the variables to consider, employers who may feel they have a virtual lock on section 530 relief may be the least likely to enter the program. After all, section 530 relief allows them to not only avoid liability for their past misclassification, but allows them to continue it.[11] The IRS would surely have an entirely different response to its new program if section 530 relief had been repealed.

Another significant issue may be the spillover effect of state law as well as the possibility of claims by workers themselves. I am already seeing companies interested in relinquishing independent contractor positions for some workers for the future, but expressing concern that the IRS does not offer one-stop shopping. Although the IRS issues a closing agreement for the past, what about the states? Couldn't the states perceive weakness for the past, or even view participation in the program as an admission?

Another concern is how the workers themselves may react. Presumably an employer will consult workers to ensure that they have no objection to being reclassified from independent contractors to employees prospectively. However, isn't it possible that some workers with their new status will consider whether they have some claim for the past?

Some of these issues may depend on the nature of the benefits offered by the employer and the extent to which the employer starts implementing a benefit package that is special for these conversions. But however it is done and whatever workers are provided in their new role as employees, they may (either on their own or with encouragement from a plaintiff lawyer) inquire about what else they might be entitled to receive. It might be a replication of the benefits they are receiving in their new status, simply some reimbursements of business expenses for the past, or more.

It may sound farfetched, but there are tort and agency liabilities to consider as well. Most employers will reclassify their workers for all purposes — not merely with the IRS. They will begin paying unemployment insurance, workers' compensation premiums, and more.

But if they are facing any liability issue — say an "independent contractor" driver was in an accident six months ago and a lawsuit is brewing — the respondeat superior liability employee status brings will be a concern. Reclassifying the worker prospectively may be protected viz. the IRS by the IRS closing agreement. But like erecting a fence around a swimming pool after a drowning accident, the state law liability issue may be worrisome.

Conclusion

Independent contractor controversies are expensive and frustrating. The rules involve traps for the unwary, while big, well-funded, and well-advised taxpayers often do just fine. Others often do not.

The IRS has long seemed to focus primarily on the future in resolving payroll tax assessment issues, often willing to abate most or all of an

[11] *See* Robert W. Wood, "Is the IRS Raising the Worker Status Relief Bar?" *Tax Notes*, Oct. 3, 2011, p. 105, *Doc 2011-19918*, or *2011 TNT 194-10.*

assessment in exchange for the taxpayer's agreement to convert workers to employee status going forward. The VCSP does that in an explicit and non-audit-centric way. To me, it seems like a good deal.

Yet the IRS will be criticized for gathering the wrong taxpayers into its fold. Some may choose to participate even though they have legitimate and defensible independent contractor arrangements. With the rise of even more seamless information exchanges, some taxpayers may participate because they fear a witch hunt, and an expensive one at that. In that sense, we can expect parallels to the 2011 OVDI and the 2009 OVDP, in which some taxpayers without much to fear participated, while many who should have had much to fear might not have.

As we watch the ensuing worker status drama unfold, another variable may be whether companies will perceive that giving up on one class of workers — agreeing to treat them as employees prospectively — will somehow immunize other classes of workers from re-characterization. The VCSP contains no details suggesting that this will occur or that there would be any such immunization effect. Nevertheless, I am sure I am not the only adviser to wonder how many taxpayers might think this will occur. Stay tuned.