Internal Revenue Service Offers Voluntary Employee Reclassification Program

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On September 21, 2011, the Internal Revenue Service ("IRS") announced its new Voluntary Worker Classification Settlement Program (the "Program"), which, according to the IRS, "will enable many employers to resolve worker classification issues and achieve certainty under the tax law at a low cost by voluntarily reclassifying their workers." The Program allows employers the opportunity to reclassify certain workers[1] as employees, while limiting the resulting federal payroll taxes for their most recent tax years, and avoid related penalties and interest for prior years.

Terms and Conditions

The IRS characterizes participation in the Program as entirely voluntary. To participate in the Program, employers must submit Form 8952 at least sixty (60) days before they want to begin treating their workers as employees. Form 8952 is available at http://www.irs.gov/pub/irs-pdf/f8952.pdf. To be eligible, an employer must:

1. consistently have treated the workers in the past as non-employees;
2. have filed all required Forms 1099 for the workers for the previous three years;
3. not currently be under audit by the IRS; and
4. not currently be under audit by the Department of Labor ("DOL") or a state agency concerning the classification of these workers.

Under the terms of the Program, an employer must:

1. identify those workers (or the group or class of workers) being reclassified and voluntarily reclassify them as employees;
2. enter into an appropriate settlement agreement with the IRS[2];
3. pay a federal employment tax penalty with respect to prior misclassification[3]; and
4. agree to extend, for three years, the limitations period used to assess employment taxes for the first three years following the signing of the settlement agreement.

The Dangers of Reclassification

Proper classification of workers has been a monumental concern for employers nationwide as both the IRS and the DOL have stepped up audits and enforcement in this area. In 2010, the IRS launched a national research project in which it sent thousands of audit letters to employers. In addition, on Sept. 19, 2011, just two days prior to the launch of the Program, the DOL announced that it had entered into a memorandum of understanding with the IRS--and similar information sharing agreements with at least eleven (11) states--to coordinate and enhance its worker misclassification enforcement efforts. Thus, at least in theory, the Program could prove beneficial to many employers by providing significant incentive and savings for employers who may have misclassified their workers.

What may be beneficial in theory, however, may not always be so in practice, as there may be several causes for concern with voluntary participation in the Program. As noted above, the IRS has entered into information sharing arrangements with the DOL and numerous states. Thus, the information gathered pursuant to the Program may provide a detailed road map for DOL or state officials to pursue separate enforcement actions against employers for misclassification of workers.[4]

Also, reclassifying a worker to employee status confers important procedural and substantive rights on the worker, of which the employer must be mindful. For example, the National Labor Relations Act explicitly denies independent contractors the right to unionize and bargain collectively. Thus, an employer voluntarily participating in the Program may also, in effect, be providing that right to its reclassified workers.[5] Moreover, reclassifying some or all of its workers as employees may subject an employer to certain federal employment statutes and their various requirements[6]

Finally, under the terms of the Program, an employer must prospectively agree to treat the workers as being reclassified to employee status for future tax periods. To put it another way, there is no going back. Thus, an employer that participates in the Program but later changes its mind with regard to future workers may be found to be engaged in "willful" misclassification.[7] This consideration is particularly important for any employer that may choose to reclassify some, but not all, of its workers as employees, which may find itself being accused of acting "willfully" with regard to those workers that it did not reclassify.[8]

To participate or not to participate, that is the question

It is not difficult to see that many employers will be tempted to rush to participate in the Program; considering all of the potential pitfalls described above, however, employers should pause before rushing ahead with participation. Rather, employers should arrange for an audit of their workforce to analyze potential worker misclassification issues. This will allow the employer to determine whether it, in fact, has misclassified certain workers or whether it has a defensible basis for its classifications. Furthermore, such an audit should take into consideration both the tax and non-tax consequences of voluntary participation.[9] If, after an audit, an employer finds that it has no colorable defense to employee misclassification, it probably should take advantage of the voluntary program (while exercising care in doing so). Organizations where the misclassification issues are less clear, however, should pause and reconsider the appropriate course of action.

[1] Most often, this will involve a reclassification from independent contractor to employee. The Program, however, can also be used to reclassify other "non-employees" such as leased employees, presumably creating a joint or concurrent employment relationship.

[2] The IRS retains discretion over whether to accept an employer's application for the Program.

[3] The IRS describes this penalty as "10% of the employment tax liability that may have been due on the compensation paid to the workers, calculated at the reduced rates of IRC section 3509(a), for the most recent year, with no liability for any interest or penalties."

[4] Just because the employer has entered into a voluntary settlement with the IRS does not mean that it also has settled with other federal or state agencies. This may be particularly worrisome, because participation in the Program could be used as a key admission in a separate enforcement action.

[5] It is also important to note that, while the standard for determining "employee" status varies among federal statutes, tax classification is often invoked as one of the factors to be considered.

[6] For example, the Age Discrimination in Employment Act is applicable only to employers with twenty (20) or more employees. The Americans with Disabilities Act and Title VII are applicable to employers with fifteen (15) or more employees. Any employer with a small number of employees, that may be on the verge of having to

comply with one or more of such federal statutes, must carefully consider the impact that adding additional workers to the "employee" category will have on its business.

[7] Willful misclassification of workers can be criminal under both federal and state law. *See e.g.,* 26 U.S.C. ? 7215; Cal. Labor Code ? 226.8. Moreover, the statute of limitations for violations of the Fair Labor Standards Act is increased from two to three years if an employer is found to have acted willfully.

[8] Such an employer should be careful to consider and document its basis for reclassifying certain workers but not others as employees.

[9] This should include a determination whether reclassification would subject the organization to certain employment laws, whether any affected workers may use their reclassification for asserting personal claims under federal or state employment statutes, and whether affected workers may attempt to organize after their reclassification.

For more information about this topic, please contact the author or any member of the Williams Mullen Labor & Employment Team.

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