

IRS offers relief on employees misclassified as contractors

Properly classifying workers as employees or independent contractors is a high-stakes issue for businesses.

Make the wrong call and you can be on the hook for back taxes, penalties and interest—not to mention the possibility of civil liability under the labor law.

One key area of exposure is federal employment taxes. The Internal Revenue Service has recently initiated a new program that provides relief from employment tax penalties for employers that fix misclassification problems. The program highlights the importance of classifying workers properly and provides an opportunity for businesses that made classification errors in the past to correct them without paying penalties or interest.

Generally, all workers are classified as either employees or independent contractors. A worker usually is an employee if the service recipient has the right to control not only the result of the services but also the means by which that result is accomplished. In other words, you're an employee if your boss tells you what to do and how and when to do it.

An independent contractor, on the other hand, is a person in an independent trade or business that offers services to the general public. Unlike employees, independent contractors work for multiple service recipients at a time, and they can realize a profit or loss from performing each specific task or job.

The IRS and the courts have developed a facts-and-circumstances test to use to determine whether an employer-employee relationship exists. The test focuses on the behavioral and financial control the service recipient has over the worker, as well as the relationship of the parties.

Classification has important consequences for income taxes and employment taxes at the federal, state and local levels. Employers are required to withhold income and employment taxes from their employees and pay the employers' portion of those taxes.

Generally, independent contractors just



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get a check—no withholding required. The independent contractor is responsible for paying his or her self-employment tax.

Failure to comply with the classification rules can result in serious consequences for the employer. These include back taxes (including taxes that would otherwise come out of the worker's salary), interest and penalties. In addition, there is the possibility of liability under labor laws.

Despite the high stakes, employee misclassification is rampant. A recent Cornell University study estimated that more than 10 percent of workers are misclassified.

Because of the extent of the problem, the government has been cracking down on employee misclassification in recent years.

In 2009, the IRS announced a project to conduct 6,000 random employment tax compliance audits over three years. Congress is considering legislation increasing the consequences for misclassification under the labor laws.

Earlier this fall, the IRS also decided to try a carrot approach. The agency initiated a new Voluntary Classification Settlement Program, which provides relief from federal employment taxes for taxpayers that agree to prospectively treat misclassified workers as employees. (The program does not address income taxes, labor law or state tax.)

To be eligible for the program, a taxpayer must have consistently treated workers as non-employees, must have filed all tax returns for the workers for three years, and must not be under audit.

Taxpayers participating in the program

can correct misclassification problems on a prospective basis while paying only a portion of the past tax liability.

Specifically, participating taxpayers must pay 10 percent of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year, determined under reduced rates. They will not be liable for any interest and penalties or subject to an employment tax audit with respect to the workers for prior years.

In exchange, participants must agree to treat the workers as employees from then on and to extend the period of limitations

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on assessment of employment taxes to six years for the three years after the date of entry into the program.

The new program provides an opportunity for business to proactively correct misclassification problems prior to the audit process. The terms are generally more favorable than those previously provided under the existing program for settlement of misclassification issues during audits.

Now that the program has been established, businesses should review the classification of their employees and make sure it is in order. If a misclassification is discovered, employers may wish to consider the benefits of the clean slate that participating in the new program provides.

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