

# Tax memo

U.S. corporate tax updates



## US federal payroll tax requirements: Action must be taken by June 30, 2013

*Outlines a US program that gives employers a way to reduce US federal payroll tax penalties, if they act before June 30, 2013.*

*May 3, 2013*

Canadian and US companies may not realize that they have failed to comply properly with US federal payroll tax requirements and could face penalties. Fortunately, new rules temporarily expand eligibility to the Voluntary Worker Reclassification Program (VCSP), making it possible to significantly reduce penalties, but employers must act before June 30, 2013.

This *Tax memo* discusses how the rules apply.

### **Canadian companies with workers in the US**

Canadian companies that send employees or self-employed contractors to the United States to perform services may mistakenly believe that they have no US tax liability or tax filing requirements, as long as their employees do not spend 183 days or more in the US each year.

Generally, US employment tax withholding rules are based on where the services are rendered, not on the payor's residence or place of incorporation. Therefore, a Canadian corporation with employees or contractors working in the US may be required to deduct and remit:

- US federal withholding taxes to the Internal Revenue Service (IRS); and
- state taxes to the relevant state tax authority (depending on employees' or contractors' states of residence or work).

Individuals rendering services in the US may be subject to US federal, state and city income taxation and filing requirements. Even when withholding may be avoided based on the Canada-US income tax treaty, certain forms are required to document the exception, and reporting continues to be required.

If employees establish residence in the United States while employed by the Canadian corporation, the Canadian corporation:

- must deduct and remit income tax (no treaty-based exception exists);
- may have to deduct and remit social security taxes, Medicare tax and all other amounts normally deducted from US resident employees, and remit them periodically to the IRS; and
- may be subject to state and city payroll tax requirements.

## ***IRS relief: the VCSP***

As an employer, you can take several approaches to rectify a failure to comply with US federal payroll withholding requirements. Employers generally must file delinquent employment tax returns and pay tax and interest deficiencies. Penalties are often applied. On occasion, employers may seek resolution directly with the IRS through an informal voluntary disclosure.

A more formal approach currently available through the IRS – the Voluntary Worker Reclassification Program (VCSP) – can be very beneficial. The VCSP, initiated by the IRS in October 2011, addresses some of the US tax issues noted above.

The VCSP was designed to increase US employment tax compliance and provide certainty for taxpayers that wish to reclassify workers engaged as independent contractors to the status of employee. Participation in the VCSP allows a business to prospectively reclassify workers as employees by completing an application and paying a considerably reduced portion of the previous year's tax liability.

One threshold requirement for participation in the VCSP program was that businesses filed the required information returns (Forms 1099 MISC) to report income paid to the independent contractors who are the subject of the settlement program. Canadian businesses that were unaware of the Form 1099 requirements were ineligible to participate in the VCSP. Under a recent expansion of the program, the IRS extended eligibility for VCSP until June 30, 2013, for certain taxpayers that did not previously file Forms 1099.

## ***Background***

Whether a worker should be classified for US tax purposes as an independent contractor or an employee can be a difficult question. The applicable common law standard requires an examination of the facts and circumstances surrounding the relationship between the service recipient and service provider to assess whether the service recipient has the right to direct and control the performance of services.

In recent years, worker misclassification has garnered increased attention from the IRS, the US Department of Labor (DOL), and several state agencies. The IRS has also teamed with the DOL to address worker misclassification. To encourage compliance, the IRS introduced VCSP in 2011 for businesses that intend to reclassify independent contractors as employees under Announcement 2011-64.

## ***Relaxed eligibility requirements: Announcement 2012-45***

### ***VCSP modifications***

In Announcement 2012-45, the IRS described several modifications as of December 17, 2012, that should significantly reduce potential burdens associated with the eligibility requirements for VCSP. In particular:

- taxpayers under IRS audit may participate in VCSP as long as the examination is not an employment tax audit;
- taxpayers that are members of an affiliated group under section 1504(a) may participate in VCSP if members of the affiliated group are not under an employment tax audit; and
- an extension of the period of limitations on the assessment of employment taxes as a part of the VCSP closing agreement is no longer required.

### ***PwC observations***

Eliminating the requirement for extension on the period of limitations is significant. Under the original program guidelines, taxpayers were required to consent to an additional three-year statute extension for the three calendar years beginning after the date of the agreed-upon reclassification. As a result, all employment tax issues were open to IRS scrutiny for twice the usual statute period. Businesses participating under the revised program guidelines will not be required to extend the statute as a result of program participation.

## **Continued VCSP eligibility requirements**

Under one requirement of the original program that remains in effect, businesses under a current audit by the Department of Labor or by a state agency concerning the classification of a class or classes of workers are ineligible for VCSP. In addition, the taxpayer must have consistently treated the relevant workers in the past as non-employees. Another requirement of the original program was that the taxpayers must have filed Form 1099 in the previous three years, reflecting the compensation paid to the non-employees. This requirement was not eliminated but was addressed separately in *Announcement 2012-46* under a temporary program.

To participate in VCSP, an eligible taxpayer must submit a Form 8952, *Application for Voluntary Classification Settlement Program*. The application form should be filed at least 60 days before the date that the affected workers will be treated as employees. Once the IRS reviews and approves the application, the IRS will contact the taxpayer to enter into a VCSP closing agreement. Unlike the temporary program detailed in *Announcement 2012-46*, there is no deadline for applying for VCSP.

## **VCSP temporary eligibility expansion: Announcement 2012-46**

The IRS also expanded the scope of VCSP to taxpayers that had not filed required Forms 1099. The new program described in *Announcement 2012-46* is called the VCSP Temporary Eligibility Expansion. The temporary initiative allows taxpayers that did not file Forms 1099 in the previous three years but otherwise met the VCSP eligibility requirements to nevertheless participate in VCSP until June 30, 2013.

To be eligible, before executing the VCSP closing agreement the business must furnish and file all required Forms 1099 for the previous three years with respect to the workers being reclassified.

If a taxpayer is accepted under the VCSP Temporary Eligibility Expansion, the IRS will make an employment tax assessment at a slightly higher rate than for those taxpayers that furnished and filed Forms 1099 on time.

The amount due under the VCSP temporary eligibility expansion includes:

- 25% of the employment tax liability for the prior year under the reduced rates of section 3509(b); and
- a reduced penalty for failure to furnish and file Forms 1099 based on the number of forms that were not filed in the previous three years. Part IV of the application Form 8952 was modified to include a calculation worksheet to determine the applicable penalty amount.

In spite of the applicable rates under the VCSP temporary eligibility expansion being slightly higher than the traditional program, the liability will be lower than if the IRS determined under exam that the workers were misclassified.

## **Benefits of VCSP and VCSP temporary eligibility expansion**

The cost of entering into the original VCSP was minimal but had to be weighed against the eligibility requirements and necessary extension of the period of limitations. The IRS now has removed key concerns addressed by taxpayers, which will make the program more appealing in many instances.

In assessing whether to participate in VCSP, taxpayers should also consider the following:

- The IRS eliminated several requirements for VCSP participation but did not change the key benefit of the program. Taxpayers that have met all of the modified requirements, including filing Forms 1099, will be liable for just over 1% of wages paid to reclassify workers in the last tax year, because section 3509(a) already applies reduced federal income tax and FICA tax rates. This assessment is made without penalties and interest.

- Until June 30, 2013, taxpayers that did not file all required Forms 1099 for affected workers are eligible for VCSP under a limited expansion of the program.
- The Internal Revenue Code provides a safe harbour for employers that historically treated a class or classes of worker as independent contractors. This safe harbour rule in Section 530 has three substantive requirements:
  - reporting consistency;
  - substantive consistency; and
  - a reasonable basis for treating the individuals as independent contractors.

In some instances, taxpayers may want to continue to treat workers as independent contractors if the requirements of Section 530 are met, rather than participate in this program. This determination should be made based on the facts and circumstances of each taxpayer.

- An affected individual may independently seek a determination of his or her classification status as an employee or independent contractor irrespective of the VCSP closing agreement between the IRS and business (taxpayer).

## We can help

For more on the implications of changes related to the VCSP, please contact your PwC advisor or any of the individuals listed on this page.

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