

# PCS Tax Insight

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## IRS announces voluntary worker reclassification program

*The IRS recently introduced the Voluntary Classification Settlement Program (VCSP), a new program for businesses wishing to reclassify workers from independent contractor to employee status. Participating businesses will be required to complete an application, pay a small portion of the prior year's tax liability, and agree to treat the affected worker or class of workers as employees on a prospective basis.*

The IRS recently introduced the Voluntary Classification Settlement Program (VCSP), a new program for businesses wishing to reclassify workers from contractor to employee status (Ann. 2011-64). Participating businesses will be required to complete an application, pay a small portion of the prior year's tax liability, and agree to treat the affected worker or class of workers as employees prospectively. According to the IRS, the program is intended to increase compliance and provide certainty for businesses. The IRS also has published a series of Frequently Asked Questions related to VCSP on the IRS web site, located [here](#).

It is clear that this issue has assumed a higher profile based on the increased focus and attention from the Obama Administration, the IRS, the Department of Labor (DOL), and several state agencies. VCSP seems to be the IRS's effort to resolve this issue without the burden of the recently

publicized enhanced enforcement efforts.

### Background

A DOL report issued in 2000 concluded that up to 30 percent of businesses misclassify workers. A 2009 report from the Government Accountability Office found that misclassification of workers cost the federal government \$2.72 billion in 2006.

The IRS announcement of the VCSP follows recent reports that the IRS has joined with the DOL and seven state agencies in a broad review of the hiring and pay practices of businesses that the government believes may routinely misclassify workers as independent contractors instead of as employees. Such businesses include home builders, restaurants, and other companies that lack sufficient resources to make a proper analysis and determination.



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## Eligibility

The VCSP is available to most businesses. Eligibility for VCSP is similar to that for the Classification Settlement Program (CSP) introduced by the IRS in March 1996, except that CSP is available only to businesses that are undergoing an IRS examination of the worker classification issue. CSP has provided a successful option for businesses and examiners to resolve a misclassification issue early in the administrative process, avoiding a protracted dispute.

As with CSP, the VCSP eligibility requirements are fashioned generally after the requirements described in the relief provisions of section 530 of the Revenue Act of 1978 (section 530). To be eligible, an applicant must:

- Consistently have treated the workers in the past as nonemployees
- Have filed all required Forms 1099 for the workers for the previous three years,
- Not currently be under audit by the IRS, and
- Not currently be under audit by the DOL or a state agency concerning the classification of these workers.

## Applying to the Program

To participate in VCSP, an eligible taxpayer must complete and submit an application, using Form 8952, *Application for Voluntary Classification Settlement Program*. The application should be filed at least 60 days before the date the taxpayer wants to begin treating its workers as employees. Once an application is submitted, the IRS will review it and verify the eligibility of the business.

Once the application is approved, the IRS will contact the business (or the

authorized representative if an executed Power of Attorney is included with the application) to enter into a VCSP closing agreement with the IRS.

## Program Commitments

Under the VCSP closing agreement, the business agrees to treat the class or classes of workers as employees for future tax periods for employment tax purposes. Once a business chooses to reclassify certain of its workers as employees, all workers in the same class must be treated as employees for employment tax purposes.

The business will pay 10 percent of the employment tax liability -- calculated at the reduced rates of section 3509 -- that would have been due if the workers had been treated as employees for the most recent tax year. The business must make full payment of amounts due under VCSP when it returns the signed VCSP closing agreement to the IRS. The assessment will be made without interest or penalties. Businesses entering into VCSP will not be subject to employment tax audits with respect to the classification of the workers for prior years.

**Note:** A taxpayer must agree to extend the period of limitations on assessment of employment taxes for three years for the first, second, and third calendar years beginning after the date the taxpayer has agreed under the VCSP closing agreement to begin treating the class or classes of workers as employees.

## Actionable Insights

### **Benefits of VCSP**

- From a federal employment tax standpoint, VCSP offers businesses a simple means to resolve the

- classification matter with finality and without an IRS examination.
- The cost of entering into VCSP is relatively insignificant -- just over one percent of the wages paid to the reclassified workers for the past year. The section 3509 rate, the starting point for the VCSP calculation, is already reduced from the full FICA and federal income tax withholding rates applicable in cases of wage underreporting. VCSP provides for an assessment at only 10 percent of the calculation under section 3509.
  - If the assessment due under VCSP is paid at the time of the agreement, it is made without interest and penalties.

The VCSP agreement provides relief from examination of this issue for the applicable classes of workers for the current and prior years. We expect the VCSP agreement -- which has not yet been released -- to be similar to the CSP agreement. Under CSP, an assessment is made for the current year, but there is no reclassification of the contractor to employee status until the business makes the voluntary change as committed to under the agreement. In that case, participation in the program does not affect the worker's prior-year income tax returns.

### ***Evaluating VCSP***

The cost of entering into an agreement under VCSP is minimal and will make the program appealing in many cases. When determining whether to participate in VCSP, taxpayers should consider these additional issues:

- Under VCSP, taxpayers will be subject to a special six-year statute of limitations for their first three years under the program, rather than the three-year period that

generally applies to payroll taxes. This allows the IRS an additional three years to examine not only the applicable classification issues but also any wage or employment tax issue on the tax returns for those years. Taxpayers therefore may wish to weigh whether the savings from paying the "discounted" cost of resolving the misclassification issue is worth the risk of a full-scale IRS employment tax examination for the next six years.

- While VCSP resolves the classification issue for federal employment tax purposes, it is unclear whether the states and DOL will offer similar "prospective reclassification only" opportunities and what information the IRS has committed to share with these agencies.
- In some cases, a business that is incorrectly treating workers as independent contractors may continue such treatment with limited risk. Section 530 provides businesses with both retroactive and prospective relief from federal employment tax obligations if certain requirements are met, even if workers were incorrectly classified as independent contractors. It terminates the business's employment tax liability for FICA, FUTA, and federal income tax withholding, as well as any related interest or penalties. A taxpayer wishing to reclassify workers previously protected as contractors under section 530 may do so without paying an assessment and entering into a VCSP agreement. However, the relief provided under section 530 is not applicable once the worker is treated as an employee.

## How PwC can help

Businesses should evaluate their potential exposure related to worker classification. Taxpayers that became aware of potentially misclassified workers may wish to seek an agreement under VCSP.

PwC can assist taxpayers in evaluating their potential exposure related to

misclassifying workers and can advise as to whether, based on their facts and circumstances, VCSP presents a good opportunity. Where participation in VCSP is deemed appropriate, PwC can assist in navigating the application process, ultimately yielding increased compliance and certainty for taxpayers.

*For more information, please do not hesitate to contact:*

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