

# WNTS Insight



## Administration proposes significant changes to worker misclassification relief provisions

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President Obama's fiscal year 2012 budget reintroduces a proposal designed to end the broad relief provided under current law to employers that fail to properly treat their workers as employees. When Congress passed Section 530 of the Revenue Act of 1978, the concern was that small businesses -- acting in good faith -- failed to properly classify workers as employees could be forced out of business by an IRS examination resulting in an employment tax assessment and assertion of penalties. Since 1978, numerous companies, large and small, have relied on the protections of Section 530.

The Administration now indicates that it is seeking to reduce uncertainty regarding classification, eliminate the potential competitive advantage for some businesses if qualifying for Section 530 protection, reduce noncompliance, and maintain the benefits and worker protections associated with employee status. The Administration's 2012 budget would provide broader authority for the IRS and the Department of Labor to administer programs that pursue appropriate reclassification of workers from independent contractor to employee status.

### **Background**

Under current law, if the requirements of Section 530 are met, the IRS cannot assess employment taxes based on the employer's improper treatment of workers as independent contractors. The employer can continue in the future to treat the workers as independent contractors provided the employer continues to meet the requirements of Section 530. Accordingly, Section 530 provides broad retroactive and prospective relief for businesses that meet the requirements.

To establish entitlement to Section 530 relief, a business must demonstrate that it (and its predecessor) treated all similarly situated workers as independent contractors, that it reported all payments to these individuals on Forms 1099, if required, and that it had a "reasonable basis" for treating the workers as independent contractors.

### **Administration proposal**

The budget proposal released by the Obama Administration would make

significant changes to the existing structure. Prospective relief currently afforded to businesses that are relying on Section 530 would end in the year beginning one full calendar year following enactment. Accordingly, if the proposal were to become law in 2011, as of January 2013 a business no longer could rely on Section 530. A two-year transition period is provided for workers with existing written contracts indicating independent contractor status.

Upon enactment, the IRS could reclassify workers and require a business that fails to meet the Section 530 requirements to treat the workers as employees subject to federal income tax withholding, FICA, and FUTA. Under current law, businesses that misclassify workers and are not entitled to Section 530 relief generally may use a special reduced tax rate to remedy the reclassification either during an IRS examination or as part of a voluntary reclassification. Under the proposed changes, these special reduced tax rates would still apply, but only to employers that voluntarily reclassify workers, with a waiver of even the reduced rates for small businesses that voluntarily reclassify workers. **Note:** The proposal refers to reduced penalties, but the only statutorily reduced rates are those in section 3509, which are taxes, not penalties. The reference to reduced penalties may be a misstatement in the explanation of the proposal.

Further, the proposed changes also would allow the IRS to issue administrative guidance regarding the proper classification of workers under the so-called common law test and to establish safe-harbor provisions for particular jobs or industries. It is not clear from the proposed changes whether any administrative guidance issued by the IRS would be effective prior to the date that the substantive provisions of the proposal become effective. The proposal provides that priority for the development of guidance would be given to industries and jobs in which application of the common law test has been particularly problematic, such as industries in which there has been a history of worker misclassification or failures to report compensation paid.

Businesses also would be required to give notice to independent contractors when they first begin performing services that explains how

they will be classified and the tax consequences, as well as worker compensation and wage and hour implications of independent contractor status.

Finally, independent contractors receiving payments totalling \$600 or more in a calendar year from a business would be permitted to require the business to withhold for Federal tax purposes a flat-rate percentage of their gross payments, with the flat-rate percentage being selected by the contractor.

### **Observations**

The Administration in the FY12 budget has again proposed to eliminate the protection benefiting some employers under Section 530. The proposed changes are intended to encourage businesses now taking advantage of Section 530 relief and businesses that have a questionable basis for treating workers as independent contractors to reclassify their workers voluntarily. The proposal is estimated to raise \$8.7 billion over 10 years.

It is not known whether this proposal will be acted on by Congress. If the proposal were to become law, it would bring significant change to employers that are currently relying on Section 530 and specific industries that rely heavily on contractors.

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