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Legal Alert: IRS Voluntary Classification Settlement Program

Overview

The IRS recently [amended](#) the eligibility requirements for its Voluntary Classification Settlement Program (“VCSP”) by (i) permitting an organization that is under IRS audit, other than an employment tax audit, to participate and (ii) eliminating the requirement that an organization agree to extend the limitations period on assessment of employment taxes. The IRS has further clarified that an organization will not be eligible to participate in the VCSP if it is (a) part of an affiliated group and any member of that affiliated group is under employment tax audit or (b) contesting in court the classification of workers from a previous audit by the IRS or the U.S. Department of Labor. The IRS has also [announced](#) a Temporary Eligibility Expansion through June 30, 2013 for the VCSP for organizations that have not filed all required Forms 1099 for the previous three years with respect to the workers to be reclassified but meet all other VCSP eligibility requirements.

Under the VCSP, organizations that have misclassified all or certain classes of their workers as independent contractors rather than employees have the opportunity to enter into a settlement with the IRS, in which the organization pays 10% of employment taxes owed for the most recent tax year, without penalties or interest, and correctly classifies workers going forward. Under the settlement, organizations will not be subject to an employment tax audit with respect to the worker classification for prior years. This program encompasses federal income tax withholdings and taxes owed under the Federal Insurance Contributions Act and Federal Unemployment Tax Act.

Under VCSP’s Temporary Eligibility Expansion, organizations that have misclassified all or certain classes of their workers as independent contractors rather than employees and have failed to file the Forms 1099 for the past three years for such employees, have the opportunity to enter into a settlement with the IRS, in which the organization pays 25% of employment taxes owed for the most recent tax year, without penalties or interest; pays a reduced penalty for the unfiled Forms 1099; and correctly classifies workers going forward. Under the settlement, organizations will not be subject to an employment tax audit with respect to the worker classification for prior years.

This Legal Alert provides an overview of the distinction between employees and independent contractors; the consequences of misclassification; VCSP and VCSP Temporary Eligibility Expansion requirements; the application process; the potential effects of reclassification; and voluntary disclosure options under New York State law. Further information about the VCSP and the VCSP Temporary Eligibility Expansion is available on the [IRS website](#).

Employees v. Independent Contractors

The IRS will consider a number of factors to determine whether a worker is an employee or an independent contractor. The key difference is that the organization retains the right to supervise and control an employee’s work, while an independent contractor is in business for him/herself.

The determination does not depend on the number of hours the worker works, and a contract designating the worker as an independent contractor is not conclusive. For further discussion of whether a worker is an independent contractor or an employee, see the end of this Legal Alert.

Consequences of Misclassifying Workers

If an organization misclassifies an employee as an independent contractor, the organization can be held civilly and criminally liable under federal and state law. This includes owing back taxes, plus interest; penalties for failure to maintain disability, workers' compensation, and unemployment insurance; and penalties for failure to adhere to wage and hour laws. Additionally, if an agency opens an investigation regarding the misclassification of one worker, it often also investigates the organization's overall classification practices.

If the organization failed to withhold or remit to the IRS all or portions of the employee's tax liabilities, then the IRS may impose a 100% penalty on the responsible persons, such as the executive director. The responsible persons will be individually liable for this penalty.

VCSP Eligibility

VCSP is available to any organization, including exempt organizations, that want to voluntarily reclassify certain workers as employees for federal employment taxes for future tax periods if the organization meets the following criteria:

1. The organization is presently treating workers as non-employees (*i.e.*, independent contractors).
2. The organization has consistently treated the workers as non-employees.
3. Over the previous three years, the organization filed Forms 1099 for each of the workers it wishes to reclassify. If the organization has been in existence for less than three years, then this requirement is satisfied if it has filed for each of the years it has been in existence. *Organizations that have failed to file the required Forms 1099, but meet all other VCSP requirements, may be eligible to participate under VCSP's Temporary Eligibility Expansion through June 30, 2013.*
4. The organization (or any member of its affiliated group) is not currently under *employment tax audit* by the IRS
5. The organization is not currently under audit concerning the classification of the workers by the U.S. Department of Labor or by a state government agency.
6. If the IRS or the U.S. Department of Labor previously audited the organization concerning the classification of the workers, the organization has complied with the results of that audit.
7. The organization is not contesting in court the classification of workers from a previous audit by the IRS or the U.S. Department of Labor.

VCSP Application Process and Closing Agreement

VCSP Application: Form 8952

An organization applies for the VCSP by submitting [Form 8952](#) to the IRS at least 60 days before it wants to begin treating workers as employees. Click [here](#) for the instructions to the form.

Form 8952 requires the organization to describe the class or classes of workers to be reclassified. Workers are in the same class if they perform the same or similar services or tasks, regardless of which program or division they are in. Joseph Perera, Associate Chief Counsel at the Office of the Tax Exempt and Government Entities Division Counsel, provided the following example: all workers who do dry-walling would be in the same class, even if some are in the large building division, others are in the small building division, and the rest are in the household division.

Part IV of the application provides a formula for calculating the amount the organization will be required to pay as part of the settlement (“VCSP payment”). The organization should fill out the columns provided as per the instructions, resulting in a payment equal to 10% of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year, based upon reduced rates. Information on how to calculate the 25% employment tax liability under the VCSP’s Temporary Eligibility Expansion is included below. The VCSP payment will not be due until closing.

If the organization is a corporation or limited liability company, Form 8952 must be signed by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other authorized corporate officer. If the organization is a trust, the form must be signed by the fiduciary or an authorized representative. The person signing on behalf of the organization does so under penalties of perjury.

If the organization is receiving assistance from an attorney, accountant, or other authorized representative, it should include a Power of Attorney ([Form 2848](#)) along with its application.

The IRS retains discretion whether to accept a taxpayer’s application for the VCSP.

Closing Agreement

If the IRS accepts an organization’s application, the IRS and the organization will enter into a closing agreement, which will finalize the terms of the VCSP. The full and complete VCSP payment will be due upon closing.

VCSP Temporary Eligibility Expansion Application

Organizations interested in participating in the VCSP through its Temporary Eligibility Expansion must submit Form 8952 on or before June 30, 2013. Interested organizations should write “VCSP Temporary Eligibility Expansion” at the top of the Form 8952 and should file their applications with the following modifications:

- put a line through Part V, Line A3, to indicate that it has not filed all required Forms 1099 for the reclassified workers for the preceding three years and

- do not complete Part IV, Payment Calculation; instead, applicants should complete and attach to their Form 8952 the worksheet provided in IRS announcement [2012-46](#) to calculate their payment.

Once the IRS has reviewed an organization's eligibility under the Temporary Eligibility Expansion program, it will send applicants instructions on how to electronically file the required Forms 1099. The applicant must then provide the IRS with confirmation that it has electronically filed all Forms 1099 and furnished the forms to the workers being reclassified. Upon receiving confirmation, the IRS will contact the applicant to finalize the terms of the closing agreement, as described above.

Effects of Reclassification under the VCSP

Compliance with Future Federal Employment Regulations

As with any employee, the organization must withhold and remit to the IRS federal income tax and issue a Form W-2 to the workers it has reclassified as employees. It must also withhold and pay social security and Medicare taxes for these employees.

Investigation by Other Agencies

Because the IRS is bound by certain confidentiality requirements under Internal Revenue Code § 6103, it may not release the contents of a VCSP settlement agreement to the federal Department of Labor or to any state agency. However, if the organization begins to classify workers differently, this may cause these other agencies to begin their own investigation.

Entering into a VCSP settlement with the IRS will not insulate the organization from liability under federal labor laws or under state law.

Application of Employment Laws

Organizations with employees typically are subject to more federal, state, and local laws than organizations without employees. In addition to federal employment tax laws, federal laws include anti-discrimination laws such as the Americans with Disabilities Act and Title VII of the Civil Rights Act, the Fair Labor Standards Act, the Family Medical Leave Act, and the [Genetic Information Nondiscrimination Act](#). New York State laws include the Unemployment Insurance Law, the Workers Compensation Law, wage and hour laws, including the Minimum Wage Law and the [Wage Theft Prevention Act](#), and the [Human Rights Law](#).

Classifying a worker as an employee rather than an independent contractor may also impact the organization's employee benefits plans. It should consider whether it is subject to the federal Employee Retirement Income Security Act and whether reclassification alters what it must do to comply. The organization should also review the provisions in its employee handbook and in any of its benefits policies.

Voluntary Disclosure of Misclassification Under New York State Law

New York State Joint Enforcement Task Force on Employee Misclassification

The NYS DOL, New York State Office of the Attorney General, New York State Department of Taxation and Finance ("NYS Tax Department"), the New York State Workers' Compensation

Board, and the New York City Office of the Comptroller are part of a Joint Enforcement Task Force on Employee Misclassification. Through this Task Force, the agencies share information and enforcement efforts to ensure workers are appropriately classified. The Task Force is aware of the VCSP, but it currently has no official position on its impact on New York State law or enforcement actions. At this time, it is also unclear whether or how an organization that wants to voluntarily reclassify workers as employees for the purposes of state law can do so through this Task Force.

New York State Department of Taxation and Finance

The NYS Tax Department has its own [Voluntary Disclosure and Compliance program](#) (“VDC program”), which has been in effect since April 23, 2008. Under this program, an eligible organization voluntarily discloses that it has been misclassifying workers as independent contractors and pays back taxes, with interest. In exchange, the organization will not be penalized and will be immune from criminal prosecution related to the information it disclosed. Additionally, an organization that is also required to file New York City returns can request a unified agreement to encompass both City and State taxes.

An organization may be able to request a limited look-back period of three years for mistake, confusion, or ignorance of the law. If granted, then the organization only needs to disclose information about and pay back taxes and interest on those three years. But, the immunity from criminal prosecution will also only apply to those years.

As with the federal VCSP, the NYS Tax Department will not notify other agencies that an organization has applied for the VDC program. However, the Department will provide other state agencies and the IRS with actual returns and reports filed. Participation in the VDC program also will not provide the organization with immunity from being audited.

For additional information and to apply online, go to the [NYS Tax Department website](#).

New York State Department of Labor

If an organization requires assistance in determining the status of any of its workers, the NYS Department of Labor’s Liability and Determination Section can provide guidance. The NYS Department of Labor advises that failure to report earnings and pay tax due on the earnings of any person on the assumption that he or she is an independent contractor may result in additional assessments and interest if such person is later determined to be an employee. See <http://www.tax.ny.gov/pdf/publications/withholding/nys50.pdf> for additional information.

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Any organization that believes it may be incorrectly classifying its employees as independent contractors is strongly urged to contact an attorney to discuss whether it should apply for the VCSP and any similar state law programs. The organization will need to consider the possible consequences of voluntary disclosure and of failure to do so.

This alert is meant to provide general information only, not legal advice. Please contact Judith Moldover at (212) 219-1800 ext. 250 if you have any questions about this alert.

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corporations and staff of experienced attorneys collaborate to deliver expert corporate, tax, real estate, employment, intellectual property, and other legal services to community organizations. By connecting lawyers, nonprofits, and communities, we help nonprofits to develop affordable housing, stimulate economic development, promote community arts, and operate and advocate for vital programs for children and young people, the elderly, and other low-income New Yorkers.

EMPLOYEE OR INDEPENDENT CONTRACTOR?

GETTING THE FACTS AND BUSTING THE MYTHS

Why is this distinction important?

The distinction between employees and independent contractors is particularly critical at the moment because of the IRS Voluntary Classification Settlement Program and increased misclassification enforcement action on both the state and federal level. This issue typically arises for nonprofits when an individual who has performed services as an independent contractor files for unemployment insurance with the State Department of Labor (“DOL”). A finding that the individual should have been classified as an employee usually triggers an audit of all of the organization’s independent contractor relationships.

What are the major differences between employees and independent contractors?

Employees perform services at the direction and control of their employers in exchange for compensation, while independent contractors are engaged to complete a specific project with minimal input from the organization. Employers have many legal obligations to their employees that do not apply to independent contractors. Below are the major legal implications for a worker’s classification.

- *Employers are subject to withholding tax requirements for employees but not for independent contractors. Generally, organizations must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. Organizations do not generally have to withhold or pay any taxes on payments to an independent contractor, which are reported on IRS Form 1099.*
- *Employers are responsible for workers compensation and disability coverage for employees, but not for independent contractors. All independent contractors should carry a full line of insurance coverage, including workers compensation and disability insurance, for their own employees.*
- *Employees must adhere to wage and hour laws and anti-discrimination laws for employees; these laws do not cover independent contractors.*
- *Independent contractors are excluded from coverage under the Unemployment Insurance Law.*

What are the consequences of misclassification?

If a nonprofit organization misclassifies an employee as an independent contractor, the organization can be held liable for back taxes for that individual, plus interest and penalties for failure to maintain disability insurance, worker’s compensation, and unemployment insurance, and the failure to adhere to wage and hour laws. Additionally, if an issue with one individual is being investigated by the Department of Labor, often the Department investigates the organization’s overall classification practices.

How can I tell whether an individual is an employee or an independent contractor?

The Department of Labor examines behavioral, financial, and relationship evidence to determine whether an individual is properly classified as an employee or an independent contractor. An in-depth explanation of these different types of evidence is available on the IRS website.¹ While no single factor is conclusive in deciding if an employer-employee relationship exists, the decision rests the following analysis: 1) the extent to which the hiring party has the right to control the “manner and means” by which the worker completes his/her assigned task, and 2) the question of whether, as a matter of “economic reality” the individual is truly in business for him/herself. The following factors represent significant indicators of an employment relationship:

- Providing direct supervision over services performed
- Services performed are an integral part of the business
- Providing the individual with facilities, equipment, tools, or supplies
- Requiring that the individual work full-time or for a designated number of hours
- Requiring the individual to comply with instruction as to when, where, and how to do the job
- Providing training
- Restricting the individual from performing services for other organizations
- Requiring attendance at meetings
- Requiring permission for absence from work
- Setting the rate of pay for service performed
- Providing compensation in the form of a salary or an hourly rate of pay
- Providing reimbursement or any form of allowance for routine business or travel expenses
- Providing fringe benefits
- Providing the individual with enough business that the individual is economically dependent on your organization
- Giving the individual a title
- Requiring services to be rendered by specific personnel
- Furnishing business cards, or other means of identification of the individual as a representative of the employer
- Contracting individual may engage another person to actually perform the services

Some of the factors that the Department has found significant to establishing the existence of an independent contractor relationship include:

- The individual is in business for him/herself and offers services on the free market. An independent business is usually marked by such elements as advertising, commercial telephone listings, business cards, business stationery, carrying business insurance, and maintaining one’s own establishment
- The individual has a significant investment in facilities and equipment
- The individual assumes the risk of profit or loss in providing services
- The individual has the freedom to establish his/her own work schedule

¹ See IRS.gov, <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html> (last visited January 2, 2013).

- The individual is free to provide services to other organizations, competitive or noncompetitive
- The individual is providing highly specialized skills (e.g., computer programmer, photographer, graphic artist, etc.)

Myth Busters!

Many organizations make the mistake of believing that certain actions protect them against claims that individuals providing services are their employees. Below, Lawyers Alliance busts several common myths regarding the independent contractor/employee distinction.

- **Myth 1:** A contract designating the individual to be an independent contractor will prevent a finding that the individual is an employee.
 - **Busted:** While a well-drafted written agreement should document the independent contractor relationship, the mere designation by the employer of an independent contractor status, *even if the individual insisted on that status*, is not conclusive. Because courts and the DOL examine relationship evidence beyond the four edges of the contract, it is critical that the employer treat the individual like an independent contractor in all aspects of the working relationship.
- **Myth 2:** If the individual works part time, he/she is an independent contractor.
 - **Busted:** The simple fact that the individual does not work full-time for an organization does not protect the organization from a claim that the individual is an employee. Any control by the employer over the individual's work schedule or hours will serve as evidence of an employment relationship.
- **Myth 3:** Because other organizations treat people similarly situated to the individual as independent contractors, the individual is an independent contractor.
 - **Busted:** Industry practice is rarely determinative. Courts examine working relationships on a case by case basis.
- **Myth 4:** It does not matter whether the services the individual provides for the organization constitutes substantially all of his/her business.
 - **Busted:** If a worker must devote substantially all of his/her time to the business of the organization, the individual is more likely to be classified as an employee than as an independent contractor.
- **Myth 5:** An organization can use the individual's services as frequently as desired or establish an ongoing relationship with the individual without compromising his/her independent contractor status.
 - **Busted:** Because courts consider the permanency of the relationship between the organization and the individual, frequent or continual use of an individual's services will likely serve as evidence of an employment relationship.
- **Myth 6:** Requiring that an individual work on the organization premises will not compromise his/her independent contractor status.
 - **Busted:** Physical constraints on where the work must be performed will serve as evidence of an employment relationship, unless the nature of the contractor's services is such that they can only be performed on the organization's premises.

- **Myth 7:** Paying the individual on an hourly or weekly basis will not compromise his/her independent contractor status.
 - **Busted:** The worker should be paid a flat fee for his/her services.
- **Myth 8:** Helping the individual learn what is requested by the organization by watching another individual perform similar services will not qualify as “training.”
 - **Busted:** If you allow an individual to “learn” what is desired of him/her by allowing him/her to watch an other individual perform a similar act, this may qualify as training because it demonstrates the employer’s desire to have the work performed in a particular fashion.
- **Myth 9:** Requesting the services of a particular person from the business providing services doesn’t affect the analysis of whether the individual is an employee.
 - **Busted:** Any indication that a worker’s services must be rendered personally will be considered evidence of an employment relationship.
- **Myth 10:** The organization can hire someone to assist the individual without compromising the individual’s independent contractor status.
 - **Busted:** When an organization hires, supervises, and pays assistants to the individual in question, the organization is likely to be seen as exercising control in an employment relationship.
- **Myth 11:** Having the individual choose between “shifts” to work will not count as establishing hours of work and so will not serve as evidence of an employment relationship.
 - **Busted:** Setting any time constraints on when the individual can work will serve as evidence of an employment relationship.
- **Myth 12:** So long as the organization does not *actually* control the way the work is performed, the individual’s independent contractor status will not be compromised.
 - **Busted:** What matters is whether the organization *has the right* to control the way the work is performed. It is critical to ensure that the contract language does not convey this right.

Predetermined Categories

Certain types of workers are automatically covered employees under New York law. Some examples include agricultural workers, aliens lawfully in the U.S., and certain drivers and distributors of food products. For more information, see <http://www.labor.ny.gov/ui/dande/covered1.shtm>.

Questions?

The process of determining whether a worker is an employee or an independent contractor is complex, and the consequences of misclassification are expensive. Several of the considerations that come into play in a determination of whether an individual is an employee or an independent contractor are not included here.

This alert is meant to provide general information only, not legal advice. If you have questions about a particular individual’s proper classification or need assistance in structuring

relationships with independent contractors, please contact Senior Staff Attorney Judith Moldover at the Lawyers Alliance for New York at (212) 219-1800 x 250 or visit our website www.lawyersalliance.org for further information.