



Independent Contractor or Employee?

Part One

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TABLE OF CONTENTS

Overview	3
Employees Defined	5
Independent Contractors Defined	6
Advantages and Disadvantages	7
Liability of Employee Misclassification	10
Memorandum of Understanding	11
Statutory Employee / Other Important Worker Classification	12
Voluntary Classification Settlement Program (VCSP)	15
About the Author	25

Independent Contractor or Employee?

Overview

A business subjects itself to a tremendous amount of legal obligations when it hires an employee. It has the burden of complying with numerous, and sometimes contradictory laws, put in place by federal, state and local governments as well as other regulatory agencies. Here are just a few things that potential employers may find themselves subject to as they weigh this decision:

- Minimum wage requirements of both state and federal governments
- Overtime requirements of both state and federal governments including brand new rules passed in 2016
- Withholding, remitting, and proper reporting of Social Security and Medicare taxes
- Withholding, remitting, and reporting state income taxes
- Must comply with state and federal anti-discrimination laws
- Must accommodate certain disabilities
- Must allow time off to vote
- Must allow time off for jury duty
- Must provide workers compensation coverage and pay premiums
- Must report and pay federal unemployment taxes
- Must report and pay state unemployment taxes
- Must comply with various OSHA requirements
- May be required to allow time off to have a baby or care for sick parents
- May have special requirements from their liability insurance carrier
- May be required to provide a minimum level of health insurance or face a fine
- May have demands from employees for vacation time, sick time, or personal time off
- May have demands from employees for benefits such as vision, dental, life insurance, supplemental insurance, 401K or other retirements plans, health savings plans, reimbursements plans, or child care.

As you can see, this list continues on and on...

Having employees has a significant cost to the employer on top of the hourly or salaried rate of pay to the employee. This cost is more than just the dollars, since it also costs an employer time to do the continual reporting required of them. It also increases their risk associated with having employees. With all these concerns weighing on an employer, it is no wonder that a business owner may look for other options to pay for labor to get work done. It may be an option to outsource some of this work to other businesses at times. There are businesses that earn a decent income providing labor to other businesses to save them the hassle of dealing with having employees.

The business may also have the opportunity to hire independent contractors instead of employees and reduce the costs associated with getting the work done as well as provide flexibility sometimes to work within the necessary time requirements with the added benefit of not having to pay an employee for idle time.

This can work out well for the business as long as the independent contractors really are independent contractors and not employees. However, if the workers really are employees instead of independent contractors, the risks can be significantly higher for the business than it was for hiring employees. If the IRS audits the business and reclassifies the workers as employees instead of being treated as independent contractors, the back taxes and penalties that can be assessed can become so burdensome that it can easily put an organization out of business.

There is also a higher potential risk if an independent contractor is injured and files for workers compensation benefits since there could be an investigation launched and the workers could be then reclassified as employees. This could cause back workers compensation premiums to be charged to the business, as well as potentially increasing future premiums well into the foreseeable future. An independent contractor can also file for unemployment benefits and cause the state department of labor to open up an investigation as well.

In this section of the course, we will define what employees and independent contractors are as well as reasons to have one or the other. We will cover the factors that are most commonly used to compare employees and independent contractors to determine how to identify which one an individual worker is. We will cover the factors the IRS uses because they are most common and all encompassing. They provide reasonably accurate results and most of the time if the results lean strongly in one direction, the result will commonly be similar with other agencies too. However, keep in mind that there can be situations where different agencies can get different and conflicting results if a worker is an independent contractor or an employee.

Employees Defined

An employee is a person who works in the service of another person under an express or implied contract of hire, under which the employer has the right to control the details of work performance (Black's Law Dictionary). Even though this is the technical legal definition, let's see if we can define it a little more ...

An employee is an individual that contributes labor to the activities of an organization and who works in the service of someone else. Employees are usually hired to do specific duties and often have job descriptions. Payment to employees is often made as a specific amount per time worked, like an hourly wage for example, but they can also be paid salaries or be paid by a piece rate.

For federal employment tax purposes, an individual is an employee if they meet the requirements set out in three sections of the Employment Tax Regulations. These sections are 31.3121(d)-1(c); 31.3306(i)-1; and 31.3401(c)-1. These sections describe an employer-employee relationship exists when an organization or person for whom the work is performed has the right to control and direct the work; but it only requires that they have the right to exercise such control, not that it must be actually exercised. These sections also describe that when an employer-employee relationship exists, it makes no difference if it is defined as, or even if there are agreements to treat the relationship as an independent contractor relationship.

Independent Contractors Defined

A person who contracts to do work for another person according to his or her own processes and methods; the contractor is not subject to another's control except for what is specified in a mutually binding agreement for a specific job. Again, while this legal dictionary description is a good start, let's see if we can define it a little more ...

An independent contractor provides goods or services to another business on terms determined by a written or oral contract. Generally, payment to an independent contractor is made by the job with little regard for the time involved in accomplishing the work. Independent contractors may perform services that are not in the general course of business of the organization that hires them. For example, a doctor's office may hire an independent contractor to do landscaping, or repair the leaky faucet, but these individuals do not provide services in the medical industry.

The same employment tax regulations referred to above provide that those individuals who hold themselves out to the public as offering the same services to the public and follow an independent trade, business, or profession are generally not employees, but are independent contractors. Examples of independent trades that fall in this category are physicians, lawyers, dentists, contractors, and accountants.

The primary determination of worker classification is common law standard. Common law flows chiefly from court decisions handed down over time and suggests that the treatment of a worker as an independent contractor or employee is a function of the legal definitions developed in the law of agency – whether one party, *the principal*, is legally responsible for the acts or omissions of another party, *the agent*, and depends on the principal's right to direct and control the agent.

However, the government uses a variety of factors which will be discussed shortly to determine if the worker is subject to the will and control of the company, not only for what work will be done, but how it will be done.

Advantages & Disadvantages

From the standpoint of the business or organization, we will next take a look at the pros and cons of hiring independent contractors.

Advantages of hiring independent contractors:

- You could save money by not having to pay benefits and taxes
- You have the added advantage of not having a full time employee when not needing them
- Staffing flexibility – You can hire for specific needs, times, and skills
- Potential reduction in exposure to lawsuits by spreading the liability to others.
- Potential for flat fees that can help control your costs for projects.
- You may be able to get extended terms for payment.
- Independent contractors generally don't attempt to form unions.
- Generally you do not have discrimination issues with contractors.

Disadvantages of hiring independent contractors:

- You have less control over your workers.
- The actual individuals performing the work may vary.
- The right to fire will depend on your written agreement.
- You may not own copyrights or work created by the independent contractor.
- Increased risk of government audits from the IRS, labor boards, OSHA, or others.
- They may not understand your business needs as fully as an employee working in-house.
- They may lack loyalty to your organization.
- Higher risks regarding confidentiality and privacy issues.
- An injured independent contractor that is not covered under workers compensation may create investigations or potential liability in that area.

Now viewing this from the standpoint of the worker, we will take a look at the pros and cons of being an independent contractor vs an employee.

Advantages of being an independent contractor:

- Since they are not generally tied to an employer, they are free to set their own rules of business, limited only by their bargaining power and skills.
- Gives them the opportunity to be their own boss, and not answer to a supervisor.
- Gives them the opportunity to build and lead their own organization and have potentially unlimited earnings.
- They can duplicate their efforts by teaching others to do their work and get more accomplished.
- Allows the creator of a work, copyright, or patent ownership instead of the employer owning the created work.
- They don't have to be concerned with petty office politics and drama. At least not as much.
- They may be paid more than an employee would for similar work.
- They have the opportunity to take increased business deductions, possibly an office in home or vehicle deductions for example that they would likely be unable to take as an employee.
- They can set their own prices.
- They may have a flexible work schedule.
- May be able to work from home.
- May be able to work part time.
- They may be able to put more money in a tax deferred retirement account.

Disadvantages of being an independent contractor:

- They have no job security.
- The loss of one or two clients can have a significant effect on their livelihood unless they develop a reasonably large network of clients.
- They might not get paid.
- They must pay self-employment taxes.
- They may be personally liable for business debts.
- They have no employer provided benefits and must cover these costs themselves.
- They have no unemployment insurance benefits.
- They have no employer provided worker's compensation insurance
- They have very few labor law protections.
- They must maintain their own bookkeeping records.
- They must file a more complex income tax return, maybe even multiple returns.
- They must make estimated income tax payments quarterly.
- They may have to file sales tax returns.
- They must keep accurate mileage records.
- They may have to hire out employees and deal with the requirements of recordkeeping and petty employee problems.
- They will need additional bank account(s).
- They may have to deal with payroll reporting requirements, workers compensation, and unemployment tax reporting.
- They must market themselves as well as get the actual work done.
- They can make a bad decision and lose money.
- They may have increased liability and insurance costs.
- They may have more difficulty getting loans.
- They may have to deal with OSHA requirements.
- They may have to invest significant amounts of money in tools, equipment, facilities, or inventory.

Liability of Employee Misclassification

Each taxing agency has its own liability of misclassification. Generally the two primary agencies will be the IRS for federally mandated taxes and the state labor department.

Federal:

If the Internal Revenue Service finds that the misclassification is intentional, an employer will be required to pay the full portion (employer and employee share) of FICA taxes. The employer may not recover nor deduct any of the FICA tax from the employee.

In addition to FICA taxes, the IRS will collect Federal Unemployment taxes from that employer as well. Penalties and interest for late tax payments will also be charged.

State:

The liability to the employer for misclassification varies by state. For purposes of this training we will look at the state of Colorado. House Bill HB09-1310 added additional employer requirements as well as increasing penalties. The new notification requirement alerts employees and contractors of their right to file a complaint and the requirement of the Colorado Department of Labor and Employment to accept complaints and conduct investigations. Also changed was an increase to the penalties charged to employers. Employers are now required to pay all back taxes owed with interest plus penalties of \$5,000 for each misclassification for the first offense and up to \$25,000 for each misclassification for a second or subsequent offense.

Memorandum of Understanding

Additional warning to employers: the agencies are talking to each other! In 2011, the IRS and United States Department of Labor (USDOL) entered into a Memorandum of understanding (MOU). This MOU sets forth an agreement to share information, resources and enforcement between the agencies. Specific objectives defined by the MOU include:

- Expand the IRS-DOL partnership launched in the Questionable Employment Tax Practices program
- Reduce the employment tax portion of the tax gap
- Increase compliance with federal employment and unemployment tax requirements.
- Increase compliance with federal labor laws enforced by the DOL
- Reduce fraudulent filings
- Reduce abusive employment/unemployment tax schemes
- Reduce worker misclassification
- Reduce questionable employment tax practices
- Work together to create educational and outreach materials and guidance for employers and workers.

Additionally, as of update writing of this manual, 27 state agencies have signed an agreement to join the MOU with the Department of Labor's Wage and Hour Division, and in some cases have now expanded it to include agreements with its Employee Benefits Security Administration (EBSA), Occupational Safety and Health Administration (OSHA), Office of Federal Contract Compliance Programs (OFCCP), and the office of the Solicitor. The department of labor is still actively pursuing MOU's with additional states as well.

Using Colorado as our example still, the IRS, USDOL, and Colorado Department of Labor & Employment (CDLE) have all agreed to share information and resources to battle employee misclassification, and although the original MOU would have expired after three years, Colorado renewed it on December 5, 2014. Even though this agreement will once again expire December 5, of 2017, there is little doubt they will fail to renew it or that it will go away.

Statutory Employees

There are four categories of individuals referred to as statutory employees. They are:

1. Agent drivers or commission drivers
2. Full time life insurance salespersons
3. Home workers, and
4. Traveling or city salespersons.

These workers are considered employees for FICA tax and in some instances for FUTA tax, but not for income tax withholding. A statutory employee must also meet these three basic requirements:

1. The worker is expected to perform substantially all the work
2. The worker has no substantial investment in facilities other than transportation facilities used in performing the work
3. There is a continuing work relationship with the person or organization for whom the services are performed.

Other Important Worker Classifications

Domestic Workers

Domestic workers are generally treated as employees. Internal Revenue Code Section 3306 covers domestic workers. If the work is done in the home of the employer and particularly if the employer also provides room and board, the worker is most likely an employee. An exception to this would potentially be a domestic worker who is working in multiple homes and is a legitimate business operation.

Domestic workers income is generally reported on a form W-2 and the employers' 1040 Schedule H where the employer will report and pay the appropriate federal withholding, FICA taxes, and federal unemployment taxes. The employer will also be responsible to pay and report any necessary state unemployment to their state labor departments.

Corporate Officers, Owners, and Directors

Corporate officers are specifically included as employees by Internal Revenue Code Section 3121(d)(1). Federal regulations provide that generally an officer of a corporation is an employee of the corporation. IF the officer does not provide any services or minor services and the officer is not entitled to receive, directly or indirectly, any compensation, then the officer is not considered an employee. When the IRS examines a return and determines that an officer is an employee, they will examine all payments to such an officer to determine if any payments which were not accounted for as income on the W2 should be reclassified as W-2 wages subject to withholding and other taxes. The types of payments looked at will include “draws”, loans, dividends, or any other type of distribution or payment to the officer.

Subchapter S corporations must pay a reasonable salary to the active owners/shareholders. An IRS examiner will look extremely close at the situation where Subchapter S owners/shareholders are paid a salary for personal services as well as have distributions made to them. If the largest part of the revenue of the S corporation is from personal services of the owner/shareholder, the W-2 income should be the vast majority of the payments to that owner/shareholder during that year.

A Director of a corporation is not considered an employee. It is feasible for a director who is also an employee to receive a W-2 form for compensation received as an employee and a 1099 form for compensation as a Director.

Some examples of occupations where independent contract arrangements are common:

- Accountant
- Author
- Barber or Hair Stylist
- Boxer
- Courier
- Court Reporter
- Dry Cleaner
- Engineering Consultant
- Entertainer
- Gardner
- General Contractor
- General Practitioner
- Hair Stylist
- Interpreter or Translator
- Lawn Care Worker
- Lawyer
- Market Stall
- Mason
- Massage Therapist
- Doctor
- Nurse
- Newspaper Carrier
- Personal Trainer
- Pool Maintenance Person
- Private Investigator
- Private Military Company
- Radio Presenter
- Private Security
- Professional Wrestler
- Professional Athlete
- Real Estate Agent
- Sales Representative
- Short Term University Instructor
- Stock Broker
- Talent Agent
- Tattoo Artist
- Taxi or Limousine Driver
- Telephone Psychic
- Tradesman
- Truck Driver
- Tutor

Voluntary Classification Settlement Program (VCSP)

Information taken from Announcement 2012-45

The Internal Revenue Service has developed a program to permit taxpayers to voluntarily reclassify workers as employees for federal employment tax purposes. The Voluntary Classification Settlement Program (VCSP) allows eligible taxpayers to voluntarily reclassify their workers for federal employment tax purposes and obtain relief similar to that obtained in the current Classification Settlement Program (CSP). The VCSP is optional and provides taxpayers with an opportunity to voluntarily reclassify their workers as employees for future tax periods with limited federal employment tax liability for the past nonemployee treatment. To participate in the program the taxpayer must meet certain eligibility requirements, apply to participate in VCSP, and enter into a closing agreement with the IRS.

Eligibility

The VCSP is available to taxpayers who want to voluntarily change the prospective classification of their workers. The program applies to taxpayers who are currently treating their workers (or a class of workers) as independent contractors or other nonemployees and want to prospectively treat the workers and employees. To be eligible, a taxpayer must have consistently treated the workers as nonemployees, and must have filed all required forms 1099 for the workers for the previous three years. The taxpayer cannot currently be under audit by the IRS. Furthermore, the taxpayer cannot be currently under audit concerning the classification of workers by the Department of Labor or by a state government agency. A taxpayer who was previously audited by the IRS or Department of Labor concerning the classification of the workers will only be eligible if the taxpayer has complied with the results of that audit.

Effect of VCSP

A taxpayer who participates in the VCSP will agree to prospectively treat the class of workers as employees for future tax periods. In exchange, the taxpayer will:

- Pay 10 percent of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of section 3509 of the Internal Revenue Code;
- Will not be liable for any interest and penalties on the liability; and
- Will not be subject to an employment tax audit with respect to the worker classification of the workers for prior years.
- Additionally, a taxpayer participating in the VCSP will agree to extend the period of limitations on the assessment of employment taxes for three years for the first, second, and third calendar years beginning after the date on which the taxpayer has agreed under the VCSP closing agreement to begin treating the workers as employees.

Application Process

Eligible taxpayers who wish to participate in the VCSP must submit an application for participation in the program. Information about the VCSP and the application is available on www.irs.gov. Along with the application, the name of a contact or an authorized representative with a valid Power of Attorney (Form 2848) should be provided. The IRS will contact the taxpayer or authorized representative to complete the process once it has reviewed the application and verified the taxpayer's eligibility. The IRS retains discretion whether to accept a taxpayer's application for the VCSP. Taxpayers whose application has been accepted will enter into a closing agreement with the IRS to finalize the terms of the VCSP and will simultaneously make full and complete payment of any amount due under the closing agreement.

In January 2013 the VCSP was expanded via Announcement 2012-45 to:

- Permit a taxpayer under audit to be eligible but not if the audit is employment tax related.
- Not allow a taxpayer who is part of an affiliated group where another member of the group is undergoing an employment tax audit.
- Eliminate the requirement that the taxpayer agree to extend the statute of limitations.
- Clarify that a taxpayer is not eligible to participate if it is contesting in court the classification of workers from a previous audit by the IRS or Department of Labor.

Further, in January 2013 the IRS issued Announcement 2012-46 which temporarily made the VCSP available to more taxpayers than originally. These temporary regulations which were only effective until June 30, 2013, waived the requirement that the employer filed forms 1099. Even though this temporary Announcement is no longer in effect, it does show they are constantly reviewing and revising the requirements for this program to allow employers to take advantage of this program.



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Announcement 2012-45

Voluntary Classification Settlement Program

Table of Contents

-
- [I. PURPOSE](#)
- [II. BACKGROUND](#)
- [III. ELIGIBILITY](#)
- [IV. EFFECT OF THE VCSP](#)
- [V. APPLICATION PROCESS](#)
- [VI. DRAFTING INFORMATION](#)

This document provides notice and information regarding the revised Voluntary Classification Settlement Program (VCSP) that provides partial relief from federal employment taxes for eligible taxpayers that agree to prospectively treat workers as employees.

I. PURPOSE

This announcement modifies and supersedes Announcement 2011-64, 2011-41 I.R.B. 503.

In light of feedback received from taxpayers and taxpayer representatives, the Internal Revenue Service (IRS) has modified the VCSP, described in Announcement 2011-64. The VCSP has been modified to: (1) permit a taxpayer under IRS audit, other than an employment tax audit, to be eligible to participate in the VCSP; (2) clarify the current eligibility requirement that a taxpayer that is a member of an affiliated group within the meaning of section 1504(a) is not eligible to participate in the VCSP if any member of the affiliated group is under employment tax audit; (3) clarify that a taxpayer is not eligible to participate in the VCSP if the taxpayer is contesting in court the classification of the class or classes of workers from a previous audit by the IRS or the Department of Labor; and (4) eliminate the requirement that a taxpayer agree to extend the period of limitations on assessment of employment taxes as part of the VCSP closing agreement with the IRS.

The VCSP permits eligible taxpayers to voluntarily reclassify workers as employees for federal employment tax purposes and obtain relief similar to that obtained through the current Classification Settlement Program (CSP). The VCSP is optional and provides taxpayers with an opportunity to voluntarily reclassify their workers as employees for future tax periods with limited federal employment tax liability for the past nonemployee treatment. To participate, the taxpayer must meet certain eligibility requirements, apply to participate in the VCSP, and enter into a closing agreement with the IRS.

II. BACKGROUND

Whether a worker is performing services as an employee or as an independent contractor depends upon the facts and circumstances and is generally determined under the common law test of whether the service recipient has the right to direct and control the worker as to how to perform the services. In some factual situations, the determination of the proper worker classification status under the common law may not be clear. For taxpayers under IRS examination, the current CSP is available to resolve federal employment tax issues related to worker misclassification if certain criteria are met. The CSP permits the prospective reclassification of workers as employees, with reduced federal employment tax liabilities for past nonemployee treatment. The CSP allows businesses and tax examiners to resolve the worker classification issues as early in the administrative process as possible, thereby reducing taxpayer burden and providing efficiencies for both the taxpayer and the government.

In order to facilitate voluntary resolution of worker classification issues and achieve the benefits of increased tax compliance and certainty for taxpayers, workers and the government, the IRS determined that it would be beneficial to provide taxpayers with a program that allows for voluntary reclassification of workers as employees outside of the examination context and without the need to go through normal administrative correction procedures applicable to employment taxes. Accordingly, the VCSP was established on September 21, 2011, through Announcement 2011-64.

The VCSP has been well-received and the IRS has received many applications to date. Taxpayers and taxpayer representatives have provided feedback regarding certain requirements that limit or discourage participation in the program. In particular, they requested that the IRS reconsider the requirement that a taxpayer not currently be under any IRS audit in order to be eligible and the requirement that a taxpayer agree to extend the period of limitations on assessment as part of the VCSP closing agreement with the IRS. The IRS is modifying these VCSP requirements for future applications.

III. ELIGIBILITY

The VCSP is available for taxpayers who want to voluntarily change the prospective classification of their workers. The program applies to taxpayers who are currently treating their workers (or a class of workers) as independent contractors or other nonemployees and want to prospectively treat the workers as employees. To be eligible, a taxpayer must have consistently treated the workers as nonemployees, and must have filed all required Forms 1099, consistent with the nonemployee treatment, for the previous three years with respect to the workers to be reclassified. The taxpayer cannot currently be under employment tax audit by the IRS. A taxpayer that is a member of an affiliated group within the meaning of section 1504(a) is considered to be under employment tax audit for purposes of the VCSP if any member of the affiliated group is under employment tax audit. Furthermore, the taxpayer cannot be currently under audit concerning the classification of the class or classes of workers by the Department of Labor or by a state government agency.

A taxpayer who was previously audited by the IRS or the Department of Labor concerning the classification of the class or classes of workers is eligible for the VCSP if the taxpayer has complied with the results of that audit and is not currently contesting the classification in court.

IV. EFFECT OF THE VCSP

A taxpayer who participates in the VCSP agrees to prospectively treat the class or classes of workers identified in the application as employees for future tax periods. In exchange, the taxpayer pays 10 percent of the employment tax liability that would have been due on compensation paid to the workers being reclassified for the most recent tax year if those workers were classified as employees for such year, determined under the reduced rates of section 3509(a); is not liable for any interest and penalties on the liability; and is not subject to an employment tax audit with respect to the worker classification of the class or classes of workers for prior years.

V. APPLICATION PROCESS

Eligible taxpayers who wish to participate in the VCSP must submit an application for participation in the program using Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*. Information about the VCSP and the application is available on www.irs.gov. Along with the application, the taxpayer may provide the name of a contact or an authorized representative with a valid Power of Attorney (Form 2848). The IRS retains discretion whether to accept a taxpayer's application for the VCSP. The IRS will contact the taxpayer or authorized representative to complete the process once it has reviewed the application and verified the taxpayer's eligibility. Taxpayers whose application has been accepted enter into a closing agreement with the IRS to finalize the terms of the VCSP and must simultaneously make full and complete payment of any amount due under the closing agreement.

IRS Expands Voluntary Worker Classification Settlement Program; Relief From Past Payroll Taxes Available to More Employers Who Reclassify Their Workers As Employees



IR-2013-23, Feb. 27, 2013

WASHINGTON — The Internal Revenue Service has expanded its Voluntary Classification Settlement Program (VCSP), paving the way for more taxpayers to take advantage of this low-cost option for achieving certainty under the law by reclassifying their workers as employees for future tax periods.

The IRS is modifying several eligibility requirements, thus making it possible for many more interested employers, especially larger ones, to apply for this program. Thus far, nearly 1,000 employers have applied for the VCSP, which provides partial relief from federal payroll taxes for eligible employers who are treating their workers or a class or group of workers as independent contractors or other nonemployees and now want to treat them as employees. Businesses, tax-exempt organizations and government entities may qualify.

Under the revamped program, employers under IRS audit, other than an employment tax audit, can qualify for the VCSP. Furthermore, employers accepted into the program will no longer be subject to a special six-year statute of limitations, rather than the usual three years that normally applies to payroll taxes. These and other permanent modifications to the program are described in [Announcement 2012-45](#) and in [questions and answers](#), posted on IRS.gov.

Normally, employers are barred from the VCSP if they failed to file required Forms 1099 with respect to workers they are seeking to reclassify for the past three years. However, for the next few months, until June 30, 2013, the IRS is waiving this eligibility requirement. Details on this temporary change are in [Announcement 2012-46](#).

To be eligible for the VCSP, an employer must currently be treating the workers as nonemployees; consistently have treated the workers in the past as nonemployees, including having filed any required Forms 1099; and not currently be under audit on payroll tax issues by the IRS. In addition, the employer cannot currently be under audit by the Department of Labor or a state agency concerning the classification of these workers or contesting the classification of the workers in court.

Interested employers can apply for the program by filing [Form 8952](#), Application for Voluntary Classification Settlement Program, at least 60 days before they want to begin treating the workers as employees.

Employers accepted into the program will generally pay an amount effectively equaling just over one percent of the wages paid to the reclassified workers for the past year. No interest or penalties will be due, and the employers will not be audited on payroll taxes related to these workers for prior years. Employers applying for the temporary relief program available for those who failed to file Forms 1099 will pay a slightly higher amount, plus some penalties, and will need to file any unfilled Forms 1099 for the workers they are seeking to reclassify.

Voluntary Classification Settlement Program (VCSP) Frequently Asked Questions



Q1. What is the Voluntary Classification Settlement Program (VCSP)?

A1. The VCSP is a program developed by the IRS that allows taxpayers to voluntarily reclassify their workers as employees for future tax periods for employment tax purposes. Under the VCSP, a taxpayer will pay 10 percent of the amount of employment taxes that would have been due on compensation paid to the workers being reclassified for the most recent tax year, calculated under the reduced rates of section 3509(a) of the Internal Revenue Code. In addition, the taxpayer will not be liable for any interest and penalties on the payment under the VCSP, and will not be audited for employment tax purposes for prior years with respect to the worker classification of the workers. Taxpayers may apply for the VCSP using [Form 8952, Application for Voluntary Classification Settlement Program](#). For more information on the VCSP, see [Announcement 2012-45](#).

Q2. Do all workers have to be reclassified as employees?

A2. No. The VCSP permits taxpayers to reclassify some or all of their workers. However, once a taxpayer chooses to reclassify some of its workers as employees, all workers in the same class as those workers must be treated as employees for employment tax purposes.

Example: ABC Company is a construction firm that currently contracts with its drywall installers, electricians and plumbers to perform services at housing construction sites. ABC Company determines it wants to voluntarily reclassify its drywall installers as employees. ABC Company submits an application, is accepted into the VCSP and enters into a closing agreement with the IRS to reclassify its drywall installers as employees for future periods. Once the VCSP closing agreement is executed, ABC Company must treat all drywall installers as employees for employment tax purposes.

Q3. Which taxpayers are eligible for the VCSP?

A3. Taxpayers who want to voluntarily change the classification of their workers going forward and who meet certain requirements are eligible for the VCSP. Specifically, a taxpayer must be treating the workers to be reclassified as independent contractors or other nonemployees; additionally, the taxpayer must have consistently treated the workers as nonemployees, including having filed any required Forms 1099, consistent with the nonemployee treatment, for the previous three years with respect to the workers to be reclassified. The taxpayer cannot be currently under employment tax audit by the IRS. A taxpayer that is a member of an affiliated group within the meaning of section 1504(a) is considered to be under employment tax audit for purposes of the VCSP if any member of the affiliated group is under employment tax audit. The taxpayer also cannot be under audit by the Department of Labor or any state agency regarding the classification of workers.

Q4. Are exempt organizations eligible for the VCSP?

A4. Yes, exempt organizations are eligible if all eligibility requirements are met.

Q5. Are government entities eligible for the VCSP?

A5. Yes, government entities are eligible if all eligibility requirements are met.

Q6. Is the VCSP available to state and local government agencies for workers covered under a Section 218 agreement?

A6. No, the VCSP is not available to state and local government employers for workers covered under a Section 218 agreement. However, the VCSP is available to state and local government employers for workers not provided Social Security coverage under a section 218 agreement.

Q7. Can a taxpayer who is not currently under audit but who was previously audited be eligible for the VCSP?

A7. A taxpayer who was previously audited by the IRS or the Department of Labor concerning the classification of the workers may be eligible for the VCSP if the taxpayer has complied with the results of the IRS or Department of Labor audit and is not currently contesting the classification in court.

Q8. How does a taxpayer take part in the VCSP?

A8. In order to participate in the 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 from the date the taxpayer wants to begin treating its workers as employees.

Q9. Should payment be submitted with the application?

A9. No, taxpayers should not submit payment with the VCSP application.

Q10. What happens once the VCSP application has been submitted?

A10. Once submitted, the IRS will review the application and verify the taxpayers eligibility. The IRS will then contact the taxpayer (or the taxpayers authorized representative if an executed Power of Attorney Form 2848, is included with the application) to enter into the VCSP closing agreement with the IRS.

Q11. When does the taxpayer pay the amount due under the VCSP?

A11. Taxpayers must make full and complete payment of any amount due under the VCSP when they return the signed VCSP closing agreement to the IRS.

Q12. What are the results of participating in the VCSP?

A12. A taxpayer who participates in the VCSP agrees to treat the class or classes of workers as employees for future tax periods for employment tax purposes and will not be subject to an employment tax audit with respect to the worker classification of the class or classes of workers for prior years. The taxpayer will pay 10 percent of the employment tax liability, calculated at the reduced rates of IRC section 3509(a), that would have been due on compensation paid to the workers being reclassified for the most recent tax year if those workers were classified as employees for that year, with no liability for any interest or penalties.

Q13. Will I be contacted if my application is rejected?

A13. Yes, if you are not eligible, the IRS will contact you to inform you that your VCSP application has not been accepted.

Q14. If my application is rejected, can I apply again at a later point in time?

A14. Yes, if your VCSP application has been rejected because you are not eligible, you may reapply.

Q15. How is the amount of the VCSP payment calculated?

A15. Payment under the VCSP is 10 percent of the amount of employment taxes calculated under the reduced rates of section 3509(a) of the Internal Revenue Code for the compensation paid for the most recent tax year to the workers being reclassified under the VCSP. Under section 3509(a), the effective tax rate for compensation up to the social security wage base is generally 10.68 percent; however, for 2011 and 2012 it is 10.28 percent. The effective rate for the compensation above the social security wage base is 3.24 percent.

The amount due under the VCSP is calculated based on compensation paid in the most recently closed tax year, determined at the time the VCSP application is being filed. Accordingly, for example, the 10.28 percent effective rate applies for the VCSP applications submitted in 2013 since the most recently closed tax year is 2012. The rate of 3.24 percent applies to compensation above the social security wage base. These effective rates constitute the sum of the rates as calculated under section 3509(a), and are made up of the following:

Description	3509(a) Percentage for compensation paid in 2011 and 2012 up to the social security wage base	3509(a) Percentage for compensation in years other than 2011 and 2012 up to the social security wage base	3509(a) Percentage for compensation paid above the social security wage base
Federal Income Tax Withholding	1.5	1.5	1.5
Employee Social Security Tax	.84	1.24	0
Employer Social Security Tax	6.2	6.2	0
Employee Medicare Tax	.29	.29	.29
Employer Medicare Tax	1.45	1.45	1.45
Totals	10.28	10.68	3.24

Under the VCSP, the taxpayer then pays 10 percent of the amount calculated under section 3509(a).

Example 1: In 2012 you paid \$1,500,000 to workers that are the subject of the VCSP. All of the workers identified in the VCSP application were compensated at or below the social security wage base (e.g., under \$110,100 for 2012). You submit the VCSP application on October 1, 2013, and you want the beginning date of the quarter for which you want to treat the class or classes of workers as employees to be 1/01/2014. You look to amounts paid to the workers in 2012 for purposes of calculating the VCSP amount, since 2012 is the most recently completed tax year at the time the application is being filed. Under section 3509(a), the employment taxes applicable to \$1,500,000 would be \$154,200 (10.28 percent of \$1,500,000). Under the VCSP, your payment would be 10 percent of \$154,200, or \$15,420.

Example 2: The facts are the same as in the example above, except that some of the workers identified in the VCSP application were compensated above the social security wage base in the amount of \$250,000. Under section 3509(a), the employment taxes applicable to \$1,250,000 would be \$128,500 (10.28 percent of \$1,250,000) and the employment taxes applicable to the remaining \$250,000 would be \$8,100 (3.24 percent of \$250,000). Under the VCSP, your payment would be 10 percent of \$136,600 (\$128,500 plus \$8,100), or \$13,660.

Q16. I was just contacted by the IRS for information based on one of my workers filing an IRS SS-8 determination letter request. Can I still apply for the VCSP?

A16. Yes. The SS-8 determination process is not an audit, and, therefore, does not prevent you from being eligible for the VCSP.

Q17. Will the IRS share information about VCSP applicants with the Department of Labor?

A17. No, the IRS will not share information about VCSP applicants with the Department of Labor.

Q18. Will the IRS share information about VCSP applications with state agencies?

A18. No, the IRS will not share information about VCSP applications with state agencies.

Q19. To be eligible under the VCSP, you must have filed all required Forms 1099 for the previous 3 years for the workers you want to reclassify. If I filed Forms 1099 late, am I still eligible for the VCSP?

A19. The IRS will consider you eligible for the VCSP if you filed the required Forms 1099 within 6 months of their due date (including extensions), assuming you meet the other eligibility requirements. Taxpayers who have not previously filed required Forms 1099 or who filed them more than 6 months after their due date (including extensions) are not eligible for the VCSP.

Q20. If I apply for the VCSP and my application is rejected, will I open myself up to an audit?

A20. No, rejection of a VCSP application will not automatically trigger initiation of a Federal audit. You could be audited for another reason, but not as a result of filing Form 8952.

Q21. By signing the VCSP closing agreement am I admitting any liability or wrong doing for past periods?

A21. No, the VCSP concerns future years only. The IRS is not making any determination with regard to prior years and you are not making any representation as to the workers' proper status for prior years for federal employment tax purposes.

Q22. If my parent or subsidiary or another member of my consolidated group is under IRS audit, can I still participate in the VCSP?

A22. No, an employment tax audit of one of the members of an affiliated group is treated as an employment tax audit of the applicant for purposes of the VCSP.

Q23. If I sign a VCSP closing agreement will I be opening myself to an audit in the future?

A23. Executing a VCSP closing agreement will not increase your chances of being audited in the future. However, the IRS will periodically review the Form(s) 1099 and Form(s) W-2 that you file and may contact you if our VCSP review indicates that you have not complied with the terms of your Agreement.

Q24. If I am currently in IRS Appeals contesting the results of an employment tax examination, am I considered to be under employment tax examination for purposes of the VCSP?

A24. Yes, for purposes of the VCSP you will be considered to be under employment tax audit if you are contesting the results of the audit in IRS Appeals.

About the Author

Tanya Baber, EA, PA, CTRS is the founder of Tax Edge, Inc., an accounting, tax preparation, and tax representation service in Grand Junction, Colorado. She has been a Western Colorado native all her life but enjoys traveling whenever she has the opportunity. She enjoys the great outdoors and activities like hiking, fishing, camping and horseback riding. She volunteers in her spare time for various non-profits including providing communications for Search and Rescue in Mesa County Colorado and assisting with training a search dog named Sego (Who is also the family pet).

Discovering a passion for accounting and taxes after working in an accounting company for fifteen years, she studied and passed her Enrolled Agent exam first, then went to college to achieve her Bachelor of Science degree with honors from Colorado Mesa University in Public accounting soon after. Next, she passed her CTRS certification (Certified Tax Resolution Specialist) and is only one of a handful of people across the United States that shares this distinction.

She enjoys consulting with accountants and helping clients solve a variety of tax problems with the IRS and state including audits, appeals, offers in compromise, employment tax issues, non-compliance and negotiating hardship situations where a taxpayer has difficulty making payments. Tanya has been in public accounting for over twenty-five years and helps business owners with all phases of their business needs. She also enjoys teaching classes and seminars to accountants, CPA's, EA's and business owners and sharing her vast experience and knowledge with them. You may contact her at tbaber@taxedge365.com.

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