August 2014

AN ALERT FROM SMITH LEONARD PLLC:

Smith Leonard Employment Update

Subject: IRS LAUNCHES VOLUNTARY CLASSIFCATION SETTLEMENT PROGRAM

CONTACT:

Kevin Benson – Tax Partner
336.821.1402
kbenson@smithleonardcpas.com

Addison Maille – Tax Partner
336.821.1304
amaille@smithleonardcpas.com

Mark Bulmer – Tax Partner
336.821.1411
mbulmer@smithleonardcpas.com

Aimee McWhorter – Tax Partner
336.243.2772
amcwhorter@smithleonardcpas.com

Jon Glazman – Tax Partner
336.821.1407
jglazman@smithleonardcpas.com

Tom Smith – Tax Partner
336.243.2772
tsmith@smithleonardcpas.com

IRS LAUNCHES VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM

SUMMARY

If you have independent contractors in your office, you need to pay attention to an employment tax settlement program launched by the IRS—the Voluntary Classification Settlement Program (VCSP). This program allows employers to reclassify as employees those workers they have erroneously treated as independent contractors. The program has generous payment terms, and participants get relief from employment tax audits for previous years.

Here are the details:

EMPLOYEE OR INDEPENDENT CONTRACTOR?

Whether a worker is classified as an employee or as an independent contractor makes a big difference for federal income tax and employment tax purposes. If a worker is an employee, the employer must withhold federal income tax and FICA taxes on the employee's wages, pay the employer's share of FICA taxes and the FUTA tax, and often provide the worker with fringe benefits it makes available to other employees. There may be state tax obligations as well.

None of those obligations apply for workers who are independent contractors. Instead, the business merely sends the independent contractor a Form 1099-MISC for the year showing what he was paid (if it amounts to $600 or more).

In general, an individual is an employee if the enterprise he works for has the right to control and direct him regarding the job he is to do and how he is to do it. Otherwise, he is an independent contractor.

Because the stakes are high, the issue is often hotly contested between taxpayers and the IRS. The VCSP will allow employers to resolve past worker classification issues by voluntarily reclassifying their workers without undergoing an audit.

WHO IS ELIGIBLE

The VCSP is available to taxpayers who have consistently treated their workers (or a class or group of their workers) as independent contractors and now want to begin treating them as employees. To be eligible, the taxpayer must have filed all required Forms 1099 for the workers for the previous three years within six months of the Form 1099 due dates (including extensions).

A taxpayer who is currently under IRS audit isn't eligible for the program. Likewise, a taxpayer who is under an employment tax audit by the Department of Labor (DOL) or a state government agency is ineligible. However, a taxpayer that was previously audited by IRS or the DOL about the classification of its workers will be eligible if it has complied with the results of that audit.

A taxpayer doesn't lose eligibility for the program by having been contacted by the IRS for information based on one of his workers filing a Form SS-8 with the IRS requesting a determination of whether the worker is an employee or independent contractor. The VCSP is still available, since the SS-8 determination process isn't an audit.

If a corporate taxpayer's parent, subsidiary, or other member of its consolidated group is under audit, then the taxpayer can't participate in the VCSP. An audit of one member of a taxpayer's consolidated group is treated as an audit of the taxpayer for these purposes.

TERMS OF THE PROGRAM

A taxpayer who is accepted into the VCSP must agree to treat the class of workers as employees for future tax periods. The taxpayer must also agree to allow the IRS an extra three years to assess employment taxes. This extension applies for the first three calendar years beginning after the agreement takes effect.

In exchange for making these concessions, the taxpayer gets the following benefits:

- The taxpayer must pay only 10% of the employment tax liability on compensation paid to the workers for the most recent tax year, determined under reduced rates (see "Figuring the payment due," below).
- The taxpayer won't be liable for any interest and penalties on the employment taxes.
- The taxpayer won't be subject to an employment tax audit for the classification of the workers for prior years.

Taxpayers may choose to reclassify some or all of their workers. However, once a taxpayer chooses to reclassify certain workers as employees, it must treat all workers in the same class as employees. For example, suppose that a construction firm currently contracts with its drywall installers, electricians, and plumbers to perform services at construction sites. It wants to voluntarily reclassify its drywall installers as employees. Once the VCSP closing agreement is signed, the company must treat all drywall installers as employees for employment tax purposes.

FIGURING THE PAYMENT

The payment due under the VCSP is 10% of the employment taxes, calculated under reduced rates, on the compensation paid to the reclassified workers in the most recently completed tax year, determined at the time the VCSP application is filed. If you apply for the VCSP in **2014**, the most recently completed tax year is 2013. The reduced rate is 10.68% of compensation up to $113,700 (the Social Security wage base for 2013) and 3.24% of compensation above $113,700. You will pay only 10% of that amount.

ILLUSTRATION

A company paid $1.5 million in 2013 to workers that are the subject of a VCSP application. None of the workers were paid more than $113,700 in wages. The company submits its application on October 1, **2014**. It wants to begin treating the workers as employees on January 1, 2015. The company calculates the payment due based on amounts paid to the workers in 2013, because 2013 was the most recently completed tax year when the application was filed. Under the reduced rates, the employment taxes on $1.5 million of wages would be $160,200 (10.68% of $1.5 million). The company's VCSP payment would be 10% of $160,200, or $16,020.

PROCEDURE

Taxpayers apply to participate in the VCSP by filing Form 8952 with the IRS at least 60 days before the date they want to begin treating the workers as employees. No payment should be made at that time. After the IRS reviews the application, it will contact the taxpayer, or the taxpayer's authorized representative, to complete the process.

Taxpayers who are accepted into the VCSP must enter into a closing agreement with the IRS. Full payment is due when the taxpayer returns the signed closing agreement to the IRS.

SHOULD YOU PARTICIPATE IN THE VCSP?

Although the VCSP's terms are generous, any decision to participate in the program should be made carefully, after weighing the costs and benefits. Agreeing to treat workers as employees may have far-reaching consequences under a variety of federal and state statutes. The right choice may depend on how clear it is that the workers are in fact employees.