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New IRS Classification Settlement Program Provides Tax Relief for Independent Contractor Misclassification

The Internal Revenue Service (IRS) has announced a new voluntary compliance program, the **Voluntary Classification Settlement Program**, that provides significant tax relief for qualifying employers who have mistakenly classified workers as independent contractors rather than as employees.

The misclassification of workers as independent contractors has been, and continues to be, an area of great concern (and expense) for employers and a fertile audit (and revenue generating) area for the IRS and most state revenue and labor departments. Both employers and individual owners and officers can face significant liabilities for taxes, interest and penalties based upon a misclassification of a worker as an independent contractor rather than as an employee. Earlier this month, the IRS and eleven state agencies, including agencies from Connecticut, entered into an agreement to coordinate their efforts to fight employee misclassification.

The **Voluntary Classification Settlement Program** is part of the IRS's efforts to increase tax compliance with respect to worker classification and provide for the prospective reclassification of workers erroneously treated as independent contractors.

Employers eligible to participate in the program include businesses, tax-exempt

organizations and government entities. Participants in the program will benefit from a significantly reduced tax liability with respect to any reclassified workers. If accepted into the program, a participant will pay only 10% of the employment tax liability for the most recent tax year that would likely be assessed in the event of an IRS audit and subsequent reclassification.

In addition, under the program, no interest and no additional penalties (such as the 20% accuracy penalty) will be assessed by the IRS against the employer, and the IRS will agree not to audit prior years' employment tax returns with respect to the reclassified workers.

To be eligible to participate in the program, a business, tax-exempt organization or government entity must:

1. Want to voluntarily reclassify certain workers as employees for federal income tax withholding, Federal Insurance Contribution Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax purposes for future tax periods;
2. Have consistently treated these workers as independent contractors;
3. Be presently treating these workers as independent contractors;
4. Have filed all required Forms 1099 for these workers for the previous three calendar years;



5. Have no dispute with the IRS as to whether these workers are employees or independent contractors;
6. Not be involved in a current audit by the IRS;
7. Not be involved in a current audit for worker classification issues by the U.S. Department of Labor or any state agency; and
8. Have complied with the results of a previous audit, if any, by the IRS or the U.S. Department of Labor with respect to worker classification issues.

To participate in the program, the employer must (1) apply to the IRS for acceptance in the program by filing IRS Form 8952, *Application for Voluntary Classification Settlement Program (VSCP)*, (2) agree prospectively to treat the workers as employees for future tax periods, and (3) agree to extend the period of limitations for the assessment of employment taxes for three years for each of the first, second and third calendar years beginning after the date on which the workers begin to be treated as employees. Form 8952 should be filed at least 60 days before the date on which the workers begin to be treated as employees.

If accepted into the program, the employer will be expected to enter into a closing agreement with the IRS to finalize the terms of the arrangement and pay the full amount of the reduced tax liability due under the agreement.

The federal tax savings under the program can be significant. For example, an

employer who paid a worker \$100,000 per year for the past three calendar years (2008, 2009 and 2010) who unintentionally misclassified the worker as an independent contractor could have a potential liability to the IRS of \$38,448 (consisting of tax of \$10,680 per year for three years, plus a penalty of \$2,136 per year for three years) plus interest. Under the program, assuming the employer agreed to treat the worker as an employee effective January 1, 2012, the employer would have a tax liability to the IRS of only \$1,068, representing only 10% of the \$10,680 potential tax liability for 2010, and a potential savings of \$37,380. In addition, no interest or tax penalties would be assessed by the IRS.

As of the date of the publication of this Tax Alert, neither the Connecticut Department of Revenue Services nor the Connecticut Department of Labor has announced a similar voluntary compliance program and taxpayers should be aware that their participation in the IRS program may have state tax and unemployment insurance consequences. Nevertheless, use of the Connecticut Department of Revenue Services' voluntary disclosure program may help mitigate certain of those consequences.

Questions or Assistance?

If you have any questions about the IRS's new Voluntary Classification Settlement Program, or whether your workers are properly classified as employees or independent contractors, please contact any of the members of Shipman & Goodwin LLP's Tax Practice Group listed on page 1 of this alert.

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