



## Employees and Contractors: The Cost of Proper Classification

Today's "gig economy" lends itself to temporary jobs, short-term contracts and flexible work arrangements between businesses and the professionals providing services. Since the beginning of the gig economy following the Great Recession, the number of contract workers has grown to more than one third of the total workforce in the U.S. With an increasingly remote labor force, this growth is expected to continually increase.

As a result of the rise in independent contractors in the U.S., it has become more difficult for businesses and their owners to properly classify workers as either independent contractors or employees. Since employment taxes withheld by employers account for more than 70 percent of all revenue collected by the IRS, it is an issue facing intense scrutiny.<sup>1</sup> In 2018 alone, the IRS conducted over 43,000 employment tax examinations resulting in additional employment tax assessments of almost \$800 million.<sup>2</sup>

On this topic, the IRS has issued guidance in the form of publications,<sup>3</sup> information guides<sup>4</sup> and form instructions,<sup>5</sup> all of which address and clarify facts related to the degree of control and independence of the worker in question. Those parameters fall into three broad categories:

1. **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. **Financial:** Are the business aspects of the worker's job controlled by the payer? This includes how a worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.
3. **Type of Relationship:** Are there written contracts or employee benefits (i.e., pension plan, insurance, vacation pay, etc.)? Will the relationship continue beyond a specific project or period and is the work performed a key aspect of the business?

Despite establishing these parameters and providing additional clarification from the 20 factors found on Form SS-8, the IRS understands that proper classification of an employee can be challenging. In an IRS employment tax examination involving the reclassification of workers from independent contractors to employees, the IRS will generally follow the provisions of Internal Revenue Code Section (IRC) § 3509 which allows some degree of relief in the amounts assessed for FICA.

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<sup>1</sup> See Department of Justice Press Release 16-497, 4-27-16

<sup>2</sup> See IRS Data Book Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, Fiscal Year 2018, Table 9a

<sup>3</sup> See IRS Publication 1779 (Rev. 3-2012): Independent Contractor or Employee and IRS Publication 15 (Rev. 12-2019): (Circular E), Employer's Tax Guide

<sup>4</sup> See Information Guide for Employers Filing Form 941 or Form 944

<sup>5</sup> See Instructions for Form SS-8 (Rev. May 2014): Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding

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## Penalty Relief

### *During an Audit*

Under IRC § 3509(a), if the employer filed Forms 1099 for the workers being reclassified as employees by the examiner, the taxes are assessed at a reduced rate of 1.5 percent for federal income taxes, 20 percent of the employee's share of FICA taxes and the full employer share of FICA taxes for the tax periods under examination. If Forms 1099 were not filed, the amounts for the employee share are doubled to 3 percent and 40 percent, respectively.<sup>6</sup> Although IRC § 3509 provides some relief, it still results in significant FICA assessments and provides no relief from FUTA or SUI taxes.

### *Before an Audit*

In the interest of voluntary compliance, the IRS unveiled the Voluntary Classification Settlement Program (VCSP) on September 21, 2011, which allows taxpayers to voluntarily reclassify independent contractors as employees and pay significantly reduced prior year employment taxes with no penalties or interest.<sup>7</sup> Prior to the introduction of this program, the Classification Settlement Program was a similar program that allowed resolution of worker classification cases that were under IRS examination.<sup>8</sup> However, the introduction of the VCSP gave taxpayers the ability to voluntarily resolve worker classification issues at a low cost without having to wait for an IRS audit.<sup>9</sup>

The VCSP is meant to encourage voluntary compliance with worker classification rules and signaled an increased IRS focus on the issue. Two days before announcing the program, the IRS and Department of Labor stepped up enforcement efforts by signing a memorandum of understanding to strengthen information sharing on enforcement actions aimed at misclassified workers.<sup>10</sup> In conjunction with the stepped-up enforcement, the IRS introduced the VCSP as part of a larger "Fresh Start" initiative. Upon its launch, IRS Commissioner Doug Shulman stated, "This settlement program provides certainty and relief to employers in an important area. This is part of a wider effort to help taxpayers and businesses to help give them a fresh start with their tax obligations."<sup>11</sup> The program signals that the IRS was aware of the ambiguity that surrounded worker classification and was an important step to help mitigate that ambiguity.

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<sup>6</sup> See IRC § 3509(b)

<sup>7</sup> The Tax Adviser: IRS Launches Worker Classification Settlement Program. G. Edgar Adkins Jr., CPA, Washington DC; Jeffrey A. Martin, CPA, Washington, DC; and Adam Lambert, CPA, New York, NY. February 1, 2012

<sup>8</sup> IRM 4.23.6.1.1 (1) (12-21-2017)

<sup>9</sup> News Releases: Announcement 2014-62, 05/08/2014, IRC Sec(s). 45R

<sup>10</sup> The Tax Adviser, *supra* note 7

<sup>11</sup> News Release: News Release 2011-95, 09/21/2011, IRC Sec(s). 3509



After the positive reception of the VCSP program, the IRS further demonstrated their willingness to help taxpayers wade through the muddy waters of worker classification and made specific amendments to the initial program based on the feedback from taxpayers and taxpayer representatives. The IRS updated the initial program's eligibility requirements to permit a taxpayer under IRS audit, other than an employment tax audit, to be able to participate in the program, and eliminated the requirement that a taxpayer agree to extend the period of limitations on assessment of employment taxes.<sup>12</sup> These changes opened up the program to more taxpayers and removed a requirement that made many hesitant to utilize the program.

Under the current program, many businesses are eligible to participate in the VCSP program, including exempt organizations and government entities. Employers are eligible for the program if they:

- Currently treat their workers (or class of workers) as independent contractors or other nonemployees and want to prospectively treat the workers as employees;
- Have consistently treated their workers as nonemployees and must have filed Forms 1099 for the previous three years for the workers being reclassified;
- Are not currently under employment tax audit by the IRS or audit concerning the classification of the workers by the Department of Labor or a state government agency; or
- Have complied with the results of previous audits concerning classification of workers and are not currently contesting the classification in court.

To apply for the program, taxpayers file Form 8952, *Application for Voluntary Classification Settlement Program*, at least 60 days before the taxpayer wants to begin treating the workers as employees. No payment should be sent when the application is submitted to the IRS. The IRS will review the application and verify the taxpayer's eligibility. If the IRS confirms the taxpayer is eligible for the program, a closing agreement will be mailed to the taxpayer. The taxpayer is then required to send a signed copy of the closing agreement with full and complete payment of any amount due under the program. Conversely, if a taxpayer is deemed to not be eligible for the program, the IRS will inform the taxpayer that the application was rejected. However, this does not prohibit the taxpayer from reapplying at a later time.

For those eligible to participate in the program, the amount due is calculated based on compensation paid in the most recently closed tax year at the time the VCSP application is filed. The payment amount is 10 percent of the employment taxes of the compensation calculated at the reduced rates under section 3509(a) of the Internal Revenue Code. The IRS FAQs on the program and the instructions for Form 8952 provide good examples of how the payment is calculated.

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<sup>12</sup> Announcement 2012-45, Internal Revenue Bulletin: 2012-51



The VCSP program has had more than 1,500 employers apply to participate since its inception.<sup>13</sup> The program offers a low-cost solution to the often ambiguous problem of worker classification. Participation in the VCSP is not an admittance of wrongdoing, and taxpayers who participate in the program will not have an increased chance of being audited in future years; however, the IRS will periodically review that necessary 1099 and W-2 forms that are being filed in accordance with the terms of a taxpayer's closing agreement. The program is an example of the IRS identifying a compliance issue and taking initiative to provide taxpayers with a solution.

**Learn More**

To learn more about the proper classification of contractors and employees and seeking relief from penalties, contact [James Pickett](#) by calling 770.396.2200.

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<sup>13</sup> News Releases, *supra* note 9