

INDEPENDENT CONTRACTOR OR EMPLOYEE

GETTING IT RIGHT THE 1ST TIME

WHICH ARE YOU?

For federal tax purposes, this is an important distinction. Worker classification affects how you pay your federal income tax, social security and Medicare taxes, and how you file your tax return. Classification affects your eligibility for employer and social security and Medicare benefits and your tax responsibilities. If you aren't sure of your work status, you should find out before getting started.

The courts have considered many facts in deciding whether a worker is an independent contractor or an employee. These relevant facts fall into three main categories: behavioral control; financial control; and relationship of the parties. In each case, it is very important to consider all the facts – no single fact provides the answer. Carefully review the following definitions.

BEHAVIORAL CONTROL

These facts show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done – as long as the employer has the right to direct and control the work.

FINANCIAL CONTROL

These facts show whether there is a right to direct or control the business segment of the work.

RELATIONSHIP OF THE PARTIES

These are facts that illustrate how the business and the worker perceive their relationship.

1. **INSTRUCTIONS** – if you receive extensive instructions on how work is to be done, this suggests that you are an employee. Instructions can cover a wide range of topics, for example:
 - ✓ How, when, or where to do the work
 - ✓ What tools or equipment to use
 - ✓ What assistants to hire to help with the work
 - ✓ Where to purchase supplies and services

Special Note: If you receive less extensive instructions about what should be done, but not how it should be done, you may be an independent contractor. For instance, instructions about time and place may be less important than directions on how the work is performed.
2. **TRAINING** – If the business provides training about required procedures and methods, this indicates that the business wants the work done in a certain way, and this suggests that you may be an employee. Training can be provided either in class, by another worker, or by other means.
3. **INTEGRATION** – Integration of the worker’s services into business operations generally shows that the worker is subject to the direction and control of the business and is therefore an employee. Integration in this context means that the success or continuation of the business depends upon the performance of certain services rendered by the worker. (**For example, the company is a window manufacturer and the worker is a window installer**), more likely represents that the worker is an employee.
4. **SERVICES RENDERED PERSONALLY** – If the workers is required to perform the services personally, then this shows control by the business over the worker, making it probable that the worker is an employee.
5. **HIRING, SUPERVISING, AND PAYING ASSISTANTS** – When the business hires, supervises and pays assistants, this shows control by the business over the worker making it more likely that the worker is an employee. However, if one worker hires, supervises and pays the assistants under a written contract to provide materials and labor, the worker may be an independent contractor.
6. **CONTINUING RELATIONSHIP** – A continuing relationship between the worker and the business tends to show an employer – employee relationship. A continuing relationship may exist when work is frequently performed, even though it may be at irregular intervals.
7. **SET HOURS OF WORK** – Control is exhibited when the business sets the hours of work or schedule that has to be followed by the worker. The total freedom to plan one’s own work day is the hallmark of independent contractor status.
8. **FULL TIME REQUIRED** – If the worker must devote substantially full time to the needs of the business, and is restricted from doing other gainful work, and can’t reject any job offered by the company, then the worker is probably an employee.
9. **DOING WORK ON THE COMPANY’S PREMISES** – An independent contractor should have his or her own places of business. When a worker is required to perform the work at the business’s premises, control over the worker is suggested.
10. **ORDER OR SEQUENCE SET** – As an independent contractor the worker should set the work schedule. If the worker must perform the work according to the order or sequence established by the business, then the worker is more likely and employee.

11. **ORAL OR WRITTEN REPORTS** – If the business requires the worker to submit oral or written reports, this most likely indicates that the worker is an employee because there is an element of control.
12. **PAYMENT MADE BY HOUR, WEEK OR MONTH** – If payment is made by the hour, day, week, or month it generally implies that there is an employer – employee relationship. Payment made by the job or on a straight commission basis usually indicates that the worker is an independent contractor.
13. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES** – An independent contractor should pay for his or her own expenses. If the business pays the worker’s business and/or travel expenses, this would suggest that the worker is an employee since the business has the right to control expenses.
14. **FURNISHING OF TOOLS AND MATERIALS** - When the company provides or pays for the worker’s tools, supplies, and equipment, this may tend to show that an employee – employer relationship exists.
15. **SIGNIFICANT INVESTMENT** – The greater the worker’s investment in his or her own facilities the more likely it is that an independent contractor status can be justified. **(For example, the worker rents his own office or building from an unrelated party, not from the employer).**
16. **REALIZATION OF PROFIT OR LOSS** – A worker who can realize a profit or suffer a loss as a result of the worker’s services is generally an independent contractor. A real risk of economic loss must exist in order to be an independent contractor.
17. **WORKING FOR MORE THAN ONE BUSINESS AT A TIME** – A worker that performs services for a number of unrelated companies or persons is generally an independent contractor.
18. **MAKING SERVICES AVAILABLE TO THE GENERAL PUBLIC** – A worker who makes his or her services available to the general public on a regular and consistent basis indicates that the individual is an independent contractor.
19. **RIGHT TO DISCHARGE** – Usually an independent contractor cannot be discharged by the business so long as the contract obligations are being met. The business having the right to discharge a worker is an indication that the worker is an employee.
20. **RIGHT TO TERMINATE** – If the worker has the right to terminate his or her relationship with the company at any time without incurring liability, this suggests that the worker is an employee. However, an independent contractor cannot just walk away from contractual obligations to the business. If the worker wishes to terminate the independent contractor agreement, it must be done with reasonable notice, per the terms of the independent contractor agreement.

Special Note: The 20-factor test is very important in determining the employment status of workers for IRS purposes. The degree of importance given to the answers of each of these 20 questions varies with each particular situation. Even if a business is able to answer “NO” to 13 of the 20 questions, this does not mean that the IRS will make a determination that an employer – employee relationship does not exist.

When You Are an Employee:

- The employer must withhold income tax and your portion of social security and Medicare taxes.
- The employer is responsible for paying social security, Medicare, and unemployment (FUTA) and (SUTA) taxes on your wages. Your employer must give you a Form W-2, Wage and Tax Statement, showing the amount of taxes withheld from your pay.
- In some states and in some cases, the employee may deduct unreimbursed employee business expenses when they itemize deductions on their personal state return. This deduction is no longer allowed on U.S. Federal Returns.

When You Are an Independent Contractor:

- The business may be required to give you Form 1099-MISC, Miscellaneous Income, to report what it has paid to you.
- You are responsible for paying your own income tax and self-employment tax (Self-Employment Contributions Act – SECA).
- The business does not withhold taxes from your pay. You may need to make estimated tax payments during the year to cover your tax liabilities.
- You may deduct business expenses on Schedule C of your income tax return.

Who Are Employees?

Generally, employees are defined either under common law or under special statutes for certain situations.

Employee Status under Common Law

Generally, a worker who performs services for a business is an employee if the business can control what will be done and how it will be done. This is so even when the business gives the employee freedom of action. What matters is that the business has the right to control the details of how the services are performed.

Workers in business for themselves are generally not employees. For example, accountants, doctors, lawyers, veterinarians, and others in an independent trade in which they offer their services to the public are usually not employees. However, if the business is incorporated, corporate officers who work in the business are employees. If an employer-employee relationship exists, it does not matter what it is called. The employee may be called an agent or independent contractor. It also does not matter how payments are measured or paid, what they are called, or if the employee works full or part time.

Statutory Employees

A “*statutory employee*” can be defined as a worker who cannot be classified as an employee under the common law rules but is classified as an employee for some payroll tax purposes because of specific statutory requirements.

There are some special definitions of employees for Social Security, Medicare, and FUTA taxes.

While the following persons may not be common law employees, they are considered employees for Social Security and Medicare purposes if the conditions under *Tests* below are met.

- **An agent or commission driver** who delivers food or beverages (other than milk) or picks up and delivers laundry or dry cleaning for someone else.

- **A full-time life insurance salesperson** who sells primarily for one company.
- **A homemaker** who works by the guidelines of the person for whom the work is done, with materials furnished by and returned to that person or to someone that person designates.
- **A traveling or city salesperson** (other than an agent-driver or commission-driver) who works full time (except for sideline sales activities) for one firm or person getting orders from customers. The orders must be for items for resale or used as supplies in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging.
- **Corporate Officers** are usually statutory employees. However, certain corporate directors are not employees. Below is the text of Treasury Regulation §31.3121(d) – 1(b):
 - ❖ **Corporate Officers** – Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation.

Tests

A business must withhold Social Security and Medicare taxes from statutory employees' wages if all three of the following tests apply.

- 1) The service contract states or implies that almost all of the services are to be performed personally by them.
- 2) They have little or no investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
- 3) The services are performed on a continuing basis for the same payer.

Statutory Non-Employees

There are two categories of “*statutory non-employees*”. If a worker fits within either of the statutory definitions, the business does not need to fear the IRS when it treats the worker as an independent contractor. In these situations, it is clear that the worker is classified as self-employed and bears the responsibility of paying in federal income taxes and self-employment taxes. The two categories of statutory nonemployees are:

- **Direct sellers** – Are statutory non-employees if certain factors are met. First, if the salesperson sells consumer goods in the home or sells consumer goods at a place of business other than a permanent retail establishment. Second, if the salesperson sells consumer products to any buyer on a buy-sell basis, a deposit commission basis, or any similar basis prescribed by regulations, for resale in the home or at a place of business other than a permanent retail establishment.

Additionally, substantially all of the payment made to the direct seller for the performance of services must be directly related to sales or other output (including performance or services) rather than to the number of hours worked by the direct seller.

Special Note: In order to obtain the direct sellers exemption, the services performed by the direct seller must be pursuant to a written contract between the direct seller and the company. The contract must provide that the direct seller will not be treated as an employee with respect to such services for federal tax purposes. **(Door-to-door salespersons and home demonstration persons are direct sellers).**

- **Real estate agents** – May also be statutory non-employees. A qualified real estate agent is licensed, receives substantially all his or her remuneration from sales or other output as opposed to the number of hours worked, and renders services that are covered under a written contract stating that he or she is not treated as an employee for federal tax purposes. Services performed by a qualified real estate agent include advertising or showing real estate property, acquisition of a lease to real property and the recruitment, training or supervision of other real estate persons. Property management services are not included.

Special Note: Employers do not pay FICA, FUTA, or withhold federal income taxes on statutory non-employees. However, a statutory non-employee can still be an employee for other purposes, such as state worker's compensation and tort liability.

Consequences and Penalties of Misclassification

If an employer incorrectly classifies an employee as an independent contractor and does not withhold Social Security and Medicare taxes, it will be liable for the taxes. The obligation to collect withholding taxes from an employee's wages is imposed on the employer. If the employer violates this obligation, it becomes liable for the taxes that it should have withheld, as well as for the penalties that it may be assessed.

In certain situations, the employer may ask for an abatement of the liability for the taxes it should have withheld if it can provide evidence that the employee has paid the taxes. For example, Joe's Pizza has erroneously treated some employees as independent contractors and the IRS has assessed the business for the taxes that it should have withheld. Joe's Pizza may request an abatement by filing Form 4670 (Request for Relief from Payment of Income Tax Withholding), if it can submit statements from the employees that they have paid the income taxes. The employee's statement would be submitted on Form 4669 (Statement of Payments Received). The abatement would not affect the employer's liability for penalties or interest that would otherwise be applicable because of its failure to withhold.

Penalty for Failure to File Returns

A 5% penalty for failure to file applies when an employer fails to file a return on the due date and there is a tax due. The penalty is based upon the amount required to be reflected on the tax return less any part of the tax that was paid on or before the due date. Another 5% penalty is charged for each additional month, or fraction thereof during which the failure continues. However, the penalty may not exceed a maximum of 25%.

Penalty for Willful Failure to Collect Tax

Any business that willfully fails to collect or account for and pay over trust fund taxes, or willfully attempts in any manner to evade or defeat the tax, may be liable for a penalty equal to 100% of the tax evaded, not collected or not accounted for and paid to the government. "Trust Fund Taxes" include federal income and FICA taxes that were required to be withheld from the employee's wages. The 100% penalty is imposed on the person, who is required to collect, account for and pay the taxes.

The Internal Revenue Code states that a person is liable for the Trust Fund Recovery Penalty (100% penalty) if the following two requirements are met.

- 1) The person(s) against whom the penalty is assessed must be a responsible person (for example, have the duty to perform and the power to direct the act of collecting, accounting for, and paying the trust fund taxes) and
- 2) The responsible person must have "willfully" failed to collect or pay the trust fund taxes.

The Internal Revenue Service defines "willful" as intentional, deliberate, voluntary, reckless, knowing, as opposed to accidental. Thus, it appears that the 100% penalty can only be assessed in a situation when the company did not have a reasonable basis for classifying an employee as an independent contractor.

A business should make sure that its classification procedures are thorough and that the basis behind its decision is well documented.

Example: When an individual misclassified employees as independent contractors, a court determined that the individual was not liable for the 100% penalty because of his failure to collect and pay the trust fund taxes. Although the individual was clearly a responsible person for purposes of collecting and paying the corporation's withholding taxes, the court held that he did not make a willful attempt to evade payment. The court based its decision on the fact that the individual had a reasonable basis for concluding that no withholding was required.

Further, it was his understanding, based upon the advice of an attorney and an accountant that the workers qualified as independent contractors.

Crowd Management Services, Inc. DC Ore., 95-1 USTC ¶150,260

How Many Years Back Can the IRS Go in a Reclassification Case?

The statute of limitations is based upon the date the business files its Form 941 and Form 940. If the business does not file the forms, there is no statute of limitations as far as the IRS is concerned.

If fraud is involved, there is no statute of limitations for reclassifying independent contractors to employees. In most cases, the limit is the preceding three calendar years.

COMPLETING FORM SS-8

Form SS-8 (Determination of Employee Work Status for Purposes of Federal Employment taxes and Income Tax Withholding) consists of four pages of questions concerning the activities of the business and the worker. The questions are basically a restatement of the 20 common-law questions that are covered above. Additional questions must be answered if the worker is a salesperson or provides services directly to customers.

The business or worker that is seeking the determination can submit a detailed explanation concerning why it is believed that the worker is an employee or independent contractor.

If a worker wants to submit Form SS-8 but does not give the IRS permission to release the worker's name to the business, the IRS will not act on the request.

An IRS auditor who is questioning the classification of workers may give the company a Form SS-8 to complete. Additionally, the IRS auditor may send copies of Form SS-8 to some or all of the workers in question. The IRS may send the form to workers' homes, so the workers can fill out the form. This allows the IRS auditor to compare the information provided by the company with the information given by the workers.

Furthermore, the IRS may also send Form SS-8 to the company or to a worker when it is considering the status of an individual worker (the company is not under audit, but the status of an individual worker is at issue for some reason).

Form SS-8 is an excellent self-audit tool. It reveals the strengths and weaknesses of the independent contractor relationship for a particular class of worker.

When drafting an independent contractor agreement, it is useful to have the company fill out Form SS-8. The many issues which will emerge form a valuable basis of discussion in deciding which provisions are necessary in the independent contractor agreement.

Federal vs. State Law

Unemployment Insurance – The ABC Test

Just like each state has its own flag, each state has its own definition of independent contractor status for unemployment insurance purposes. The term “employee” is usually not defined or used in the state unemployment insurance laws. Coverage depends upon whether or not a worker’s services constitute employment. In most states, “employment” means any services performed for remuneration or under a contract of hire, written or oral, express or implied.

Many states have incorporated into their laws a broad concept of what constitutes an employer-employee relationship. These states provide that service for remuneration is “employment” unless it is proved that:

- (A) The worker is free from control or direction of the performance of the work;
- (B) The service is either outside the usual course of the business for which the service is performed, or it is performed outside of all the places of business of the enterprise for which the service is performed; and
- (C) The worker is customarily engaged in an independently established trade, occupation, profession or business.

These conditions are typically referred to as the “ABC test”.

The burden of proving that the test has been satisfied falls upon the business that retained the worker. In a majority of states all three conditions must be satisfied in order for the worker to be deemed an independent contractor. However, some states only require that one or two of the conditions be satisfied. States that do not use some version of the ABC test generally use a common law standard (i.e. the IRS 20 factor test) to make the determination.

The following Chart of State Unemployment Insurance Law Tests to Define Independent Contractor Status shows that there are many definitions of independent contractor status for state unemployment insurance purposes.

State Unemployment Insurance Law Tests to Define Independent Contractor Status

| Three Part ABC Test | | |
|----------------------------|----------------------|----------------------|
| Alaska | Louisiana | New Jersey |
| Arkansas | Maine | New Mexico |
| Connecticut | Maryland | Rhode Island |
| Delaware | Massachusetts | Tennessee |
| Georgia | Nebraska | Vermont |
| Hawaii | Nevada | Washington |
| Illinois | New Hampshire | West Virginia |

Common Law (Like IRS 20 Factor Test)

| | | |
|-----------------------------|-----------------------|-----------------------|
| Alabama | Kentucky | North Dakota |
| Arizona | Minnesota | South Carolina |
| California | Mississippi | Texas |
| District of Columbia | Missouri | Utah |
| Florida | New York | |
| Iowa | North Carolina | |

Variations of State Unemployment Insurance Tests

| State | Test |
|-----------------|-----------------------|
| Colorado | AC |
| Idaho | AC |
| Indiana | A – part of B – C |
| Kansas | AB |
| Michigan | Economic Reality Test |
| Montana | AC |
| Ohio | A – part of B – C |
| Oregon | AC |
| Pennsylvania | AC |
| South Dakota | AC |
| Virginia | AB or AC |
| Wisconsin | Unique 8 Factor Test |
| Wyoming | AC |

Special Note: These charts are meant to provide a rough guide only. State laws are subject to change at any time. Some states have additional or alternative tests. It is not uncommon for a state legislature to change its state's unemployment insurance definition or independent contractor. Therefore, be certain to research a state's current test and regulations.

Example 1

Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others that he engaged to assist him. She pays them an hourly rate and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. Jerry Jones and his assistants are employees of Wilma White.

Example 2

Milton Manning, an experienced tile setter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 3

Wallace Black agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount that he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Co.

Example 4

Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 5

Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies that she obtained through advertisements. Vera is an independent contractor.

Trucking Industry

Example 6

Rose Trucking contracts to deliver material for Forest, Inc., at \$140 per ton. Rose Trucking is not paid for any articles that are not delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan and she is responsible for all maintenance. None of the drivers are provided by Forest, Inc. Jan Rose, operating as Rose Trucking, is an independent contractor.

Computer Industry

Example 7

Steve Smith, a computer programmer, is laid off when Megabyte, Inc. downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It is not clear how long that it will take to complete the project, and Steve is not guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself. Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay federal and state taxes, and receives no benefits from Megabyte. Megabyte will file Form 1099-MISC, Miscellaneous Income, to report the amount paid to Steve. Steve works at home and is not expected or allowed to attend meetings of the software development group. Steve is an independent contractor.

Automobile Industry

Example 8

Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works six days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She is required to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Example 9

Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example 10

An auto sales agency furnishes space for Helen Bach to perform auto repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other individuals and does all of the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is an independent contractor and the helpers are her employees.

Attorney

Example 11

Donna Yuma is a sole practitioner who rents office space and pays for the following items: telephone, computer, on-line legal research linkup, fax machine, and photocopier. Donna buys office supplies and pays bar dues and membership dues for three other professional organizations. Donna has a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2 each year. For the past 2 years, Donna has had only three clients, corporations with which there have been long-standing relationships. Donna charges the corporations an hourly rate for her services, sending monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, on-line research time, fax charges, photocopies, postage, and travel, costs for which the corporations have agreed to reimburse her. Donna is an independent contractor.

Taxicab Driver

Example 12

Tom Spruce rents a cab from Taft Cab Co. for \$150 per day. He pays the costs of maintaining and operating the cab. Tom Spruce keeps all fares that he receives from customers. Although he receives the benefit of Taft's two-way radio communication equipment, dispatcher, and advertising, these items benefit both Taft and Tom Spruce. Tom Spruce is an independent contractor.

Worker Classification Examination Process

Why Does the IRS Conduct an Examination?

- The employee files a request for a ruling on IRS Form SS-8.
- The business issues an “extraordinarily high number” of 1099-MISC forms.
Special Note: A high dollar amount of 1099's is likely to attract an IRS audit
- The state unemployment department shares information with the IRS from one of their state audits.
- The IRS performs project audits on a certain industry.
- Informants tip off the IRS and provide audit leads. (Disgruntled former employees or vengeful competitors).

Two Types of Worker Classification Audits

- 1) Employment tax examinations
- 2) Income tax examinations

Employment tax exams focus on employment tax issues. However, during an employment tax exam, the IRS agent may look for additional issues.

In the past, income tax exams were strictly an examination of revenues and expenses, not necessarily an exam of proper classification of workers. With the passage of Section 530 and the IRS often losing employment tax issues due to a ‘prior IRS exam’, the independent contractor versus employee area is reviewed now in every income tax exam.

Even though the classification of workers may not have been specifically addressed in the prior exam, the courts have said that the IRS has had the opportunity to address the issue.

A new IRS technique is to inform the taxpayer that it is conducting a mere compliance check - “not an exam”. This is a weak attempt by the IRS to claim that it never truly audited the business in hopes that the company won't later be entitled to Section 530 Safe Haven Protection.

Examination Location

The IRS will request the examination to take place at the taxpayer's business location. The taxpayer or their representative should always attempt to schedule the examination away from the company's location, in order to better control the flow and pace of information shared. By conducting the exam at a location other than the business premises, the chances for "*misinterpretation*" of events observed or overheard are avoided.

Documents Requested by IRS for a Worker Classification Examination

The typical Initial Information Document Request (IDR) will include the following:

- 1) Copies of the following returns/forms for the agent's case file:
 - ✓ Form 940 for prior years, exam year, and subsequent years.
 - ✓ Form 941 for each quarter in prior years, exam year, and subsequent years.
 - ✓ State unemployment tax returns for each quarter for prior years, exam year, and subsequent years.
 - ✓ Form 1096 and Forms 1099 for prior years, exam year, and subsequent years.
 - ✓ Forms W-2, W-2C, W-3, and W-3C for prior years, exam year, and subsequent years.
 - ✓ Forms W-4 if any were completed by workers.
 - ✓ Forms W-9 obtained from workers.
- 2) Payroll Journal for exam year (including work papers reconciling it to the employment tax returns).
- 3) Cash Disbursements Journal for exam year.
- 4) General Journal for exam year including any adjusting entries.
- 5) Trial Balance for exam year.
- 6) Copy of the prior years' federal audit reports (if applicable).
- 7) Copies of the contracts between the company and its workers.
- 8) Additional documentation may be requested

Conclusion of Examination

Usually findings by the IRS agent are discussed with the taxpayer or their taxpayer's representative. The agent may say that they need additional documentation or more support for a certain area of the examination. At the conclusion of the exam, the taxpayer will receive one of the two notices:

Good Notice: The taxpayer may receive a "No Change Letter" that states the IRS agent came in and conducted an examination and could not find sufficient basis for any changes (i.e. "**no problems**" "**continue doing what you're doing**").

Bad Notice: The taxpayer will receive an assessment letter which is referred to as a "**30-day letter**". Within the letter, the agent takes his or her position, documents what should be changed, why, and further lays out the changes in tax, as well as any potential penalties and interest.

The taxpayer has 30 days in which to accept the revenue agent's findings or file a written appeal. If the company doesn't respond within 30 days, it loses its right to go to the IRS Appeals Office and obtain administrative review of the agent's proposed adjustments.

In certain instances, the Exam Division may send the case to the IRS National Office in Washington, D.C. The taxpayer's position may have a lot of merit, but the Exam Division doesn't want to let anybody go unnecessarily.

The VCSP is a voluntary program that provides an opportunity for taxpayers to reclassify their workers as employees for employment tax purposes for future tax periods with partial relief from federal employment taxes. To participate in this voluntary program, the taxpayer must meet certain eligibility requirements and apply to participate in the VCSP by filing Form 8952, Application for Voluntary Classification Settlement Program, and enter into a closing agreement with the IRS.

The VCSP allows eligible taxpayers to obtain relief similar to that currently available through the [Classification Settlement Program](#) for taxpayers under examination.

The VCSP, originally released in Announcement 2011-64, has been modified in Announcement 2012-45 to:

- Permit a taxpayer under IRS audit, other than an employment tax audit, to be eligible to participate in the VCSP
- Clarify the current eligibility requirement that a taxpayer who 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
- Clarify that a taxpayer is not eligible to participate if the taxpayer is contesting in court the classification of the class or classes of workers from a previous audit by the IRS or Department of Labor; and
- 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.

[Announcement 2012-45 \(2012-51 I.R.B. 724\)](#) provides notice and information about the revised program.

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 or group of workers) as independent contractors or other nonemployees and want to prospectively treat the workers as employees.

A taxpayer must have consistently treated the workers to be reclassified as independent contractors or other nonemployees, including having filed all required Forms 1099 for the workers to be reclassified under the VCSP for the previous three years to participate.

Additionally, the taxpayer cannot currently be under employment tax audit by the IRS and the taxpayer cannot be currently under audit concerning the classification of the workers by the Department of Labor or by a state government agency.

If the IRS or the Department of Labor has previously audited a taxpayer concerning the classification of the workers, the taxpayer will be eligible only if the taxpayer has complied with the results of that audit and is not currently contesting the classification in court.

Exempt organizations and government entities may participate in VCSP if they meet all of the eligibility requirements.

VCSP Agreements

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

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- Pay 10 percent of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of Section 3509(a) of the Internal Revenue Code. See [Instructions to Form 8952](#);
 - Not be liable for any interest and penalties on the amount; and
 - Not be subject to an employment tax audit with respect to the worker classification of the workers being reclassified under the VCSP for prior years.

Applying for VCSP

To participate in the VCSP, a taxpayer must apply using [Form 8952, Application for Voluntary Classification Settlement Program](#). The application should be filed at least 60 days prior to the date the taxpayer wants to begin treating its workers as employees. The IRS will make every effort to process Form 8952 with sufficient time to allow for the voluntary reclassification on the requested date.

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). However, the taxpayer, and not the taxpayer's representative, is required to sign Form 8952. The IRS will contact the taxpayer or authorized representative to complete the process after reviewing the application and verifying the taxpayer's eligibility.

Eligible taxpayers accepted into the VCSP 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.

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 taxpayer's 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 2016 and 2017 up to the social security wage base | 3509(a) Percentage for compensation in years other than 2016 and 2017 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 | 1.24 | 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 | 10.68 | 10.68 | 3.24 |

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

Example 1: In 2016 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 \$118,500 for 2016). You submit the VCSP application on October 1, 2017, 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 1/01/2018. You look to amounts paid to the workers in 2016 for purposes of calculating the VCSP amount, since 2016 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 \$160,200 (10.68 percent of \$1,500,000). Under the VCSP, your payment would be 10 percent of \$160,200, or \$16,020.

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 \$133,500 (10.68 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 \$141,600 (\$133,500 plus \$8,100), or \$14,160.

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.