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Safe Harbor or Venus Fly Trap? What to Make of the IRS Offer to Voluntarily Settle Worker Misclassification Problems

BY JOHN J. MCGOWAN, JR.

On September 21, 2011, the Internal Revenue Service (''IRS'') announced that it is establishing a new program, called the ''Voluntary Classification Settlement Program'' (also known as ''VCSP''), to help organizations more easily fix worker re-classification problems they currently may have. VCSP's terms are scheduled to be published on October 11, 2011, in *Announcement 2011-64*. Those organizations that have a persistent worker misclassification problem—a situation that could include a number of organizations that weathered the Recession over the past 3+ years—may well find VCSP to be an inviting offer.

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But is it? Should organizations consider it a good opportunity to revisit those temporary work force fixes used during the Recession to avoid hiring employees now that those ''temporary'' work relationships are several years old? And for organizations that have long relied on work performed by ''others,'' should they treat it as a once-in-a-lifetime opportunity to revamp (or at least, tune) their business model? Or is this offer something else entirely? Carefully considered, the IRS offer could be viewed as something like a Venus Fly Trap: a seemingly sweet offer that could end up costing an organization dearly once the true costs are considered. As with many things, the truth likely lies somewhere in between.

VCSP's Terms and Conditions

It first pays to understand as precisely as possible the IRS offer, which the IRS characterizes as entirely voluntary. According to the *Announcement*, to take advantage of the offer an organization nominally must:

1) identify those workers (or the group or class of workers) being reclassified, and then voluntarily reclassify them as its own employees,

2) enter into an appropriate settlement agreement with the IRS, known as a ''closing agreement,''

3) pay a modest federal employment tax penalty in respect of the prior misclassification (generally, 10 per-

cent of the employment tax liability that would have been due for the most recent tax year if the workers had been properly classified, although the details are somewhat unclear[1]), and

4) agree to extend, for three years, the limitations period used to assess employment taxes, for the first three calendar years following the signing of the closing agreement.

In addition, the organization (a) must not currently be under audit by the IRS, or by the United States Department of Labor (''DOL'') or a state governmental agency, and (b) must have consistently treated the workers being reclassified as nonemployees during the prior three years (including reporting payments made to them on Form 1099, where required). A number of additional details—the kind that keep employment tax lawyers up nights—are missing from the *Announcement*, including the impact participation will have on the organization's failure to withhold and remit federal income taxes[2] and the scope (and limitations) placed on the closing agreement itself.[3] Presumably, these additional details will become known once *Announcement 2011-64* is posted on the IRS's website and the initiative is ready to be fully implemented.

Given all that recently has occurred on the worker misclassification front, the IRS offer certainly could be viewed as benevolent. On September 19, 2011, just two days before the IRS announced that it would be implementing VCSP, DOL announced that it had entered into a memorandum of understanding with the IRS—and had forged similar agreements with officials representing 11 states from different parts of the country[4]—to coordinate and enhance its worker misclassification enforcement efforts.

Putting to one side (at least, for the moment) how the IRS and DOL hope to carry out that initiative, since each agency has no choice but to apply different legal standards (the DOL, alone, will have to apply at least two or three different standards, depending on the employment statute(s) sought to be enforced),[5] there likely is far more to the IRS offer than meets the eye—and several reasons why prudent organizations should pause before rushing out to contact the nearest IRS office—even those organizations that determine (or already know) they cannot make a colorable case for classifying certain of their workers as independent contractors or other non-employees. At least five reasons come to mind for exercising some caution.

Reasons for Exercising Caution

First, there is no going back. The IRS makes clear in VCSP that an organization that participates in the Pro-

[1] *Announcement 2011-64* describes this penalty as ''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 [without interest or penalties].'' The *Announcement* presumably refers to paragraph (a)(2) of Section 3509, which imposes an employment tax-related penalty of 20 percent of the amount otherwise imposed under subchapter A of chapter 21 (the employment tax provisions).

[2] *Announcement 2011-64* only addresses an organization's failure to properly withhold and remit, or pay, federal employment taxes. While one can reasonably infer from the *Announcement* that no failure-to-withhold penalty will be assessed in respect of income taxes (since the *Announcement* explicitly mentions Section 3509 of the Internal Revenue Code, which has such a penalty provision), as a general matter an employer is secondarily liable for any federal income taxes it fails to withhold and remit on behalf of its employees. 26 U.S.C. § 3403 (2011) and Treasury Regulations § 31.3403-1 (liability for tax). As such, the VCSP leaves unaddressed whether the IRS can, or would, hold the erstwhile employer liable for failing to withhold and remit the workers' federal income taxes if those workers were found to have left that income off their personal income tax returns in any of the open tax years.

[3] Closing agreements, which are explicitly defined in 26 U.S.C. § 7121 (2011), are final and binding on the U.S. government, but only ''as to the matters agreed upon.'' *Id.* at subsection (b); also, Treasury Regulations § 301.7121-1(c). The courts are known to construe the terms of a closing agreement strictly, because of its binding effect on the federal government. For a general discussion of how courts view closing agreements, see *Vail Resorts, Inc. v. United States*, Civ. No. 09-cv-02104-WYD-CBS, 2011 US. Dist. *LEXIS* 71864 (D. CO; July 1, 2011) (strictly construing unambiguous passages, differentiating between operative provisions and mere recitals, etc.). For a recent, telling example of how the Tax Court strictly limits the government's obligations in a closing agreement to just those specifically addressed in a worker misclassification case, and how the IRS will act to its advantage if it uncovers other violations, see *Tree-Tech, Inc. v. Comm'r*, T.C. Mem. 2011-162 (July 11, 2011).

[4] According to the news release the DOL published September 19, 2011, those states are (in alphabetical order): Connecticut, Hawaii, Illinois, New York, Maryland, Massachusetts, Minnesota, Missouri, Montana, Utah and Washington.

[5] The legal standards used to determine ''employee'' status can vary widely from federal statute to federal statute. The tax standard, which is based on 20 ''common law'' factors identified more than 25 years ago in *Rev. Rul. 87-41*, 1987-1 C.B. 296, differs markedly from the primary federal ''employment'' statutes—the Employee Retirement Income Security Act (''ERISA'') which regulates pensions, health care and other benefits; the National Labor Relations Act (''NLRA'') which regulates ''concerted'' activity and union organizing and representation; the Fair Labor Standards Act (''FLSA'') which regulates wage and hour matters such as the right to overtime; and the Age Discrimination in Employment Act (''ADEA''), the Americans with Disabilities Act (''ADA'') and Title VII of the Civil Rights Act (''Title VII'') which regulate employment-based discrimination predicated on one's age or immutable characteristics. Each has been the focus of at least one United States Supreme Court case. E.g., *Nationwide Mut. Life Ins. Co. v. Darden*, 503 U.S. 318, 323-324, 14 EBC 2625 (1992) (using 12 factors to determine who qualifies as an ''employee'' for ERISA purposes); *Walling v. Portland Terminal Co.*, 330 U.S. 148, 150-153 (1961) (rejecting use of a common law standard, articulating the economic dependence standard to determine who qualifies as an ''employee'' protected by the FLSA); *NLRB v. Town & Country Electrical, Inc.*, 516 U.S. 85, 94-95 (1995) (relying in part on *Darden* to determine who qualifies as an ''employee'' for NLRA purposes, but noting important differences in the NLRA's statutory definition when examining a concurrent employment situation); and *Clackamas Gastroenterology Assoc., P.C. v. Wells*, 538 U.S. 440 (2003) (BNA's *Pension & Benefits Daily*, 78 PBD, 4/24/03) (again, endorsing *Darden*'s emphasis on the use of common law factors as generally relevant to determine who qualifies as an ''employee'' for ADA purposes, and implicitly for ADEA and Title VII purposes, *id.* at 444-445, but there adopting a 6-factor test to determine whether shareholder/owners qualified as ''employees''—counting parties' intent as one of the factors; *id.* at 449-450). As a practical matter, that makes it impossible for federal agencies operating under different federal statutes—even the IRS and the DOL—to collaborate and adopt a single standard that can be enforced uniformly.

gram must agree to prospectively treat the class of workers being reclassified as employees for all future tax periods. While hardly surprising, that means any organization that enters into an agreement with the IRS under VCSP but later reneges on the agreement with respect to future workers (whether as a result of buyer's remorse, expediency, or otherwise) is doing more than just breaching an agreement with the IRS; it likely is engaging in the ''willful'' misclassification of workers. That can be criminal under both federal and state law.[6]

Second, reclassifying a worker—most often, from independent contractor to employee (although VCSP by its terms can be used to also reclassify ''other nonemployees'' such as leased employees, presumably transforming such employees into joint or concurrent employees)—confers important substantive and procedural rights on the worker, which the newfound ''employer'' then will be hard-pressed to deny. As already noted above (*see* Note 5), substantially different legal standards are used to determine who qualifies as an ''employee'' entitled to sue for overtime under the FLSA, as opposed to who can organize and bargain collectively under the NLRA, or who can sue for pension or medical benefits under ERISA, or who can seek relief on the grounds that they were discriminated against because they are too old (ADEA), have a disability (ADA) or are a minority (Title VII). However, how the parties are treating the relationship for tax purposes frequently appears on the list of factors to be considered, notably including ERISA[7] and the employment discrimination statutes.[8] Indeed, one federal statute (the NLRA) specifically denies independent contractors the right to organize and bargain collectively[9]—which means that an organization that elects to reclassify its workers as employees under the VCSP has, in effect, given those workers the right to organize and bargain collectively.

Third, just because an organization has settled with the IRS (in the end, presumably as to all withholding and remittance and employment tax matters, but most important not as to other issues within the IRS' purview[10]) does not mean the organization has settled anything else with anyone else. Nothing prevents a reclassified worker—or a governmental agency other than the IRS, such as one of the DOL's many subordinate agencies (e.g., EBSA, OSHA, OFCCP, etc.)—from challenging the organization over its past practices, or treating the organization's deal with the IRS as a key admission. The relevant statutes of limitation vary, and while several are comparatively short (such as the FLSA's two-year statute of limitations for non-willful violations[11]) others can be ponderously long (such as a 15-year statute of limitations for bringing a claim for plan benefits under the extant terms of an ERISA-regulated plan sitused in Ohio[12]). As noted above (*see* Note 3), only the IRS and the signatory taxpayer (here, the organization) are bound by a closing agreement. That means that any closing agreement, which is discoverable, has to be carefully negotiated with a view to how its terms will be viewed—and potentially used—in other contexts.

Fourth, for organizations with otherwise small numbers of employees, reclassifying a worker as an employee (and especially if reclassifying entire groups of workers as employees) can change the organization's

[6] The failure to collect and remit federal withholding taxes is considered a criminal act, in the absence of ''reasonable doubt.'' 26 U.S.C. § 7215 (2011). A variety of states, including California and Connecticut, also make willful misclassification of workers a crime. *E.g.*, Calif. Labor Code § 226.8 (2011). Such states could well decide to put in evidence the organization's closing agreement with the IRS as ''Exhibit A'' in any criminal action state prosecutors decided to bring.

[7] See *Nationwide Mut. Life Ins. Co. v. Darden*, 503 U.S. 318, at 323-24 (adopting the 12-factor standard used in *Community for Creative Nonviolence v. Reid*, 490 U.S. 730, 751-52 (1989) (construing ''employee'' for copyright purposes), including specifically ''the tax treatment of the hired party''). While not all federal standards explicitly cite tax treatment as one of their enumerated factors, many do (see Note 5, and the discussion of how the *Darden* factors appear to have been adopted for use in Title VII, ADEA, and ADA cases involving nonemployee workers), it is apparent that an individual's classification as an employee can influence judicial thinking even when a radically different standard is being considered, such as the 5-factor standard used in wage-and-hour cases. *See, e.g., Thibault v. Bell South Telecom, Inc.*, 612 F.3d 843, 848-849 (5th Cir. 2010) (in a FLSA case, distinguishing *Carrell v. Sunland Constr., Inc.*, 998 F.2d 330 (5th Cir. 1993) and discussing classifying a worker as an employee for tax purposes as among the ''other factors'' to be considered).

[8] See Note 5, above, citing *Clackamas Gastroenterology Assoc., Inc. v. Wells* (adopting a 6-factor test, which includes parties' intent as one of the 6 factors).

[9] Indeed, the NLRA was specifically amended to exclude ''any individual having the status of an independent contractor,'' 29 U.S.C. § 152(3) (2011), a point that did not escape Supreme Court notice in *Town & Country*. 516 U.S. 85, at 91-92.

[10] The closing agreement envisioned in *Announcement 2011-64* doubtlessly only covers payroll-related tax issues, such as failure to withhold and remit and failure to pay issues. It doubtlessly will *not* apply (or, be read to apply) to employee benefit plan-related issues such as whether an employer's benefit plans benefit an appropriate percentage of the employer's employees under 26 U.S.C. § 410(b) (2011), or whether (in the case of certain tax-exempt organizations) the employer's plans have been made available to all of its employees (subject to some exceptions), as required by 26 U.S.C. § 403(b)(12) (2011)–which can trigger other sanctions. Any ERISA/employee benefits practitioner, directly or indirectly involved with worker misclassification issues, would benefit from reading carefully *Tree-Tech v. Comm'r* (discussed above, in Note 3), with these considerations in mind.

[11] 29 U.S.C. § 255(a)(2011). Notably, the statute of limitations that applies to wage-and-hour actions, both for purposes of the right to bring the action and also the period covered by the dispute, expands to three years from two if an employer is found to have acted willfully. As discussed later in this article, how organizations respond to the IRS offer, and to some of the other pending enforcement activities in this area, could affect whether the organization is held to have acted willfully.

[12] The limitations period for bringing a claim for benefits under the terms of an ERISA-regulated employee benefit plan is based on the most analogous (and applicable) state statute, because Congress in ERISA only included a statute of limitations for breaches of fiduciary duty and statutory violations. *Compare* 29 U.S.C. § 1113 (2011) (affixing a 6-year statute of limitations; three years where the plaintiff can be shown to have had actual knowledge) with *Meade v. Pension Appeals & Review Comm.*, 966 F.2d 190, 195, 15 EBC 1755 (6th Cir. 1992) (applying Ohio's 15-year statute of limitations). For a good discussion of the problems associated with identifying the proper statute of limitations to be used in ERISA benefit claims cases, see generally, Burke and Sacco, *The Uncertainty and Unpredictability of The Limitations Period For Claims for Benefits Under ERISA § 502(a)(1)(B)*, Bloomberg Law Reports—Employee Benefits, Vol. 4, No. 13 (2011).

status from being considered a ''small'' employer exempt from any number of legal requirements to being fully subject to them. For instance, the Patient Protection and Affordable Care Act (''PPACA'') only requires organizations that employ 50 or more full-time *employees* to choose between providing their full-time employees with ''essential health benefits'' on an affordable basis (i.e., economically significant medical coverage), or paying a potentially substantial tax penalty ($2,000 per full-time employee, per year).[13] Other examples include the ADEA (applicable only to employers with at least 20 full-time employees; 29 U.S.C. § 630(b)(2011)), Title VII (applicable only to employers with at least 15 full-time employees; 42 U.S.C. § 2000(b)(2011)), the ADA (applicable only to employers with at least 15 full-time employees; 42 U.S.C. § 12111(5) (2011)) and the Medicare Secondary Payer rules (applicable only to employers with at least 20 full-time employees; 42 U.S.C. § 1395y(b)(2011)). Any organization on the tipping point of having to comply with one or more of these federal employment, health care, and benefit statutes (or a variety of others) needs to carefully weigh the full impact on its business model of formally expanding its ranks.

Fifth, the mere fact that the IRS has invited taxpayers to ''voluntarily'' come clean has potentially ominous implications—particularly for those organizations that choose to partially or completely decline the ''offer—in light of recently-announced IRS, DOL and state agency enforcement efforts, and state laws that heavily sanction businesses that ''willfully'' misclassify some or all of their workers.[14] Leaving to one side the fact that *Announcement 2011-64* has a ''come forward or else'' quality to it, given its reference to Section 3509 of the Internal Revenue Code,[15] the dividing line between inadvertent non-compliance and willfulness is not clearly drawn; an organization that turns down the IRS offer despite having workers who clearly qualify as its employees (at least, for federal tax purposes) could well be portrayed as a recidivist and treated harshly—regardless whether discovered by the IRS or the DOL on audit, or challenged in court by affected workers. The same holds for an organization that chooses to participate in VCSP with regard to some, but not all, of its workers. Such an organization would be well advised to carefully consider (and carefully document) any workers it decides to hold out of VCSP, to make sure it has at least a colorable basis for classifying them as non-employees or someone else's employees, to guard against later being accused of having been ''willful'' or for having operated with reckless or intentional disregard of relevant law.

Prudent Steps to Consider Taking

There are no simple or obvious ''red car''/''blue car'' choices to be made here. That is why this area of law has proven to be so vexatious for both employing organizations and government agencies, and why any solution touted as simple almost certainly is simplistic. But that does not mean that it does not make sense for an organization which routinely uses non-employee workers to perform ''employee''-type work to seriously consider this most recent IRS offer, before some federal or state agency—or the workers themselves—take the matter into their own hands. It just means that the decision, and all of the potential repercussions, need(s) to be carefully weighed.

In the end, an organization that finds itself tempted by this most recent IRS offer would do well to take the following steps:

- Have competent legal counsel conduct an objective review of all potential cases of worker misclassification, to determine whether at least a colorable case can be made that the current classification is defensible. While there certainly are many capable tax advisors and consultants out there, able to conduct this sort of review from a tax perspective in other circumstances, relatively few have a solid understanding of the employment law consequences, and none will be able to withstand a DOL subpoena, or a subpoena from a state agency conducting a related investigation.[16]

- Have competent legal counsel—here, one capable of assessing both the tax and non-tax consequences of the offer embodied in *Announcement 2011-64*—review all of the potential collateral consequences that could result from participating in VCSP, before deciding whether to approach the IRS (much less sign on the dotted line).

- To the extent possible, conduct a discrete and internal ''all's quiet'' review, to assess whether any of the affected workers are, or would be inclined to, use a formal change in their status as a springboard for organizing, or asserting personal claims under federal or state non-discrimination, benefits, or wage-and-hour laws—and in particular, claims that could have retroactive effect or more wide-ranging consequences.

- Conduct a thoughtful, and pragmatic, assessment of the potential for audit, given the recently-announced IRS, DOL , and state-based enforcement activities, particularly if the potentially affected workers are located in any of the eleven states currently partnering with the

[13] PPACA § 1513; also, 26 U.S.C. §§ 4980H (imposing the employer mandate generally), and 4980H(c)(2)(A) (2011) (carving out a small employer exemption).

[14] Indeed, VCSP could easily be viewed as just a ''raise the stakes'' move by IRS, where organizations that decline the IRS offer are to be branded having willfully or deliberately misclassified their workers, possibly in violation of a variety of state laws such as CA Labor Code § 226.8 (and comparable Pennsylvania, Connecticut and other states' laws).

[15] Section 3509 (found at 26 U.S.C. § 3509 (2011)) provides reduced failure-to-withhold and employment tax penalties for organizations that fail to withhold and remit or pay federal income and employment taxes due to the misclassification of workers. However, those reduced penalty provisions explicitly do not apply in cases involving intentional disregard of the requirements. Section 3509, subsection (c). Whether a taxpayer that declines to come forward under *Announcement 2011-64* would be considered to be operating in *intentional disregard* remains to be seen.

[16] While the Internal Revenue Code now has so-called ''accountant-client'' privilege, which protects a taxpayer's non-criminal communications with any ''federally authorized tax practitioner'' from being subpoenaed by the IRS or other federal agency in a ''tax matter'' or a ''tax proceeding'', see 26 U.S.C. § 7525 (2011), it pays to remember that in employment-related situations, a civil attack can come from private parties (here, the workers themselves) or from other federal and state agencies not bound by that statute—and a criminal proceeding is not covered at all.

DOL in its most recently-announced initiatives, taking into account the possibility that an audit by any of the eleven participating states could trigger a nationwide audit by the DOL and/or the IRS. Consider the extent to which the decision to participate in VCSP (or, not doing so) could affect the organization's benefit plans or jeopardize their regulatory status, and/or change the organization's legal position either in regards to a subsequent DOL or state agency-initiated audit or in regards to the initiation of private litigation—especially wage-and-hour litigation (which could raise the specter of an additional year of exposure; *see* Note 11, and its discussion of expanding the wage-and-hour statute of limitations from two years to three years).

- To the extent possible, secure an advance copy of the closing agreement (if made available on the IRS website, or if capable of being secured by counsel by approaching the IRS on a ''John Doe'' basis) to determine whether its terms preclude the organization from taking other positions regarding the worker's ''employee'' status for other (i.e., non-payroll tax) purposes—and to determine the extent to which the agreement does *not* preclude the IRS from doing so.

- For those organizations that do choose to participate in VCSP, to the furthest extent possible demand that language be included in the closing agreement, in its substantive provisions and not merely in its recitals (which could be viewed as precatory), which indicates that by entering into the agreement the organization does not agree or concede that the subject workers qualify as employees for any other federal or state law purposes.

Conclusion

The old axiom—the one which advises ''look before you leap''—applies with full force here. Organizations that find themselves with workers for whom there is no effective defense to reclassification (where such workers clearly can be shown to be the organization's employees under virtually all legal standards), probably should take advantage of the IRS offer but should exercise appropriate care when doing so, and need to participate in VCSP with their proverbial eyes open. Those that use workers whose legal status is far less clear, though (or, organizations that find themselves with a mix), would do well to first pause, and reflect.