

IRS Gives Employers a Break on Payrolls

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Businesses that have been improperly labeling their employees as independent contractors got a surprise break Wednesday: A new Internal Revenue Service program will allow those businesses to reclassify workers and make only a small payment to cover past payroll taxes.

The downside for such companies? Regulators say they are going to be more vigilant about misclassification of workers in the future.

At issue is whether a worker is deemed an employee or an independent contractor. The proper classification depends on factors including how much control or direction an employer wields over workers.

Employees are entitled to benefits and legal protections, and their wages are subject to payroll taxes. Companies aren't required to withhold income taxes from independent contractors or pay Social Security or Medicare taxes for them. Independent contractors also aren't covered by many labor protections, including minimum-wage and overtime laws, and unemployment or workers' compensation insurance.

The trouble for businesses, however, is that the distinction between the two categories is vague. The current law is based on a common-law standard involving some 20 factors.

"Despite the IRS's program, the law remains unclear," said Bill Rys, tax counsel of the National Federation of Independent Businesses. "For some firms there are three different sets of rules defining who is an employee," he said.

Calling a worker an independent contractor instead of an employee can save companies money. On Monday Labor Secretary Hilda Solis said employers can knock 20% to 30% off their labor costs by classifying employees as independent contractors.

A Government Accountability Office report in 2009 found that misclassification in the 2006 tax year cost \$2.72 billion in unpaid federal taxes, plus unpaid assessments for state workers' compensation and unemployment insurance programs.

The same report said the extent of misclassification is unknown, but the Obama administration has pointed to studies suggesting it might affect 10% to 30% of U.S. companies.

Under the new IRS initiative, called the Voluntary Worker Classification Settlement Program, firms will owe about 1% of wages paid to reclassified workers in the past year, with no interest or penalties due.

To be eligible, a company must have consistently treated the workers as nonemployees; have filed required 1099 tax forms for the past three years; and not be under a worker classification audit by federal or state agencies.

Although the program is open to companies of any size, the agency expects most applicants to be smaller businesses, because they tend to have looser structures and fewer personnel.

The IRS's Tuesday announcement is part of a broader effort to rein in misclassification. On Monday, officials from the Labor Department, IRS and seven states announced an agreement to work together to curb the practice.

The Labor Department is already investigating pay practices in the home-building industry, where subcontractors handle much of the work for big builders. In June, the Labor Department said it recovered \$203,323 in back wages for 224 drywall installers working for two companies.

In its Deficit Reduction proposal earlier this week, the Obama administration also asked Congress to change a current provision of the law preventing the IRS from issuing new guidance about how to classify workers.

But in what seemed to be a recognition of the business community's concern about over-regulation, Ms. Solis said this week that the Labor Department will work with the IRS and meet regularly not only to share information but also to "strategically educate" employers about compliance.

She said many employers don't understand the rules they must abide by, such as immigrant-owned businesses, and said it is important to educate various communities and stakeholder groups.