

IRS Break on Independent Contractors Called Risky:

Reclassifying freelancers as employees could subject employers to whopping fees and restrictions under ERISA.

The IRS has begun offering employers who have misclassified their employees as independent contractors a chance to come clean with a minimal amount of tax liability. But such employers should make sure they have erred before they come forward because reclassification could cost them much more than those tax payments.

The IRS launched a program September 21, claiming it “will enable many employers to resolve past worker classification issues and achieve certainty under the tax law at a low cost by voluntarily reclassifying their workers.”

The program will give employers the chance to properly reclassify as employees workers they had incorrectly treated as independent contractors by making a “minimal payment covering past payroll tax obligations rather than wait for an IRS audit, “ according to a press release issued by the service.

Indeed, an employer who takes part in the plan would pay just 10% of the employment-tax liability on worker’s pay for the most recent tax year and not be charged any interest and penalties on the liability. Further, the taxpayer wouldn’t be subject to an employment-tax audit for the classification of the workers in past years.

In exchange, employers must agree to prospectively treat the specified class of workers as employees for future periods. Further, they must agree to extend the period of limitations on assessment employment taxes for three years for the first, second, and third calendar years after the date when the taxpayer began treating the workers as employees.

To be eligible, employers must have consistently treated workers as nonemployees and have filed all required 1099 forms for them for the previous three years. The taxpayer can’t be under a current audit by the IRS, or an audit by the Department of Labor or by a state government agency concerning the classification of the workers.

For many companies, the IRS program amounts to a pretty good deal, attorneys say. “Eligible businesses should consider taking advantage of this opportunity to limit their liability in this often unclear area of tax law,” states an alert published on September 22 by Fulbright & Jaworski, a law firm.

But there’s also abundant risk in the act of worker reclassification. Part of the appeal for employers in maintaining independent-contractor status for workers is that it frees companies from a host of taxes, in addition to restrictions they would incur under the Employee Retirement Income Security Act if the workers were dubbed employees. “Drastic consequences can result if a business’s independent contractors are reclassified as employees, both at an individual worker level, as well as at the plan level,” warns the alert.

For example, independent contractors who become employees “may be entitled to retroactive benefits, such as restricted stock options. Further, the plan would have to be retested to ensure that it is a nondiscriminatory plan, as the newly classified employees would have to be taken into account,” the alert notes. Employers may also be slapped with Federal Insurance Contributions Act (FICA) taxes they have failed to withhold, plus federal unemployment taxes.

The program is part of a broader move by the IRS to push employers to classify workers as employees “because there’s more of an increase of tax receipts captured up front,” says, Tom Bohn, chief executive of the Institute of Financial Operations, an association representing 8,000 corporate back-office professionals specializing in such areas as accounts payable, accounts receivable, and payroll.

Via payroll deductions, the IRS can automatically capture FICA taxes charged to employees throughout the year. In contrast, independent contractors pay taxes at the end of the year after corporate taxpayers issue 1099 forms to them.

Desperate for quicker sources of revenue, “the government is rummaging in the couch, looking for spare change,” says Bohn, referring to its push to get independent contractors onto corporate payrolls.