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TAXATION SECTION  
TAX POLICY, PRACTICE  
& LEGISLATION COMMITTEE  
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**LEGISLATION TO CREATE AN EDD VERSION OF THE IRS  
VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM**

This proposal was prepared by James Bourbeau.<sup>1</sup> The author wishes to thank reviewers Steven Walker and Will Weissman for their helpful comments.<sup>2</sup>

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<sup>1</sup> **The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the State Bar of California or the Taxation Section of the State Bar.**

<sup>2</sup> Although the participants on this project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

## EXECUTIVE SUMMARY

In 2012, the federal government collected approximately \$850 billion in payroll taxes.<sup>3</sup> According to the California Employment Development Department (EDD), from July 1, 2013, through September 30, 2013, California collected \$1,027,219,798 in Unemployment Insurance contributions, \$1,362,526,478 in Disability Insurance contributions, \$10,196,027,650 in Personal Income Tax, \$9,957,025 in Employment Training Tax, and a \$26,835,839 Contingent Fund collected from penalties and interest assessed against employers for delinquent payment of Unemployment Insurance taxes.<sup>4</sup> The total “payroll tax” collected for the third quarter of 2013 was \$12,622,566,790. Multiplied by four quarters, the EDD collects \$50 billion per year in payroll taxes (give or take a few million), a considerable fraction of the federal government’s annual collection amount.

Employees are subject to payroll taxes and income tax withholding. Independent contractors are not. The misclassification of workers results in a loss of payroll tax revenue to the State, estimated at \$7 billion per year. The EDD exerts considerable effort in enforcing assessments for the misclassification of workers.

The IRS offers a Voluntary Classification Settlement Program (VCSP) whereby it grants partial tax relief for businesses who reclassify their workers from independent contractors to employees for employment tax purposes for future tax periods. There is no EDD equivalent to the IRS VCSP.

The solution proposed by this paper is very simple: i.e. the creation of an EDD equivalent to the IRS VCSP. Because the EDD does not have authority similar to the IRS to make settlements in regard to tax liabilities, state legislation would need to be drafted and passed, amending the CUIC, and either expanding the EDD’s general settlement authority or authorizing it to implement an EDD VCSP. An EDD VSCP would incentives employers to seek compliance with worker classification law and would save the State of California considerable tax enforcement resources.

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<sup>3</sup> <http://www.npr.org/blogs/money/2012/04/13/150441259/what-america-pays-in-taxes>

<sup>4</sup> [http://www.edd.ca.gov/about\\_edd/Quick\\_Statistics.htm](http://www.edd.ca.gov/about_edd/Quick_Statistics.htm)

## DISCUSSION

### I. CURRENT LAW

The IRS has broad authority to settle tax liabilities. Federal law authorizes the Secretary of the Treasury, i.e. the Internal Revenue Service (IRS) to enter into settlement agreements with taxpayers. (26 U.S.C. § 7121.)

Under its authority to settle, the IRS currently implements a VCSP under the original Classification Settlement Program (CSP). According to the IRS, the CSP allows taxpayers and tax examiners to resolve worker classification cases as early in the administrative process as possible, reducing taxpayer burden, and also helps to ensure that the taxpayer relief, (i.e. “safe harbor”) provisions for worker classification under Section 530 of the Revenue Act of 1978 are properly applied. 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 of workers) as independent contractors or other nonemployees and want to prospectively treat the workers as employees. To be eligible, a taxpayer must have consistently treated the workers as nonemployees, and must have filed all required Forms 1099, consistent with the nonemployee treatment, for the previous three years with respect to the workers to be reclassified. The taxpayer also cannot currently be under employment tax audit by the IRS. Furthermore, the taxpayer cannot be currently under audit concerning the classification of the class or classes of workers by the Department of Labor or by a state government agency. A taxpayer who was previously audited by the IRS or the Department of Labor concerning the classification of the class or classes of workers is eligible for the VCSP if the taxpayer has complied with the results of that audit and is not currently contesting the classification in court.

A taxpayer who participates in the VCSP agrees to prospectively treat the class or classes of workers identified in the application as employees for future tax periods. In exchange, the taxpayer pays 10 percent of the employment tax liability 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 such year, determined under the reduced rates listed in 26 U.S.C. § 3509(a); is not liable for any interest and penalties on the liability; and is not subject to an employment tax audit with respect to the worker classification of the class or classes of workers for prior years.

In contrast, the EDD has a more narrow authority to settle tax liabilities. The California Unemployment Insurance Code (Code) allows the EDD to settle certain

civil employment tax disputes. (See Unemp. Ins. Code §1236.)

Generally, the EDD will only consider a settlement offer when the assessment or denial of claim for refund is under petition with the California Unemployment Insurance Appeals Board (CUIAB), or under a civil writ or appeal. The CUIC specifies that a tax “dispute” must exist in order for the EDD to enter into a settlement; whereas, the IRS has broad authority to “enter into an agreement ... [with a taxpayer or their estate] ... in respect of any internal revenue tax for any taxable period.” (See Unemp. Ins. Code §1236; and 26 U.S.C. § 7121.) If the matter is not in “dispute,” the EDD will not consider settlement under Section 1236. The EDD Settlement Program is not a voluntary tax forgiveness program, like the IRS VCSP, but rather considers the risk of loss for the State and the cost of litigation balanced against the benefits of reaching a settlement agreement. Issues of fairness, financial hardship, and the survival of the business may be considered to establish a settlement amount, but cannot be used as the sole reason for entering into a settlement agreement.

The IRS VCSP does not require a disputed matter, and in fact, will not consider taxpayers currently under audit. It is, effectively, an open door to compliance for those employers who wish to proactively approach the government.

To the best of the author's knowledge, the EDD has no official policy on whether it contemplates an EDD VCSP or similar program. The EDD states the following response to the question “Is EDD cooperating with the IRS in the [VCSP], and is EDD receiving information from the IRS about the employers who have entered into this IRS program?”: “The EDD is not participating in the [IRS VCSP]. The IRS and EDD exchange data for the purpose of verifying compliance on a variety of tax issues which may be affected by the result of an employer’s participation in the IRS VCSP program.” (*Fall 2012 – EDD Responds to CSEA Questions from the CSEA State Tax Agencies Liaison Meeting* at <http://www.csea.org/advocacy/latest-advocacy-issues/>, accessed on May 15, 2013.)

## **II. PROPOSED CHANGE**

The solution proposed by this paper is the creation of an EDD equivalent to the IRS VCSP. Because the EDD does not have authority similar to the IRS to make settlements in regard to tax liabilities, state legislation would need to be drafted and passed, amending the CUIC, and either expanding the EDD’s general settlement authority or authorizing it to implement an EDD VCSP.

## **III. WHY AN EDD VCSP?**

The effect of misclassification upon employment tax revenue generation is substantial. It is estimated that from 2005 to 2010, the number of independent contractors and other workers who are not covered by unemployment insurance swelled by 4 million to 40 million, or 23% of the U.S. workforce.<sup>5</sup> In 2010, the Deputy Secretary of the U.S. Department of Labor, Seth Harris stated the following before the U.S. Senate Committee on Health, Education, Labor, and Pensions:

“One measure of the scope of the misclassification problem is its effect on tax revenues. A 1984 IRS survey estimated that nearly 15% of employers misclassified some employees as independent contractors under the tax laws, with an estimated revenue loss of \$1.6 billion in 1984 dollars.<sup>6</sup> A 1994 Coopers & Lybrand study estimated that misclassification would cost the Federal government \$34.7 billion between 1996 and 2004.<sup>7</sup> The Planmatics 2000 study concluded that between 10% and 30% of the employers audited had misclassified some employees as independent contractors.<sup>8</sup> The economy has changed significantly since those studies were performed, and even the number of workers that self-identify as independent contractors has grown.<sup>9</sup> Still, these numbers suggest that misclassification occurs in significant numbers and, across the country, workers are finding themselves without the basic protections that Congress has enacted to ensure they receive fair pay, safe workplaces, and necessary supports when they are hurt or lose their jobs. Several recent studies suggest that misclassification results in significant losses to state UI and workers’ compensation funds in addition to tax revenue. When employees are misclassified, their employers typically do not pay unemployment taxes or carry workers’ compensation insurance for those employees. As a result, UI and workers’ compensation funds are underfunded. Moreover, employers that obey the law end up carrying the weight for scofflaws in the form of higher workers’ compensation premiums.”

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<sup>5</sup> Data Spotlight: Independent Contractors On the Rise <http://www.economicmodeling.com/2011/04/29/independent-contractors-other-noncovered-workers-on-the-rise/>

<sup>6</sup> Strategic Initiative on Withholding Noncompliance (SVC-1), Employer Survey, Report of Findings, Ken Beier, Unpublished: Department of the Treasury, Internal Revenue Service, June 1989.

<sup>7</sup> Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers, Coopers & Lybrand (June 1994).

<sup>8</sup> Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs, Lalith de Silva et al, Planmatics, Inc. (2000).

<sup>9</sup> In its 2005 Survey on Contingent and Alternative Employment Arrangements, the Bureau of Labor Statistics found that the number of workers who identified as independent contractors increased by 15%, from 6.4% to 7.4%, since 2001. <http://www.bls.gov/news.release/pdf/conemp.pdf>.

While the EDD should be attracted by a possible increase in employment tax revenue from the creation of an EDD VCSP, currently employers who may be aware they have misclassified workers lack any incentive to come into compliance. This is due, in part, to the fact that participants in the IRS VCSP are still subject to audit by the EDD for current and prior periods. Re-classifying workers as employees with IRS may require taxpayers to do the same with the EDD. Participation in the IRS VCSP, at least, creates a compliance conflict with employment tax reporting at the state level. This poses a twin dilemma: California businesses are de-incentivized from entering into the IRS VCSP, because to do so will make them vulnerable to EDD assessment; and, issues stemming from misclassification of California businesses are protracted.

An EDD voluntary settlement program with protections similar those of the IRS VCSP would incentivize employers to come into compliance in both state and federal employment tax reporting of “misclassified” workers. Taxpayers would also rest assured that entry into the IRS VCSP would not subject them to an EDD audit with full exposure for liability and penalties.

The EDD currently does not have the legal authority to forgive assessment and penalties for prior periods, as exists in the IRS VCSP. If an employer does not correct prior periods to report the voluntarily reclassified workers to the EDD and the employer is subsequently selected for an EDD audit, the employer will be assessed for any unreported and unpaid payroll taxes, plus any applicable penalties and interest. It is possible that the EDD might waive a penalty for not reporting due to negligence. (Unemp. Ins. Code § 1127.) Beyond such a waiver, there is little if anything the EDD is authorized to accomplish in the way of offering in settlement when approached by a taxpaying unit, prior to assessment and petition. Further, the fact that an employer enters into the IRS VCSP does not exempt them from being audited by EDD and does not provide any employment tax immunity under the CUIC with respect to the voluntarily reclassified workers for prior years.

#### **IV. THE EDD WILL LIKELY NEED TO GET FEDERAL BUY-IN TO ESTABLISH AN EDD VCSP**

California is mandated to protect the Unemployment Insurance (UI) Trust Fund. The California UI Program is part of a national plan of unemployment reserves and social security, and is enacted for the purpose of assisting in the stabilization of employment conditions. (Unemp. Ins. Code § 102.) Section 303(a)(1) of the Social Security Act (SSA) requires, as a condition for a state to receive administrative grants for its UC program, that the law of the State provide

for “such methods of administration ... as are found by the Secretary of Labor to be reasonably calculated to insure full payment of unemployment compensation when due.” Section 303(a)(1), SSA, has been interpreted to require that state laws provide for reasonable means to enforce employer liabilities to the State unemployment fund so that UC may be paid when due.

Because the EDD is charged with the maintenance and protection of federal funds, it is likely that the federal government would need to be approached and would need to approve any approach the EDD proposes in regard to an EDD VCSP.

## **V. CONCLUSION**

The EDD, using its relationship with the U.S. Department of Labor (DOL), the IRS, and the California Governor’s Office, in concert with California business and business advocacy organizations such as the California Chamber of Commerce, should propose and draft legislation to create an EDD VCSP. Such a program would likely result in higher compliance in proper worker classification, as well as a tax relief for California businesses, similar to that found in the IRS VCSP.

An EDD VCSP would incentivize compliance with California law concerning the classification of workers. California employers will be less inclined to wait to see if “the shoe drops” and risk and audit and litigation over the subsequent assessment.

Conformity in state and federal tax law will benefit California employers that are or may be out of compliance in regard to worker classification by providing an avenue to come into compliance. Employment tax revenue should increase as a result of participation in an EDD VCSP. Participating employers will save costs in prior years’ assessments, penalties, interest and litigation costs.

Unfortunately, a legislative solution to the creation of an EDD VCSP is an expensive process, demanding the resources of the EDD, the Governor’s Office, the California Legislature, and interested business stakeholders. The creation and passage of such a program into law, while in the author’s opinion important and worthy, may not rise to the level of urgency which would demand the advocacy expenses required. In addition, the EDD might remain satisfied that its enforcement efforts offer a satisfactory method for revenue recovery, and would, therefore, lack enthusiasm to help draft and shepherd legislation to create an EDD VCSP.

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