

California Should Create Its Own Voluntary Classification Settlement Program

by James Bourbeau



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The comments in this article reflect the individual views of the author and do not represent the position of the State Bar of California or the Bar's Taxation Section.

In this article, Bourbeau writes that California should implement an employer voluntary classification settlement program similar to that used by the IRS. He argues that the program would improve employer compliance and reduce problems created by federal and state inconsistency in this area.

The IRS has broad authority to settle tax liabilities, thanks to federal authorization to enter into settlement agreements with taxpayers.¹

Under its authority to settle, the IRS has implemented a voluntary classification settlement program (VCSP) under the original classification settlement program. According to the IRS, the original classification settlement program allows taxpayers and examiners to resolve worker classification cases early in the administrative process, which reduces taxpayer burden, and helps ensure that the taxpayer relief (or 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 treating their workers (or a class of workers) as independent contractors or other non-employees and want to prospectively treat the workers as employees. To be eligible for worker reclassification, a taxpayer must have consistently treated the workers as non-employees and must have filed all required Forms 1099, consistent with the non-employee treatment, for the previous three years. The taxpayer also cannot be under

employment tax audit by the IRS, or under audit regarding the classification of the class or classes of workers by the Department of Labor or a state government agency. A taxpayer who was previously audited by the IRS or the Department of Labor is eligible for the VCSP if it has complied with the results of that audit and is not 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 that year, determined under the reduced rates listed in 26 U.S.C. section 3509(a);
- it is not liable for any interest and penalties on the liability; and
- it is not subject to an employment tax audit for the worker classification of the class or classes of workers for prior years.

In contrast, the California Employment Development Department (EDD) has a narrower authority to settle tax liabilities. The California Unemployment Insurance Code (UIC) allows the EDD to settle some civil employment tax disputes.²

Generally, the EDD will consider a settlement offer only when the assessment or denial of claim for refund is under petition with the California Unemployment Insurance Appeals Board, or under a civil writ or appeal. The UIC 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 its estate "in respect of any internal revenue tax for any taxable period." 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

¹26 U.S.C. section 7121.

²See Unemp. Ins. Code section 1236.

balanced against the benefits of reaching a settlement. 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.

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

To the best of my knowledge, the EDD has no official policy on whether it contemplates an EDD VCSP or similar program. In 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 states:

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.³

California should establish an EDD equivalent to the IRS VCSP. Because the EDD does not have authority similar to the IRS to make settlements regarding tax liabilities, state legislation would need to be drafted and passed, amending the UIC, and either expanding the EDD's general settlement authority or authorizing it to implement an EDD VCSP.

Why an EDD VCSP?

The effect of misclassification on 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 percent of the U.S. workforce.⁴ In 2010 U.S. Department of Labor Deputy Secretary Seth Harris told 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 percent of employers misclassified some employees as independent contractors under the tax laws, with an estimated revenue loss of \$1.6 billion in 1984 dollars.⁵ A 1994 Coopers & Lybrand study estimated that misclassification would cost the federal government \$34.7 billion between

1996 and 2004.⁶ The Planmatics 2000 study concluded that between 10 percent and 30 percent of the employers audited had misclassified some employees as independent contractors.⁷ The economy has changed significantly since those studies were performed, and even the number of workers that self-identify as independent contractors has grown.⁸ Still, those 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.

While the EDD should be attracted by a possible increase in employment tax revenue from the creation of an EDD VCSP, employers who may be aware they have misclassified workers lack incentive to come into compliance. That is because participants in the IRS VCSP are still subject to audit by the EDD for current and prior periods. Reclassifying workers as employees for IRS purposes 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. That poses a twin dilemma: California businesses might be discouraged from entering into the IRS VCSP, because doing so would make them vulnerable to EDD assessment and because issues stemming from misclassification of California businesses are protracted.

An EDD voluntary settlement program with protections similar to those of the IRS VCSP would encourage 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.

⁶Coopers & Lybrand, "Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers" (June 1994).

⁷Lalith de Silva et al., "Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs," Planmatics Inc. (2000).

⁸In 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 percent, from 6.4 percent to 7.4 percent, since 2001.

³See California Society of Enrolled Agents, "Fall 2012 — EDD Responds to CSEA Questions From the CSEA State Tax Agencies Liaison Meeting."

⁴Joshua Wright, "Data Spotlight: Independent Contractors on the Rise," EMSI (Apr. 29, 2011).

⁵IRS, "Strategic Initiative on Withholding Noncompliance (SVC-1), Employer Survey, Report of Findings" (June 1989).

The EDD does not have the legal authority to forgive assessment and penalties for prior periods, as the IRS VCSP does. If an employer does not correct prior periods to report the voluntarily reclassified workers to the EDD and is later selected for an EDD audit, it will be assessed for any unreported and unpaid payroll taxes, plus any applicable penalties and interest.

The EDD's official penalty waiver policy is limited to removal of penalty for good cause and restricted to specific penalty applications. Occasionally however, the EDD will perform an informal reconsideration or adjustment in an assessment, which can include adjusting the assessment itself or waiving penalties outside those specified and subject to its normal waiver policy. Taxpayers that have benefited from an adjustment are grateful for the EDD's consideration. However, there is no predictable procedure, such as the IRS VCSP, for a taxpayer wishing to expose itself and come into compliance. Further, an employer's entering into the IRS VCSP does not exempt it from being audited by EDD and does not provide any employment tax immunity under the UIC for the voluntarily reclassified workers for prior years.

EDD Will Likely Need to Get Federal Buy-In to Establish a VCSP

California is mandated to protect the Unemployment Insurance Trust Fund. The California Unemployment Insurance Program is part of a national plan of unemployment reserves and Social Security and is in place to assist in the stabilization of employment conditions. Section 303(a)(1) of the Social Security Act requires, as a condition for a state to receive administrative grants for its unemployment compensation 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) of the Social Security Act has been interpreted to require that state laws provide for reasonable

means to enforce employer liabilities to the state unemployment fund so that unemployment compensation may be paid when due.

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

Conclusion

The EDD, using its relationship with the U.S. Department of Labor, 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 establish an EDD VCSP. That program would likely result in higher compliance in proper worker classification and tax relief for California businesses similar to that found in the IRS VCSP.

An EDD VCSP would encourage compliance with California law regarding the classification of workers. California employers would be less inclined to wait to see if the other shoe drops and risk an audit and litigation over the subsequent assessment.

Conformity in state and federal tax law would benefit California employers that are or may be out of compliance regarding 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 would save costs in prior years' assessments, penalties, interest, and litigation costs.

Unfortunately, a legislative solution to establish an EDD VCSP is expensive, demanding the resources of the EDD, the governor's office, the State Legislature, and interested business stakeholders. The creation and passage of that program may not rise to the level of urgency that would demand the advocacy expenses required. Also, the EDD might think 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. ☆