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TAX ADMINISTRATION:

**Improving Independent
Contractor Compliance**

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IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE
SUMMARY OF STATEMENT BY
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IRS' estimate of the 1992 tax gap caused by self-employed individuals (which include independent contractors) who do not report all their income is \$20.3 billion. GAO is releasing a report today, requested by Senators Baucus and Pryor and Congressman Barnard, that identifies options for improving independent contractor compliance.

Businesses classify workers as either "employees" or "independent contractors." The common law rules for classifying workers remain as unclear and subject to conflicting interpretations as GAO found them in 1977. In the intervening 15 years, no final action has been taken to clarify the rules as GAO recommended. The Treasury Department acknowledged in 1982 and again in 1991 that "applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification."

While recognizing this ambiguity, IRS also feels responsible as the nation's tax administrator to enforce tax laws and rules. IRS has done this in 6,900 Employment Tax Examination Program (ETEP) audits completed from October 1987 through December 1991. These audits resulted in IRS proposing tax assessments of \$467 million and reclassifying 337,000 workers to "employee" status. The average tax assessment was \$68,000 per business. Since fiscal year 1989, IRS concluded that 5,160 (90 percent) of the 5,759 businesses audited had 1 or more misclassified workers.

GAO still believes that the classification rules need to be clarified. GAO also believes that there are two approaches in addition to ETEP that could help improve independent contractor compliance--(1) require businesses to withhold taxes from payments to independent contractors, and (2) improve business compliance with the requirement to file information returns on payments to independent contractors.

The two approaches, which can be implemented without changes to the classification rules, should help collect more of the taxes owed through means other than retroactive tax assessments provided for in the law. While both approaches would increase to some extent the burdens on independent contractors and businesses that use them, GAO believes both approaches have merit.

Congressmen Barnard, Jenkins, and Sisisky have introduced H.R. 5011 which has been referred to this Subcommittee. GAO believes this bill has considerable merit, particularly the provisions that would enhance information reporting.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into the misclassification of employees as independent contractors for federal income tax purposes. One of the issues we are addressing today is independent contractors who do not comply with federal tax laws.

We are releasing a report today on this issue, Tax Administration: Approaches To Improve Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992), which was done at the request of Senators Baucus and Pryor and Congressman Barnard. The purpose of the report is to identify options for improving independent contractor tax compliance.

Our report discusses certain aspects of the Internal Revenue Service's (IRS) Employment Tax Examination Program (ETEP). A major focus of this program is to examine small business compliance in using the rules for classifying workers as either "employees" or "independent contractors" (self-employed individuals who provide services).¹

The rules for classifying a worker as either an employee or an independent contractor come from the common law. Under the common law, the degree of control, or right to control, that a

¹For this program, IRS has defined a small business as those having assets of \$3 million or less.

business has over a worker governs the classification. If a worker must follow instructions on when, where, and how to do the work, he or she is more likely to be an employee. IRS has adopted 20 common law rules to help classify workers.

If workers are determined to be employees, the business must withhold and deposit income and social security taxes from their wages. In addition, the business pays unemployment taxes and its share of social security taxes. If workers are determined to be independent contractors, they must on their own pay income and social security taxes on payments received from the business.

IRS began the nationwide ETEP in 1988 because of the continued high level of tax noncompliance of independent contractors. IRS' strategy is to reduce this noncompliance by requiring businesses to treat misclassified independent contractors as employees subject to withholding taxes. Doing so consolidates and facilitates IRS' tax collection instead of tracking whether numerous independent contractors paid their taxes. A 1988 IRS study showed that employees subject to withholding voluntarily reported 99.5 percent of their 1987 wages.

CLASSIFICATION RULES NEED TO BE CLARIFIED
AND OTHER APPROACHES TO COMPLIANCE CONSIDERED

The common law rules for classifying workers remain as unclear and subject to conflicting interpretations as we found them in 1977.² In the intervening 15 years, no final action has been taken to clarify the common law as our report recommended. The Treasury Department acknowledged in 1982 and again in 1991 that "applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification."³

While recognizing this ambiguity, IRS also feels responsible as the nation's tax administrator to enforce tax laws and rules. IRS has done this in 6,900 ETEP audits completed from October 1987 through December 1991. These audits resulted in proposed tax assessments of \$467 million and reclassifying 337,000 workers as employees. The average tax assessment was \$68,000 per business. Since fiscal year 1989, IRS concluded that 5,160 (90 percent) of the 5,759 businesses audited had 1 or more misclassified workers.

²Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions (GAO/GGD-77-78, Nov. 21, 1977).

³Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, Department of the Treasury, Report to Congress (Washington, D.C.: Mar. 1991).

We still believe that the classification rules need to be clarified. However, we also believe that until they are, two approaches in addition to ETEP could help improve independent contractor compliance--(1) require businesses to withhold taxes from payments to independent contractors and (2) improve business compliance with the requirement to file information returns on payments to independent contractors.

The two approaches, which can be implemented without changes to the classification rules, should help collect more of the taxes owed through means other than retroactive tax assessments provided for in the law. While both approaches would increase to some extent the burdens on independent contractors and businesses that use them, GAO believes both approaches have merit.

As you know, Congressmen Barnard, Jenkins and Sisisky have introduced H.R. 5011, which has been referred to this Subcommittee. We believe this bill has considerable merit, particularly the provisions that would enhance information reporting. Congressman Lantos has also introduced a bill, which, in part, deals with independent contractor tax issues. We have not analyzed this bill.

Now I would like to discuss in some detail our first approach to improve compliance--withholding

REQUIRING WITHHOLDING ON PAYMENTS
TO INDEPENDENT CONTRACTORS

Withholding is the cornerstone of our tax compliance system for employees. It has worked very well with over 99 percent of wages voluntarily reported. In addition, it provides a gradual and systematic method to pay taxes and insures credit for social security coverage.

As early as 1979, we concluded that noncompliance among independent contractors was serious enough to warrant some form of tax withholding on payments to them. IRS studies since the 1970s have documented a lower level of compliance by independent contractors compared to employees.

We continue to believe that a withholding approach has merit, despite several administrative problems that would need to be resolved. The most important consideration in any withholding system is that the tax withheld approximates the tax due for the year. Independent contractors can have substantial business expenses that reduce annual net income and taxes owed. In such cases, withholding could adversely affect cash flow. Because such expenses may vary among independent contractors, a graduated withholding system to account for differences in expenses could be used. A simpler approach for businesses would be to withhold a flat amount (e.g., 5 or 10 percent) of all payments.

Another problem is that independent contractors may circumvent withholding by incorporating. To avoid this problem, withholding would also need to apply to corporations. Large corporations may view withholding on payments to them as unjustified since IRS data suggests that their voluntary compliance exceeds that of self-employed workers.

Because of these complexities, designing the most effective and fair withholding system was beyond the scope of our review. Nonetheless, we continue to view withholding as a potential approach for improving independent contractor compliance.

It is likely that any withholding system would exempt some independent contractors. For example, the flat 10 percent withholding proposal by the Treasury Department in 1979 would have exempted workers who (1) normally work for 5 or more businesses in a calendar year or (2) expect to owe less tax than the withheld amount. Because some workers may be exempt, it would be important to complement any withholding system with an effective information reporting system.

IMPROVING INFORMATION REPORTING ON PAYMENTS TO INDEPENDENT CONTRACTORS

A second approach to enhance compliance--improving information reporting--parallels the withholding approach by placing less

emphasis on the classification rules and shifting the emphasis to the relatively clear laws on information returns.

IRS data show that independent contractors reported 97 percent of the income that appeared on an information return. Otherwise, they only reported 83 percent of the income--a decline of 14 percentage points. Other IRS and GAO studies also show that information returns dramatically improve voluntary compliance. IRS' estimate of the 1992 tax gap caused by self-employed individuals (which include independent contractors) who do not report all their income is \$20.3 billion.⁴

While other options may exist, we identified eight that could strengthen information reporting and close potential loopholes. For the most part, we identified the options through our past and ongoing work on information reporting, independent contractors, and other compliance issues. These options, each of which has pros and cons, are as follows:

- (1) Significantly increase the \$50 penalty for not filing an information return.
- (2) Do not penalize businesses for past noncompliance with information reporting laws if they begin to file information returns when the penalty is increased.

⁴IRS defines the tax gap as the difference between the amounts of income tax that taxpayers owed and voluntarily paid for a year.

- (3) Require IRS to administer an education program to make the business community aware of the filing requirement and of IRS' intention to vigorously enforce it.
- (4) Lower the \$600 reporting threshold for payments to independent contractors.
- (5) Require information reporting for payments to incorporated independent contractors.
- (6) Require businesses to separately report on their tax return the total amount of payments to independent contractors.
- (7) Require businesses to validate the tax identification numbers (TIN) of independent contractors before making any payments, and for those with invalid TINs, withhold 20 percent of payments until the TIN is validated.
- (8) Require businesses to provide independent contractors with a written explanation of their tax obligations and rights.

A summary of the pros and cons of each option is in the appendix to my statement. In addition, the report we are releasing today discusses each option in detail.

CONCLUSION

To summarize Mr. Chairman, the common law rules for determining who is an employee or independent contractor remain as unclear today as they were 15 years ago. Efforts to clarify the rules have been unsuccessful. Yet taxpayers still need--and government

is obligated to provide--clear rules for classifying workers if businesses are to comply voluntarily. We recognize that this clarification will probably not happen in the short term, given that past efforts did not succeed. However, we favor clarification and believe that Congress should continue its efforts to develop clearer rules.

In view of the dilemma over classification rules, Congress considered withholding during the late 1970s as a way to improve independent contractors' compliance. Withholding was not implemented because of concerns about doing it fairly. Because withholding has been a successful tool for collecting taxes from employees, it deserves more consideration as a tool for improving the lower tax compliance of independent contractors.

Strengthened information reporting as proposed in H.R. 5011 would also improve independent contractor compliance. But each option for improving information reporting has implementation costs and potential burdens. And, none of the options replaces the need to clarify the unclear classification rules. In fact, these options, or others not discussed in this report, would work better in conjunction with clearer rules, if they emerged.

Finding a way to reduce the \$20 billion tax gap mentioned earlier at an acceptable level of added costs and burdens is important to tax administration. It may be even more important in the future

as technology leads to an ever-wider variety of working arrangements. Thus, we believe that any legislative deliberations should focus on the various ways to improve compliance, weighing their advantages and disadvantages, and consider input from the affected parties.

We continue to believe Congress needs to establish clear rules for classifying workers as we recommended in our 1977 report. We also believe that Congress should consider legislation to improve independent contractor compliance through withholding and/or improved information reporting.

That concludes my prepared statement. My colleagues and I would be pleased to answer any questions you or other members of the Subcommittee may have.

GAO'S ANALYSIS OF OPTIONS FOR IMPROVING
INFORMATION REPORTING

We assessed eight options for improving information reporting, which could improve tax compliance among independent contractors. The pros and cons for each option are shown in table I.1.

Table I.1: Pros and Cons of Eight Options for Improving Information Reporting to Enhance Independent Contractor Compliance

Options	Pros	Cons
(1) Increase \$50 penalty for failure to file an information return (Form 1099-MISC).	<p>Should improve compliance in filing Form 1099-MISC.</p> <p>Should increase income reported and taxes paid by independent contractors.</p> <p>Would encourage IRS to check Form 1099-MISC filing during audits.</p> <p>Would discourage businesses from agreeing to not file Form 1099-MISC if they can make lower payments.</p>	<p>Would complicate IRS administration if other penalties for failure to file Form 1099-MISC are \$50.</p> <p>Would cause equity concerns if one penalty was higher than others.</p>

<p>(2) Do not penalize businesses for past Form 1099-MISC noncompliance if they begin filing.</p>	<p>Would encourage filing compliance.</p> <p>Would ease the transition to a higher penalty for not filing Form 1099-MISC.</p>	<p>Would not punish past noncompliance.</p> <p>Would result in lost penalty revenue.</p> <p>May raise expectations of future penalty forgiveness.</p>
<p>3) Have IRS educate businesses on Form 1099-MISC filing requirements and penalties.</p>	<p>Should increase business compliance with filing Form 1099-MISC.</p>	<p>Would add to IRS' costs or use funds that could be used for other educational purposes.</p>
<p>(4) Lower the \$600 Form 1099-MISC reporting threshold.</p>	<p>Would include more payments in IRS' computer match to detect unfiled Form 1099-MISC forms and unreported income.</p> <p>Should improve independent contractor compliance.</p> <p>Would mirror other lower thresholds (e.g. \$10 royalties).</p>	<p>Would increase costs to businesses to file more Form 1099-MISC.</p> <p>Would increase costs to IRS to process and match more information returns.</p> <p>May exceed IRS' computer capacity until 1996.</p>

<p>(5) Require businesses to report payments made to incorporated independent contractors.</p>	<p>Would deter attempts to avoid information reporting.</p> <p>Businesses would not need to distinguish between incorporated and unincorporated workers.</p>	<p>Would increase costs to businesses to file more Form 1099-MISC.</p> <p>Would increase costs to IRS to process and match more Form 1099-MISC.</p> <p>May exceed IRS computer capacity until 1996.</p>
<p>(6) Require businesses to separately report on their tax return the total amount of payments to independent contractors. IRS would match amounts reported on tax return and on information returns.</p>	<p>Should increase Form 1099-MISC compliance.</p> <p>Could enhance IRS' ability to detect noncompliance.</p> <p>Give tax return preparers more incentive to check compliance.</p>	<p>Will not stop some businesses from hiding payments to independent contractors.</p> <p>May increase some businesses' costs to and report the information.</p>
<p>(7) Have businesses validate Taxpayer Identification Numbers (TIN) before making payments. If TIN is invalid, a business must withhold taxes beginning with first payment and continue withholding until a TIN is validated.</p>	<p>Should improve IRS matching and increase taxes collected.</p> <p>Should make backup withholding more cost-effective by reducing it or starting it with first payment to independent contractors.</p>	<p>Would add burden for businesses to validate TINs before paying contractors.</p> <p>Would increase IRS' equipment costs.</p>

<p>(8) Have businesses notify independent contractors of their rights and obligations to pay taxes as self-employed workers.</p>	<p>May improve voluntary tax compliance.</p> <p>Would encourage workers who believe they are misclassified to notify IRS.</p> <p>Would inform workers of their rights and obligations.</p>	<p>Would add burden on business to provide the Form 1099-MISC to the worker and retain a copy.</p>
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