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Testimony

Before the Committee on Small Business, U.S. House of  
Representatives

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TAX ADMINISTRATION

Improving Independent  
Contractor Compliance With  
Tax Laws

Statement of Natwar M. Gandhi, Associate Director  
Tax Policy and Administration Issues  
General Government Division



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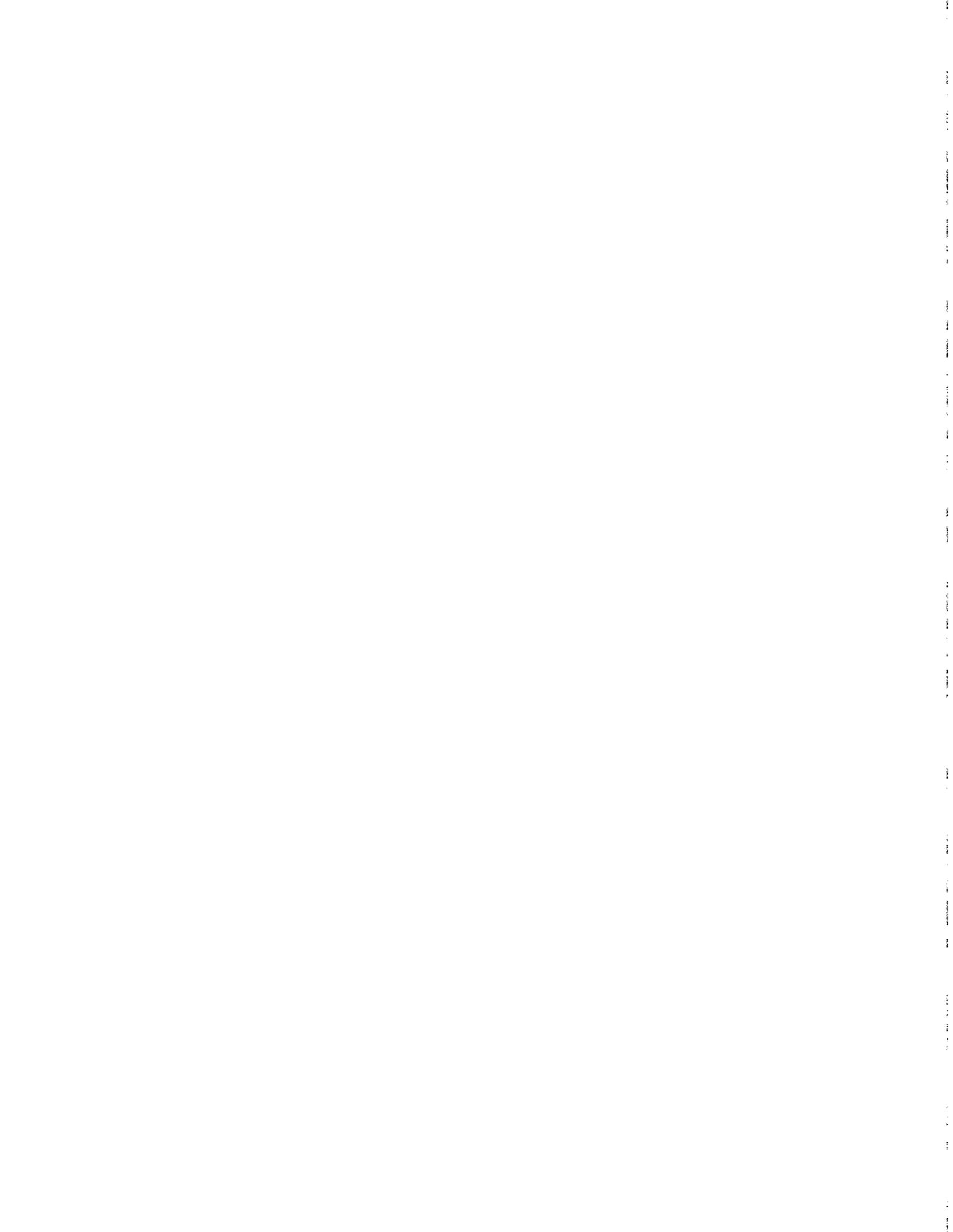
IMPROVING INDEPENDENT CONTRACTOR COMPLIANCE WITH TAX LAWS  
SUMMARY OF STATEMENT OF  
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ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES  
U.S. GENERAL ACCOUNTING OFFICE

Various health reform proposals would require many employers to pay most of the health insurance premiums for their employees. Although we are not taking a position on the overall desirability of such a mandate, any mandate could induce employers to use more independent contractors to cut costs.

However, a large-scale shift towards reclassifying employees as independent contractors raises serious tax compliance concerns and will likely lead to tax revenue losses. IRS data show that independent contractors, compared to employees, are more likely to (1) underreport their income on tax returns, (2) account for a larger share of the annual income tax gap, and (3) be delinquent in paying taxes. Also, the shift will likely result in employers misclassifying more employees as independent contractors because of factors such as confusing classification rules.

To address concerns about misclassifying employees as independent contractors, some reform proposals have provisions for clarifying the classification rules through regulation or legislation. Current law largely prohibits, and the business community has opposed, the regulatory approach. GAO has believed that the classification rules need to be clarified as far back as 1977, when it found the classification rules to be unclear and subject to conflicting interpretations. The Treasury Department acknowledged these problems in 1982 and again in 1991. Nevertheless, the classification rules remain unclear.

To address concerns about tax revenue losses stemming from an increase in the number of independent contractors, some health reform proposals also contain measures to improve information reporting on payments to independent contractors. GAO believes that improved information reporting would likely increase tax compliance by independent contractors and has recommended several ways to make improvements. GAO has also discussed withholding taxes on payments to independent contractors as an option. Either approach should improve tax compliance and could be done regardless of any changes to the classification rules. While both approaches would increase to some extent the burdens on independent contractors and businesses that use them, GAO believes both approaches have merit.



Mr. Chairman and Members of the Committee:

We are pleased to present our views on the tax compliance issues arising from proposed health care reform provisions that affect the use of independent contractors. Our testimony is based on our extensive body of work on tax issues involving independent contractors (see app. I).

Some reform provisions touch on rules for classifying workers as employees or independent contractors and reporting payments made to independent contractors on information returns. Also, some employers could be mandated to pay most health insurance premiums for their employees. Within this context, our major points are:

- Independent contractors tend to have lower tax compliance than employees.
  
- An employer mandate could induce employers to use more independent contractors, some of which will be misclassified because of unclear classification rules.
  
- To the extent that health reform can address these issues through improved information reporting and other actions, the better for tax administration.

Let me first point to basic differences between an independent contractor and employee as well as to factors affecting employer classification decisions. Independent contractors are commonly viewed as self-employed workers who provide services, such as legal or accounting advice.<sup>1</sup> Employees also may provide services but usually just for one employer over a longer time.

In deciding whether to classify a worker as an independent contractor or employee, an employer should follow rules that evolved under the common law. The Internal Revenue Service (IRS) has adopted 20 rules for classifying workers (see app. II). The rules focus on the degree of control that an employer has over a worker. Workers who must follow instructions on when, where, and how to do the work are more likely to be viewed as employees.

For workers classified as employees, the employer must withhold and deposit income and social security taxes from employee wages. The employer is also required to pay unemployment taxes and a share of social security taxes. Employers also may provide benefits, such as pension or health insurance, to employees. In addition, federal and state laws provide protections for employees in such areas as equal employment opportunity, minimum wages and hours, and workers' compensation.

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<sup>1</sup>In fact, independent contractors are small businesses.

In contrast, independent contractors--not the employer--have to take responsibility for their taxes, benefits, and income and job security. They are required to pay their income taxes and the employer and employee shares of social security taxes (self-employment tax). These taxes are subject to IRS rules on making quarterly estimated tax payments. Independent contractors themselves must provide for any benefit packages, such as life and health insurance, they choose to obtain.

TAX COMPLIANCE ISSUES ASSOCIATED  
WITH INDEPENDENT CONTRACTORS

IRS studies since the 1970s have consistently documented a difference in tax compliance between employees and self-employed workers such as independent contractors. Employees have historically reported almost all of their wage income.

Conversely, IRS has found that independent contractors, in the mid-1970s, reported 74 percent of their business income. An IRS study of independent contractors who should have been classified as employees found that they only reported 62 percent of their income for 1984.<sup>2</sup>

IRS' most recent compliance results have not distinguished

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<sup>2</sup>Compliance varied dramatically depending on whether businesses filed information returns on the income. Independent contractors receiving information returns reported 77 percent of the income; those not receiving the returns reported 29 percent.

independent contractors from other self-employed workers--known as sole proprietors. However, these results continued to show a large difference in compliance rates between sole proprietors and employees.<sup>3</sup> Similarly, IRS' most recent tax gap estimates (i.e., the gap between income taxes owed and voluntarily paid in a year) showed a much larger gap for all sole proprietors than for employees who underreported their income.<sup>4</sup>

In addition, nonwage earners such as independent contractors owed 75 percent of the delinquent taxes but comprised only 6 percent of all individual taxpayers. In sum, the compliance differences in reporting income and paying taxes pose serious concerns about employers switching from employees to independent contractors.

Speaking generally, employers may switch from employees to independent contractors to reduce labor costs and burdens.<sup>5</sup> In doing so, employers sometimes may misclassify employees as

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<sup>3</sup>These 1988 results showed that voluntary tax compliance for sole proprietors was about 80 percent compared to 93 percent for all individual taxpayers, including sole proprietors and employees.

<sup>4</sup>Employees' unreported wages created a \$1.9 billion tax gap. Unreported income by all sole proprietorships (including farmers and informal operators such as street vendors) created a \$32.1 billion gap. IRS data did not show independent contractors' portion of this tax gap. Various problems bar us from carving out this portion, but we are working with IRS to isolate the portion created by sole proprietors who provide services.

<sup>5</sup>Savings from using independent contractors have not been statistically computed but some businesses said these savings can be significant. Any savings would depend on such factors as workforce size and prevailing wage and tax rates.

independent contractors. Using special audit results, IRS has estimated the extent of misclassification among 5.2 million businesses (both small and large) that filed all required employment tax returns for 1984. Of this population, IRS estimated that 760,000 of the businesses (15 percent) misclassified 3.4 million employees as independent contractors.

Because these employees viewed themselves as independent contractors, they could have deducted business expenses, which would have reduced their taxable income. Had they been properly classified as employees, they generally would not have been allowed to deduct these expenses.

REFORM PROVISIONS ATTEMPT TO ADDRESS THE  
POTENTIAL FOR MISCLASSIFYING MORE  
EMPLOYEES AS INDEPENDENT CONTRACTORS

Various health reform proposals would require many employers to pay most health care premiums for their full-time employees. Although we are not taking a position on the overall desirability of a mandate, any mandate on employers would likely encourage them to restructure their workforces to use more independent contractors in order to avoid additional health insurance costs. Having more independent contractors raises concerns. They tend to have lower tax compliance compared to employees and employers sometimes misclassify employees as independent contractors

because of factors such as unclear classification rules.

To address such concerns, initial reform proposals granted the Secretary of Treasury the authority to issue regulations for clarifying the common law rules that govern classification. Small businesses and independent contractors alike have balked at this provision. Given this opposition, recent reform proposals instead would require the Secretary of Treasury to propose legislation that would clarify the classification rules.

This opposition centered on the belief that the Treasury would develop restrictive rules that would favor the employee classification and enable IRS to force many businesses into reclassifying workers, as it did in the 1960s and 1970s. These reclassifications often resulted in large retroactive tax assessments against businesses that misclassified workers.

The resulting controversy led Congress in 1978 to limit IRS' authority to reclassify workers. Section 530 of the 1978 Revenue Act protects employers from IRS ever reclassifying their workers. To obtain this protection, employers must show that they had a reasonable basis for their classifications, such as prior IRS audit results, and met other criteria, such as filing all required information returns. It also bars the Treasury and IRS from issuing further regulations on applying the common law rules. Intended as a temporary stopgap, Section 530 still exists

after unsuccessful attempts to pass a law that would clarify the subjective classification rules.

Some reform proposals would codify a revised version of Section 530. These revisions include (1) lifting the bans against IRS' reclassification of workers for future periods and against issuance of regulations on the common law rules, and (2) restricting the prior audit basis to audits that had checked classification practices. Such revisions would be generally consistent with our positions in previous reports.<sup>6</sup>

Changes that improve the classification rules are needed. We believe that the common law rules for classifying workers remain as unclear and subject to conflicting interpretations as we found them in 1977.<sup>7</sup> 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."<sup>8</sup>

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<sup>6</sup>Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 25, 1989) and Tax Administration: Approaches For Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992)

<sup>7</sup>Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions (GAO/GGD-77-88, Nov. 21, 1977).

<sup>8</sup>Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, Department of the Treasury, Report on Congress (Washington, D.C.: Mar. 1991).

We still believe that the rules need clarification to ensure greater certainty and consistency for IRS, employers, and workers alike. We have recommended that Congress enact legislation that resolves the classification controversy. Our 1992 report also discussed the advantages of lifting the Section 530 prohibition against IRS issuing regulations on applying the common law rules. If it lifts the prohibition, Congress could monitor how well IRS and Treasury work with business taxpayers to develop mutually acceptable regulations to guide all affected parties. We believe a cooperative relationship is desirable and could produce classification rules that offer more clarity and consistency.

#### REFORM PROVISIONS COULD ADDRESS

#### CONCERNS ABOUT TAX COMPLIANCE

#### AMONG INDEPENDENT CONTRACTORS

In addition to misclassification, having more independent contractors raises concerns about their lower tax compliance compared to employees. IRS and tax researchers generally agree that these compliance differences can be explained by "opportunity." Being subjected to income tax withholding (unlike independent contractors), employees have little opportunity to underreport income and escape detection. Withholding provides employees with a gradual and systematic way to pay their taxes. It also facilitates IRS tax collection by consolidating and filtering periodic tax payments from millions of employees

through their employers.

Our 1992 report discussed withholding taxes on payments made to independent contractors as a way to improve tax compliance among independent contractors. Withholding has been the cornerstone of our tax compliance system for employees. We concluded that noncompliance among independent contractors was serious enough to warrant some form of withholding on their income.

We continue to believe that withholding has merit despite several problems that would need to be resolved. For example, withheld amounts would need to account for business expenses that reduce net income and taxes owed. Because some independent contractors incorporate their businesses, withholding would also need to apply to them as well. Given such issues, a withholding scheme may need to exempt some independent contractors.

Absent tax withholding, information reporting helps reduce the opportunity to underreport income.<sup>9</sup> Over the years, we have found that information reporting improves voluntary compliance as well as IRS' ability to find unreported income. Specifically, one IRS study showed that independent contractors reported 97 percent of the income that appeared on an information return.

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<sup>9</sup>Third-party payors such as employers and banks send information returns to IRS and the payee to report payments such as wages, interest, and dividends as well as many payments made to independent contractors for services provided.

Otherwise, they only reported 83 percent of the income--a decline of 14 percentage points.<sup>10</sup>

Even so, tax law does not require information reporting for all independent contractor payments. Payments made to independent contractors who incorporate or who provide services to households are not subject to information reporting. Nor are payments to an independent contractor that fall below \$600 for a calendar year.

Our 1992 report also discussed information reporting for independent contractors as a way to improve compliance. While others may exist, we identified eight options to strengthen this information reporting and close potential loopholes. These options are listed in appendix III.

Given concerns about independent contractor compliance, many reform proposals have included two provisions that we have generally supported in the past. First, the \$50 penalty for not filing an information return would be increased significantly. Second, the \$50 penalty would apply (instead of this new, larger penalty) if the employer reported at least 97 percent, as required, of all aggregated payments to independent contractors for that calendar year. We continue to support these provisions

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<sup>10</sup>Although not involving independent contractors, we found that taxpayers only reported 1 percent of their forgiven debt income without information returns compared to 48 percent with these returns (Tax Administration: Information Returns Can Improve Reporting of Forgiven Debts, GAO/GGD-93-42, Feb. 17, 1993).

and encourage Congress to consider our other options for  
improving information reporting.

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That concludes my statement. I will be pleased to try to answer  
any questions you or other Committee members may wish to raise.

RELATED GAO PRODUCTS

Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions (GAO/GGD-77-88, Nov. 21, 1977).

IRS and SSA Can Improve the Verification and Recording of Data Provided by Self-Employed Taxpayers (GAO/GGD-85-21, May 28, 1985).

Tax Administration: State and Local Compliance With IRS' Information Reporting Requirements (GAO/GGD-89-63, May 4, 1989).

Information Return Requirements for Independent Contractors (GAO/T-GGD-89-21, May 16, 1989).

Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 25, 1989).

Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected (GAO/GGD-89-110, Sept. 8, 1989).

Tax Administration: IRS Can Improve Its Program To Find Taxpayers Who Underreport Their Income (GAO/GGD-91-49, Mar. 13, 1991).

Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

Tax Administration: Improving Independent Contractor Compliance (GAO/T-GGD-92-63, July 23, 1992).

Tax Administration: Federal Agencies Should Report Service Payments Made To Corporations (GAO/GGD-92-130, Sept. 22, 1992).

Correspondence to the Honorable Daniel Patrick Moynihan regarding information reporting on payments made to corporations for services rendered. July 27, 1993.

Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994).

Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175, Aug. 2, 1994).

IRS' COMMON LAW RULES

IRS has summarized the common law in 20 rules. The facts of each case govern which rules apply, and the weight assigned to them, when classifying a worker in any particular employment relationship. Even so, workers are generally employees if they:

1. Must comply with employer's instructions about the work.
2. Receive training from or at the direction of the employer.
3. Provide services that are integrated into the business.
4. Provide services that must be rendered personally.
5. Hire, supervise, and pay assistants for the employer.
6. Have a continuing working relationship with the employer.
7. Must follow set hours of work.
8. Work full-time for an employer.
9. Must do their work on the employer's premises.
10. Must do their work in a sequence set by the employer.
11. Must submit regular reports to the employer.
12. Receive payments of regular amounts at set intervals.
13. Receive payments for business and/or travelling expenses.
14. Rely on the employer to furnish tools and material.
15. Lack a major investment in facilities used to perform the service.
16. Cannot make a profit or suffer a loss from the services.
17. Work for one employer at a time.
18. Do not offer their services to the general public.
19. Can be fired by the employer.
20. May quit work anytime without incurring liability.

OPTIONS FOR IMPROVING  
INFORMATION REPORTING ON  
PAYMENTS TO INDEPENDENT CONTRACTORS

In addition to discussing clearer classification rules and withheld taxes on payments to independent contractors, our 1992 report (Tax Administration: Approaches For Improving Independent Contractor Compliance GAO/GGD-92-108, July 23, 1992) also discussed information reporting. Specifically, we analyzed the pros and cons of eight options for improving information reporting on payments made to independent contractors. The options follow.

- 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.
- 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.

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