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TAX ADMINISTRATION

Issues Involving Worker Classification

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TAX ADMINISTRATION: ISSUES INVOLVING WORKER CLASSIFICATION

SUMMARY OF STATEMENT BY
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Businesses, to determine their tax liability (e.g., employer portion of social security and unemployment taxes on employee wages) and meet the requirements of other laws, need to classify their workers as either "employees" or "independent contractors." But, the common law rules for classifying workers remain as unclear and subject to conflicting interpretations as GAO found them in 1977. Thus, businesses continue to be at risk of large retroactive tax assessments for improperly treating workers as independent contractors.

Given the potential for noncompliance associated with unclear rules and the high levels of income tax noncompliance involving independent contractors, IRS has maintained an active audit presence despite interpretational difficulties. From 1988 through 1994, IRS did 11,380 Employment Tax Examination Program audits (ETEP). These audits resulted in IRS proposing tax assessments of $751 million and reclassifying 483,000 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 requirements to file information returns on payments to independent contractors. IRS data suggest that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 billion to $30 billion of income taxes owed the federal government by individuals but not paid for tax year 1992.

The two approaches, which can be implemented without changes to the classification rules, should help to improve compliance rather than rely on 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.

Aside from tax issues, changes to the classification rules need to be cognizant of the body of laws that create a safety net for American workers. Many laws apply only to employees but do not protect workers classified as independent contractors. Because a byproduct of classification rule clarification is the potential for changing the number of workers treated as independent contractors, we believe the current deliberations should also focus on potential impacts on the social safety net established for American workers.

Madam Chairwoman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into the classification of workers either as employees or independent contractors for federal tax purposes. Ensuring the appropriate classification of workers has been of longstanding concern to GAO. Over the years we have issued several reports and presented congressional testimonies which are cited throughout my prepared statement. In the hearing this afternoon, I would like to make 4 points.

-- First: The common law rules used by IRS for classifying workers remain as unclear and subject to conflicting interpretations as GAO found them in 1977. Even the Treasury Department concedes 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." Yet, in the intervening 18 years, no final action has been taken to clarify the rules as GAO recommended.

-- Second: While recognizing this ambiguity, IRS also is responsible as the nation's tax administrator to enforce tax laws and rules. Since 1988, IRS' Employment Tax Examination Program has completed 11,380 audits resulting in IRS proposing tax assessments of $751 million and reclassifying 483,000 workers to "employee" status.

-- Third: In addition to classification rule clarification and compliance audits, GAO believes that there are two approaches 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 requirements to file information returns on payments to independent contractors. IRS data suggest that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 billion to $30 billion of income taxes owed the federal government by individuals but not paid for tax year 1992. The two approaches should help improve compliance rather than rely on retroactive tax assessments provided for in the law.

-- And fourth: Aside from tax issues, changes to the classification rules need to be cognizant of the body of laws that create a safety net for American workers. Many apply only to employees but do not protect workers classified as independent contractors. Because a byproduct of classification rule clarification is the potential for changing the number of workers considered to be independent contractors, we believe the current deliberations should

also focus on potential impacts on the social safety net established for American workers.

Before discussing each of these points in detail, I would like to briefly cover some background information to provide context.

BACKGROUND

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 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.

CLASSIFICATION RULES NEED TO BE CLARIFIED

Until the classification rules are clarified, we are not optimistic that the rather wide-spread confusion over who is an independent contractor and who is an employee can be avoided. As shown in Appendix I, the misclassification of workers has, in the past, cut across all industries and has involved up to almost 20 percent of the employers comprising some industries.

Although this overview data is now eleven years old, little has occurred to improve the situation. The Treasury Department characterized the situation in 1991 in the same terms as it used in 1982; namely 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." But, as a means to limit IRS' authority to reclassify independent contractors to employee status, IRS has been precluded from issuing clarifying regulations since passage of the Revenue Act of 1978.

Given such confusion, one should expect misclassifications to occur. For 1984 IRS estimated that about 750,000 of 5.2 million employers had misclassified about 3.4 million workers as independent contractors. Assuming no change in the misclassification rate, this noncompliance produced an estimated

tax loss for 1992 of $2 billion.[1] However, IRS officials believe that misclassifications have been increasing. Recent estimates by the Commissioner of IRS place the current tax loss at about $3 billion to $4 billion.

Also arguing for change is that, under the current tax rules, similar businesses are not necessarily required to be treated equally. Section 530 of the Revenue Act of 1978 provided qualifying businesses with some safe harbors for determining who is an employee and who is an independent contractor.[2] In 1989 we reported that for the cases reviewed, given the requirements of section 530, IRS could not assess $7 million of $17 million in recommended taxes and penalties against employers for misclassifying employees.[3] The employers usually avoided the assessments by claiming a prior audit protection clause, even when the prior audit did not intend to address employee classification issues or when it occurred over 20 years earlier. Therefore, for some businesses a prior audit may be the distinguishing feature for determining the employment status of their workers.

GAO's Simplification Proposal

For these and other reasons, we have supported measures to simplify the classification criteria.[4] We also have supported measures to allow IRS to issue clarifying regulations, and

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

[2]Under section 530, IRS may not assess employment taxes for misclassified workers against a business that had a reasonable basis for its classification, such as a reliance on (1) a judicial or administrative precedent or technical advice and letter rulings to the taxpayer, (2) a prior IRS audit that did not challenge the classification scheme, (3) an industry practice, or (4) any other reasonable basis. To qualify for this protection, the business must have filed all required information returns and have treated similar workers uniformly.

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

[4]Tax Treatment Of Employees And Self-employed Persons By The Internal Revenue Service: Problems and Solutions (GGD-77-88, Nov. 21, 1977).

authorize IRS to require employers with section 530 protection to prospectively reclassify independent contractors as employees.[5]

To make the classification decisions more certain, in 1977 we proposed a rather straightforward test. As in common law, our test recognized that one of the prime determinants as to whether a worker is an employee or independent contractor is the degree of control, or right to control, the employer has over the worker. For example, the right to direct and control the manner and details of a worker's performance suggests an employer/employee relationship.

But our test was designed to clearly recognize that where separate business entities exist, some degree of control to protect the image of the manufacturer, supplier, or prime contractor should be allowed without necessarily creating an employer/employee relationship. Our test was also intended to provide a clear standard to assure that only legitimately independent workers would qualify for independent contractor status.

Therefore, we proposed that the Internal Revenue Code be amended to exclude workers from the common law definition of employee in those instances where they:

-- Have a separate set of books and records which reflect items of income and expenses of the trade or business;

-- Have the risk of suffering a loss and opportunity of making a profit;

-- Have a principal place of business other than that furnished by the persons receiving the services; and

-- Hold themselves out in their own name as self-employed and/or make their services generally available to the public.

We also recognized that there may be some situations where a worker is able to meet some but not all of the above criteria and still have a valid basis for being considered self-employed. In these circumstances, the common law criteria should be applied. But, if an independent contractor could not meet at least three of the above four criteria, we believed that the worker should be considered an employee.

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[5]Tax Administration: Improving Independent Contractor Compliance With Tax Laws (GAO/T-GGD-94-194, August 4, 1994).

Reaction to GAO's Simplification Proposal

At the time, our proposed solution was not widely accepted. Treasury and IRS were concerned that any change in the law which increases the number of self-employed would result in lost tax revenue. This was because IRS had found that self-employed taxpayers had a low compliance rate in reporting income earned. More recent IRS data suggest that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 billion to $30 billion of income taxes owed the federal government but not paid by individuals for tax year 1992.[6] Also, the Departments of Justice and Labor were concerned that the criteria would permit taxpayers to be considered self-employed when they have the form but not the substance of self-employment.

These comments have not changed our mind about the potential for developing a clearer test. Given the continuing confusion over worker classification, we believe the abbreviated test that we put forward in 1977 still has relevance and can provide a good starting point for the current deliberations.

IRS ENFORCEMENT

While recognizing the ambiguity in the classification criteria, IRS is responsible as the nation's tax administrator to enforce tax laws and rules. Because of the misclassification difficulties and continued high level of tax noncompliance of independent contractors, IRS centralized a portion of its employment tax compliance efforts into an Employment Tax Examination Program (ETEP) during 1987. 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.

From 1988 through 1994, IRS has completed 11,380 ETEP audits. These audits resulted in proposed tax assessments of $751 million and reclassifying 483,000 workers as employees. The average tax assessment was about $66,000 per business. In addition, the IRS Examination Division auditors, as part of their regular tax audits, also address classification issues. However, the

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[6]Tax Administration: Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, Dec. 28, 1994). Because there is no generally accepted definition of the term independent contractor, the report developed statistics on service providers as a surrogate measure since many are considered by IRS and the business community to be independent contractors.

Examination Division does not accumulate data to identify audit results that involve classification issues.

APPROACHES FOR IMPROVING INDEPENDENT CONTRACTOR TAX LAW COMPLIANCE

In addition to classification rule clarification and ETEP, we believe other approaches could be adopted to improve independent contractor compliance. These approaches would (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.

These approaches, which can be implemented without changes to the classification rules, should help to promote compliance 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.

Requiring Withholding on Payments to Independent Contractors

Withholding is the cornerstone of our tax compliance system for employees. It has worked 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.[7] 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 percent) of all payments.

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[7]Hearing on Compliance Problems of Independent Contractors, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, July 17, 1979.

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

Also, it is likely that any withholding system would exempt some independent contractors. For example, the flat 10 percent withholding proposal developed by the Treasury Department in 1979 would have exempted independent contractors 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 independent contractors 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 unclear classification rules and shifting the emphasis to the relatively clear laws on information returns.[8] Focusing on information returns can have a significant effect. IRS data has indicated that, when information returns are filed, misclassified workers reported 77 percent of that income on their tax returns but only 29 percent of the income not covered by information returns.

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.[9] These options, each of which has pros and cons, are as follows:

(1) Significantly increase the $50 penalty for not filing an information return.

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[8]In general, certain third parties (e.g., businesses and banks but not individuals such as homeowners) are required to make annual information filings with IRS to report various payments made to unincorporated individuals, such as payments for services rendered and interest and dividends. The information is also reported to the individuals receiving the payments.

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

(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.

Each of these options involve tradeoffs between taxpayer burden and tax compliance. A summary of the pros and cons of each option is in Appendix II to my statement.

IMPLICATIONS FOR THE SOCIAL SAFETY NET FOR AMERICAN WORKERS

Aside from tax issues, changes to the classification rules need to be cognizant of the body of laws that create a safety net for American workers. Many laws apply only to employees but do not protect workers classified as independent contractors. Because a byproduct of classification rule clarification is the potential for changing the number of workers considered to be independent contractors, we believe the current deliberations should also focus on potential impacts on the social safety net established for American workers.

For example, unemployment insurance is nearly universal, covering over 90 percent of American workers. This 60-year old program provides short-term financial support for covered workers who, through no fault of their own, become unemployed. It also helps the unemployed from having to turn to public assistance programs. Moreover, in times of economic downturns the payments made to the unemployed may take on added significance, serving a macro-economic role of helping to stabilize the economy during recessions. However, federal law does not require coverage of independent contractors for unemployment insurance, although one

state (California) has provisions that would allow independent contractors to apply for self-coverage.

While we have not made an extensive survey of labor law to determine all affected laws, they are quite numerous, ranging from basic protections such as minimum wage, overtime, age discrimination in employment, and occupational, safety and health requirements to access to workers compensation insurance and employer-sponsored, tax-qualified, fringe benefits such as pensions and welfare benefit plans. Thus, for example, should clarification of the tax standard for differentiating between employees and independent contractors result in significant reclassifications of employees to independent contractors, then the worker protection laws would cover fewer people.

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That concludes my testimony. I would be pleased to answer any questions you or other members of the Subcommittee may have.

APPENDIX I

Table 1: Percentage of employers with misclassified workers, 1984.

Industry	Percent of total
Construction	19.8
Finance, Insurance, Real Estate	19.3
Mining, Oil and Gas	18.6
Agriculture	16.7
Manufacturing	15.8
Services	15.4
Transportation	11.2
Wholesale and Retail Trade	9.6
Government	9.6
Not Otherwise Classified	12.6
Total	13.4

Source: Treasury Department

APPENDIX II

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) discussed information reporting. Specifically, we analyzed options for improving the reporting on payments made to independent contractors. The options follow.

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

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

APPENDIX II

(5)	Require businesses to report payments made to incorporated independent contractors.	Would deter attempts to avoid information reporting. Businesses would not need to distinguish between incorporated and unincorporated workers.	Would increase costs to businesses to file more Form 1099-MISC. Would increase costs to IRS to process and match more Form 1099-MISC. May exceed current IRS computer capacity.
(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.	Should increase Form 1099-MISC compliance. Could enhance IRS' ability to detect noncompliance. Give tax return preparers more incentive to check compliance.	Will not stop some businesses from hiding payments to independent contractors. May increase some businesses' costs to report the information.
(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.	Should improve IRS matching and increase taxes collected. Should make backup withholding more cost-effective by reducing it or starting it with first payment to independent contractors.	Would add burden for businesses to validate TINs before paying contractors. Would increase IRS' equipment costs.

(8)	Have businesses notify independent contractors of their rights and obligations to pay taxes as self-employed workers.	May improve voluntary tax compliance. Would encourage workers who believe they are misclassified to notify IRS. Would inform workers of their rights and obligations.	Would add burden on business to make the appropriate notifications.

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