Testimony
Before the Subcommittee on Oversight
Committee on Ways and Means

TAX ADMINISTRATION

Issues in Classifying Workers as Employees or Independent Contractors

Statement of Natwar M. Gandhi
Associate Director, Tax Policy and Administration Issues
General Government Division
Employers, to determine their employment tax liability (e.g., social security and unemployment taxes on employee wages), need to classify workers as employees or independent contractors. Many factors affect this decision. In making the decision, employers may misclassify employees as independent contractors. IRS has estimated that 756,000 of 5.15 million employers (15 percent) misclassified 3.4 million employees as independent contractors in 1984. Factors such as costs and confusion over the classification rules can contribute to misclassification.

The common law rules for classifying workers are unclear and subject to conflicting interpretations. Employers cannot be certain that their classification decisions will withstand challenges by IRS. If not upheld, they risk large retroactive tax assessments.

Being responsible for enforcing these rules and concerned about misclassification, IRS has maintained an audit presence. From 1988 through 1995, IRS did 12,983 Employment Tax Examination Program audits, recommending $830 million in taxes and reclassifying 527,000 workers.

Deliberations over any changes to the classification rules may need to consider potential impacts on tax compliance. IRS has found that independent contractors compared to employees have much lower income tax compliance and account for a much higher portion of the income tax gap. Two approaches that could improve independent contractor compliance within the existing common law rules are (1) improved information reporting on payments made to independent contractors, and (2) withholding income taxes from such payments. Such approaches could be implemented regardless of changes to the classification rules. Although tax compliance could be improved, these approaches could increase to some extent the burdens on independent contractors and employers that use them.
Aside from tax issues, another important consideration in these deliberations is the body of laws that create a safety net for American workers. Such laws generally apply only to employees. If changes to the classification rules lead to more workers being classified as independent contractors instead of as employees, these worker protection laws would cover fewer people.
Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors

Madam Chairman 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. Proper classification of workers has been the subject of several of our reports and congressional testimonies. Today, I would like to make 4 points taken from these reports and testimonies.

• First, in deciding how to classify workers, employers may misclassify employees as independent contractors. In its most recent estimate on misclassification, IRS has estimated that 756,000 of 5.15 million employers (15 percent) misclassified workers as independent contractors in 1984. Many factors can cause misclassification, including cost considerations and confusion over the classification rules. For example, not incurring the costs of employment taxes (i.e., social security tax, unemployment tax, and income tax withholding) and employee benefits can give employers cost advantages over competitors who use employees. Further, both we and the Treasury Department have found that the common law rules used for classifying workers are unclear and subject to conflicting interpretations.

• Second, even with the confusing rules, IRS is responsible as the nation’s tax administrator to enforce compliance with them. Under its Employment Tax Examination Program (ETEP), IRS has completed 12,983 audits, resulting in $830 million in recommended tax assessments and 527,000 workers reclassified to “employee” status between fiscal years 1988 and 1995.

• Third, deliberations over any changes to the classification rules may need to consider potential impacts on income tax compliance. IRS has found that independent contractors compared to employees have lower compliance in paying income taxes and account for a higher proportion of the income tax gap. We identified two approaches that could boost independent contractor compliance within the existing common law rules. They include (1) improved information reporting on payments made to independent contractors and (2) withholding income taxes from such payments.

Fourth, aside from tax issues, an important consideration in these deliberations is the body of laws that create a safety net for American workers. Such laws generally apply only to employees. If changes to the classification rules lead to more workers being classified as independent contractors instead of employees, these worker protection laws would cover fewer people.

I would like to discuss each of these points in more detail after providing an overview on factors that affect the classification decision.

Factors in Making the Classification Decision

The rules for classifying a worker as either an employee or an independent contractor come from the common law. Under common law, the degree of control, or right to control, that a business has over a worker governs the classification. Thus, 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 employers classify workers (see appendix I).

If workers are determined to be employees, employers must withhold and deposit income and social security taxes from wages paid as well as pay unemployment taxes and the employers’ share of social security taxes. In addition, the employers may be subjected to laws that govern the use of employees and any benefits provided to them. Employers do not have these responsibilities if the workers are independent contractors. Independent contractors must pay their own income and social security taxes on payments received. They have no unemployment tax responsibility but may purchase benefit packages to cover this contingency as well as others (e.g., health insurance).

Ultimately, the decision to classify a worker as an employee or independent contractor depends on each employer’s circumstances. And, the extent to which a worker accepts the classification and understands its consequences plays a role.

Costs and Unclear Rules Can Cause Misclassification

Employers sometimes misclassify employees as independent contractors. For 1984, the last time IRS made a comprehensive estimate, IRS estimated that about 756,000 of 5.15 million employers had misclassified about 3.4 million workers as independent contractors. IRS interpreted the classification rules in making this estimate. As shown in appendix II, this
misclassification involved all industry groups and up to 20 percent of the employers in some industry groups.

This noncompliance produced an estimated tax loss for 1984, after accounting for taxes paid by the misclassified independent contractors, of $1.6 billion in social security tax, unemployment tax, and income tax that should have been withheld from wages. In another set of estimates, IRS issued an employment tax gap report in 1995 that included the estimated tax gap associated with misclassification. This estimated tax gap was $2.3 billion in 1987 and $3.3 billion in 1992 for just social security and unemployment taxes.

In doing these estimates, IRS did not identify the reasons for the misclassification but factors such as costs and unclear classification rules can play a role. For example, employers can lower their costs, such as payments of employment taxes or benefits, by using independent contractors. This cost advantage could be offset if an independent contractor can negotiate higher payments to purchase their own health, retirement, or other benefits. Otherwise, the incentive to misclassify workers as independent contractors exists.

Second, many employers struggle in making the classification decision because of the unclear rules. Until the classification rules are clarified, we are not optimistic that the confusion over who is an independent contractor and who is an employee can be avoided. 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.”

In addition to confusion over the common law factors, Section 530 of the Revenue Act of 1978 has proven to be difficult to administer. Given complaints from some employers and independent contractors about IRS’ attempts to reclassify independent contractors as employees, Congress passed this provision to limit IRS’ reclassification authority. Section 530 provided qualifying businesses with safe harbors in determining who is an employee and an independent contractor. In 1989, we reported that, for

\[\text{Under section 530, IRS may not assess employment taxes for misclassified workers against an employer that had a reasonable basis for its classification, such as a reliance on (1) a judicial or administrative precedent or technical advice and letter rulings to the taxpayer, (2) a prior IRS audit that did not challenge the classification scheme, (3) an industry practice, or (4) any other reasonable basis. To qualify for this protection, the business must have filed all required information returns and have treated similar workers uniformly.}\]
the cases reviewed, section 530 prohibited IRS from assessing $7 million of $17 million in recommended taxes and penalties against employers for misclassifying employees. The employers usually avoided the assessments by claiming a prior audit protection, even when the prior audit did not address employee classification or occurred over 20 years earlier. Section 530 also has precluded IRS from issuing clarifying regulations since 1978.

IRS Enforcement

IRS is responsible as the nation’s tax administrator to enforce the classification rules. Because of concerns about misclassification and income tax noncompliance by independent contractors, IRS centralized a portion of its employment tax compliance efforts into an Employment Tax Examination Program (ETEP) during 1987. IRS’ strategy was to identify any misclassification and require employers to correct it. Employers whose employees are reclassified are liable for the portion of the employment taxes that they would have owed if the worker had been classified as an employee for the audited tax years.

From 1988 through 1995, IRS completed 12,983 ETEP audits. These audits recommended $830 million in employment tax assessments and reclassified 527,000 workers as employees. In addition, the IRS Examination Division auditors, as part of their regular income tax audits, also may address classification issues. However, the Examination Division does not accumulate data to identify audit results on these issues.

Since late 1995, IRS has implemented initiatives to improve its enforcement of the classification rules and ease the burdens on those being audited. For example, IRS is revising its training to better ensure consistent application of the rules. IRS has circulated a draft of its training program so that employers know how IRS intends to interpret the rules. Further, IRS is testing ways to expedite and improve the settlement of disputes with employers over misclassification. These initiatives are too new for us to know whether they are working.

\(^3\)GAO/GGD-89-107, Sept. 25, 1989.
Since 1977, we have supported measures to simplify the classification rules. However, the development of clearer rules for all types of working relationships and businesses is neither simple nor easy.

In an effort to clarify the classification rules, we proposed a straightforward test in 1977 (see appendix III for details of this proposal). In sum, we proposed excluding workers from the common law definition of employee when they met each of four criteria. If the worker met three of the criteria, we proposed that the common law criteria should be applied. Otherwise, we proposed that the worker should be considered an employee. Our proposal was not widely accepted for various reasons, which we had recognized. For example, Treasury and IRS were concerned about lower tax compliance and lost tax revenue from having more self-employed workers and fewer employees.

We have viewed our 1977 proposal as a good starting point for clarifying the classification rules. In doing so, the deliberations also may need to consider the potential impact on income tax compliance. IRS studies since the 1970s have documented a much lower level of income tax compliance by independent contractors compared to employees. IRS data for 1988 suggest that independent contractors accounted for most of the income tax gap created by those self-employed individuals who underreported their business income.

IRS' most recent estimates put this part of the income tax gap at $29.2 billion for 1992. Among self-employed individuals contributing to this tax gap, IRS estimated that those who informally supply goods and services (e.g., street vendors, moonlighting craftsmen or mechanics, unlicensed child-care providers) reported less than 20 percent of their business income. The other self-employed individuals, who operated more formally (e.g., gas station owners), reported less than 70 percent; these estimates

---

4GGD-77-88, Nov. 21, 1977.

5The four criteria for independent contractor status included (1) separate set of books and records, (2) risk of a loss and opportunity for a profit, (3) principal place of business separate from those receiving the services, and (4) availability to provide self-employed services to the general public.

6Over the years, IRS has found that employees report almost 100 percent of their income while independent contractors report about three-quarters of theirs. A special IRS study in 1979 estimated that 47 percent of the independent contractors reported none of their business income.

7GAO/GGD-95-59, Dec. 28, 1994. Lacking a generally-accepted definition of "independent contractor", the report developed estimates on service providers as a surrogate measure since many are considered by IRS and the business community to be independent contractors. Depending on the definition of service provider used, their portion of the income tax gap created by self-employed individuals ranged from 56 percent to 81 percent.
do not distinguish between independent contractors and other self-employed individuals such as those who make or sell goods.

Recognizing these concerns, our 1992 report identified other approaches to improve independent contractor compliance within the framework of the existing classification rules. These approaches would (1) require businesses to withhold taxes from payments to independent contractors or (2) improve information reporting on payments made to independent contractors. While each approach would increase to some extent the burdens on independent contractors and businesses that use them, we believe each approach can help improve income tax compliance.

For example, 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 better ensure 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.

We continue to believe that withholding taxes from payments made to independent contractors has merit as a way to improve their income tax compliance. Several administrative problems would need to be resolved. For example, independent contractors with substantial business expenses, which lower taxable income, may have too much tax withheld from gross payments made to them. Appendix IV discusses such problems and possible solutions.

A second approach to enhance compliance—improving information reporting—parallels the withholding approach by shifting emphasis from unclear classification rules to the relatively clear laws on filing information returns. Focusing on information returns could 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

---

8GAO/GGD-92-108, July 23, 1992. This report also discusses the tradeoffs of clarifying the section 530 safe harbors (e.g., prior audit and longstanding industry practice) and codifying section 530 for employment as well as income tax purposes.

9Hearing on Compliance Problems of Independent Contractors, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, July 17, 1979.

10In general, third parties (e.g., businesses but not individual homeowners) are required to annually file information returns at IRS to report $600 or more in payments made to unincorporated individuals for services rendered in the course of trade or business. The information is also reported to these individuals.
returns but only 29 percent of the income not covered by information returns.

While other options may exist, our 1992 report identified eight options that could strengthen information reporting and close potential loopholes:

(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 withhold a portion of the 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 involves tradeoffs between taxpayer burden and tax compliance. Appendix V summarizes the pros and cons of each option.

Implications for the Social Safety Net for American Workers

Aside from tax issues, another consideration in deliberating changes to the classification rules is the potential impact on the body of laws that create a safety net for American workers. Because many of these laws apply only to employees, the laws do not protect workers classified as independent
contractors. Changes to the classification rules could increase the number of unprotected independent contractors.

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. During economic downturns, payments made to the unemployed may take on added significance, serving a macro-economic role of helping to stabilize the economy. 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 to determine all affected laws, they are quite numerous. They include basic protections involving issues such as minimum wage, mandatory overtime pay, discrimination, occupational safety and health requirements, workers compensation insurance, and employer-sponsored fringe benefits such as pensions. Thus, if clarification of the classification rules pushes significantly more employees into independent contractor status, the worker protection laws would cover fewer people.

Madam Chairman, this concludes my testimony. I would be pleased to answer any questions you or other members of the Subcommittee may have.
IRS' Common Law Rules

IRS has summarized the common law into 20 rules. The facts of each case govern which rules apply, and the weight assigned to them in classifying a worker. 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.
Appendix II


<table>
<thead>
<tr>
<th>Industry</th>
<th>Percent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>19.8</td>
</tr>
<tr>
<td>Finance, Insurance, Real Estate</td>
<td>19.3</td>
</tr>
<tr>
<td>Mining, Oil and Gas</td>
<td>18.6</td>
</tr>
<tr>
<td>Agriculture</td>
<td>16.7</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>15.8</td>
</tr>
<tr>
<td>Services</td>
<td>15.4</td>
</tr>
<tr>
<td>Transportation</td>
<td>11.2</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>9.6</td>
</tr>
<tr>
<td>Government</td>
<td>9.6</td>
</tr>
<tr>
<td>Not Otherwise Classified</td>
<td>12.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>13.4</strong></td>
</tr>
</tbody>
</table>

Source: Treasury Department
To make the classification decisions more certain, we proposed a straightforward test in 1977. As in common law, our test recognized that a prime determinant of whether a worker is an employee or independent contractor is the degree of control, or right to control, the employer has over the worker. But our test also intended to recognize that some degree of control to protect the image of the manufacturer, supplier, or prime contractor should be allowed without creating an employer/employee relationship. Our test was also intended to provide a clear standard to assure better compliance. Therefore, we proposed that workers be excluded from the common law definition of employee when 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 a worker may be able to meet some of our criteria and still have a valid basis for being self-employed. As a result, we proposed that the common law criteria should be applied when a worker met three of the four criteria. Otherwise, we proposed that the worker should be considered an employee.

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. 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.
Administrative Issues Concerning the Possible Withholding of Taxes From Payments Made to Independent Contractors

Withholding taxes from payments made to independent contractors has the potential to significantly improve their compliance with income tax laws. For this potential to come to fruition, several administrative problems 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 their 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.

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.
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 analyzed the pros and cons of eight options for improving the reporting on payments made to independent contractors, as follows.

<table>
<thead>
<tr>
<th>Options</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Increase $50 penalty for failure to file an information return (Form 1099-MISC).</td>
<td>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 agreements to not file Form 1099-MISC in exchange for lower payments.</td>
<td>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.</td>
</tr>
<tr>
<td>(2) Do not penalize businesses for past Form 1099-MISC noncompliance if they begin filing.</td>
<td>Would encourage filing compliance. Would ease the transition to a higher penalty for not filing Form 1099-MISC.</td>
<td>Would not punish the noncompliance. Would result in lost penalty revenue. May foster expectation of future penalty forgiveness.</td>
</tr>
<tr>
<td>(3) Have IRS educate businesses on Form 1099-MISC filing requirements and penalties.</td>
<td>Should increase compliance in filing Form 1099-MISC.</td>
<td>Would add to IRS' costs or use funds that could be used for other educational purposes.</td>
</tr>
<tr>
<td>(4) Lower the $600 Form 1099-MISC reporting threshold.</td>
<td>Would include more payments in IRS' 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).</td>
<td>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 IRS computer capacity.</td>
</tr>
</tbody>
</table>

(continued)
### Appendix V
**Options for Improving Information Reporting on Payments to Independent Contractors**

<table>
<thead>
<tr>
<th>Options</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>(5) Require information reporting on payments made to incorporated independent contractors.</td>
<td>Would deter attempts to avoid information reporting. Would not need to distinguish between incorporated and unincorporated workers.</td>
<td>Would increase costs to file more Form 1099-MISC. Would increase costs to process and match more Form 1099-MISC. May exceed IRS computer capacity.</td>
</tr>
<tr>
<td>(6) Require businesses to report the amount of payments to independent contractors on tax returns. IRS would match these amounts to amounts reported on information returns.</td>
<td>Should increase Form 1099-MISC compliance. Could enhance IRS' ability to detect noncompliance. Give tax return preparers more incentive to check compliance.</td>
<td>May not stop some businesses from hiding payments to independent contractors. May increase businesses' costs to report the information.</td>
</tr>
<tr>
<td>(7) Have businesses validate Taxpayer Identification Numbers (TIN) before making payments and withhold taxes until a TIN is validated.</td>
<td>Should improve IRS matching and increase taxes collected. Should make backup withholding more cost-effective by reducing it or starting it with the first payment.</td>
<td>Would add burden for businesses to validate TINs before paying contractors. Would increase IRS' equipment costs.</td>
</tr>
<tr>
<td>(8) Have businesses notify independent contractors of their rights and obligations to pay taxes as self-employed workers.</td>
<td>May improve tax compliance. Would encourage workers who believe they are misclassified to notify IRS. Would inform workers of their rights and obligations.</td>
<td>Would add burden on business to make the appropriate notifications.</td>
</tr>
</tbody>
</table>
Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO’s World Wide Web Home Page at:

http://www.gao.gov