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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE INTERNAL REVENUE SERVICE

OF THE

SENATE COMMITTEE ON FINANCE

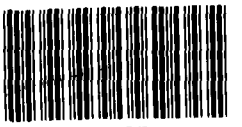
ON

SENATE BILL 2369,

INDEPENDENT CONTRACTOR TAX

CLASSIFICATION AND COMPLIANCE

ACT OF 1982



Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist your subcommittee in considering S.2369, the Independent Contractor Tax Classification and Compliance Act of 1982. The bill seeks to resolve the issues which surround the classification of workers as either employees or self-employed for Federal tax purposes. These issues led to the Congress' imposing a 3-1/2 year moratorium on employee-independent contractor determinations by the Internal Revenue Service (IRS). That moratorium is due to expire on June 30, 1982.

Our testimony is based primarily on work we have done in the past several years relating directly and indirectly to the subject of independent contractors. In late 1977, we issued a report which dealt with (1) the difficulties faced by employers and IRS in determining who is an employee and who is self-employed and (2) the problems associated with retroactive assessments against employers who IRS believed had misclassified employees as independent contractors. 1/ The report recognized the need and recommended standards for clarifying the classification rules so that businesses could more accurately make employee and self-employed determinations. In a 1978 report, we made various recommendations for improving IRS' audits of individual returns as they relate to the correct payment of social security taxes, particularly by self-employed persons. 2/ In 1979 testimony before the House Ways and Means Subcommittee on Select Revenue Measures, we reaffirmed the need to clarify the rules for determining employer-employee relationships. 3/ We have also reported and testified extensively on taxpayer compliance and the unreported income problem, including the problem involving independent contractors.

1/"Tax Treatment Of Employees And Self-Employed Persons By The Internal Revenue Service: Problems And Solutions" (GGD-77-88, Nov. 21, 1977).

2/"Additional IRS Actions Needed To Make Sure That Individuals Pay The Correct Social Security Tax" (GGD-78-70, Aug. 15, 1978).

3/Statement of Richard L. Fogel, Associate Director, General Government Division, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, on Compliance Problems of Independent Contractors.

Mr. Chairman, we support the objectives and intent of S.2369. It should ease the problems associated with classifying workers as employees or as independent contractors. Businesses will be able to make worker status determinations with more certainty and have less fear of unexpected and large retroactive tax assessments. In addition, the bill provides tools which should help IRS improve independent contractor compliance with the tax laws.

S.2369, however, will not eliminate the need for IRS reclassifications and retroactive assessments, and problems associated with those actions will continue to exist. Therefore, some legislative and administrative changes will be needed, particularly to reduce the potential for double taxation. In addition, IRS will be faced with an increased workload generated by the information reporting provisions of the bill.

S.2369 CLARIFIES THE PROCEDURES FOR CLASSIFYING WORKERS, BUT SOME RECLASSIFICATIONS AND RETROACTIVE ASSESSMENTS WILL STILL OCCUR

S.2369 clarifies the standards used in determining if workers are employees or independent contractors for Federal employment tax purposes. While there are some differences between S.2369 and the recommendations we made in 1977, S.2369 accomplishes the overall purpose of clarifying the circumstances under which a worker should be classified as an employee or an independent contractor. The bill's safe harbor provision provides standards and tests for deciding whether a worker is an employee or an independent contractor for Federal tax purposes.

We generally agree with the standards contained in the bill. However, the subcommittee may want to consider a modification to the test for ensuring economic independence.

S.2369 requires that to meet the economically independent aspect of the safe harbor provision, a worker must either risk income fluctuations or have a substantial investment in tangible assets used in performing the service. We believe the income fluctuation aspect may be too broad. For example, any worker who gets paid commissions or is involved in piecework could have significant fluctuations in income. These workers may be employees under common law and yet qualify as independent contractors under the safe harbor provision of S.2369, a result seemingly contrary to the intent of the bill. We suggest, therefore, that the income fluctuation test be replaced by a test of a worker's risk of suffering a loss as well as making a profit.

Although S.2369 should result in fewer IRS reclassifications of workers and, thus, fewer retroactive assessments of employment taxes, some reclassifications and retroactive assessments will still occur. In this regard, while the bill's safe harbor provision provides greater certainty, there will no doubt be instances where IRS and businesses disagree on the applicability of the provision. Also, many cases will continue to be resolved under the common law criteria because some workers will not qualify under the safe harbor provision or will choose the option of common law as an alternative test. Thus, the problem of businesses being assessed retroactively--even if they had

acted reasonably in making the worker status determination--will still exist, although on a smaller scale.

The likelihood of IRS reclassifications and retroactive assessments could perhaps be further reduced by Treasury's issuing timely and explicit implementing regulations after enactment of the bill. It is important that such regulations clearly define and explain the safe harbor provision and contain several examples of the applicablity of the criteria.

When retroactive assessments are made, the problem of double taxation can exist in certain cases. Some legislative and administrative remedies are thus needed. Double taxation occurs when the employer and the employee pay taxes on the same income.

IRS cannot offset the employee share of Federal Insurance Contribution Act (FICA) tax with the amount of Self-Employment Contribution Act (SECA) tax the employee paid on the same income, unless the 3-year statute of limitations period has expired. Such an offset is authorized only if the employee is prevented by law from filing for a refund of the SECA tax paid in error.

Failure to offset can result in the employee portion of social security taxes being collected twice--once from the employer as the FICA tax he or she failed to withhold and once from the employee as SECA tax paid in error. This happens because the employees often do not know that they can file for a refund of SECA tax paid. The employer's portion of the FICA tax does not represent a double payment because the tax is paid for the first time when the employer pays the tax.

On the basis of our sample of cases closed in 1975, we estimated that at least 667 employers were assessed retroactively about $2 million in FICA taxes. Of this amount, $1 million represented the employers' portion of the tax. The remaining $1 million represented the employees' portion of the tax which the employer was responsible for withholding. To the extent that the employees paid their SECA taxes while improperly classified as self-employed, a double payment of social security taxes occurred.

For example, we analyzed 5 of the employer cases in our sample. These 5 cases involved 37 employees. Our analysis showed that 24 of the 37 employees paid SECA tax on the income earned while considered self-employed. IRS assessed the five employers $6,913 for the employees' portion of the FICA taxes due on wages paid to the 37 employees. Of this amount $5,008 (72.4 percent) represented a double payment of social security taxes to the Government. The amount of the social security taxes actually due the Government was $1,905.

To help alleviate this problem, we recommended in our 1977 report that the Congress amend Section 6521 of the Internal Revenue Code to authorize IRS to reduce the employees' portion of FICA taxes assessed against employers by an appropriate portion of the amount of SECA taxes paid by reclassified employees for the open statute years. The Congress has not yet acted upon that recommendation. In the interest of equity, we still think it should.

In our 1977 report, we also recommended that to avoid double taxation IRS should use information in its files to adjust retroactive assessments. IRS opposed this recommendation contending that it would shift from the employer to IRS the whole burden of proving which employees had paid self-employment and income taxes and in what amounts. Our intent was not to shift to IRS the whole burden of proving which employees had paid SECA and income taxes. Rather, we intended that, in instances where employers had made reasonable but unsuccessful efforts to obtain employee certifications that the proper tax had been paid, the IRS agent would

(1) where possible and practical, obtain copies of tax returns for those employees from whom the employer was unable to obtain a certification;

(2) make limited checks as to the taxes reported as paid by these employees; and

(3) if justified on the basis of these checks, abate a portion of the employer's tax assessment.

We think our recommendation still merits consideration. We recognize that our recommendation would increase IRS' costs without producing additional revenue. Our concern in this instance, however, is more with the inequity of double taxation. Also, the cost to implement the recommendation should be less after S.2369 is enacted. S.2369 should reduce the number of reclassifications and retroactive assessments and, thus, the number of potential double taxation situations. This, in turn, should result in fewer cases that IRS would need to research.

S.2369 SHOULD IMPROVE INDEPENDENT CONTRACTOR COMPLIANCE IF IRS CAN HANDLE INCREASED WORKLOAD

We also support S.2369 because it should enhance independent contractors' compliance with the tax laws by emphasizing information reporting and providing penalties to ensure that the information reported is accurate and complete. However, the additional information reports and penalties will increase IRS' workload at a time when overall compliance is declining and IRS resources are not keeping pace.

Specifically, S.2369 would expand existing information reporting requirements to include direct sellers who provide consumer goods to others for resale in the home on a buy-sell or deposit-commission basis. It also provides for stiff penalties for payers who fail, without reasonable cause, to provide the information reports to IRS or to the independent contractors. Additionally, the bill would authorize tax withholding when payees fail to provide the identification numbers IRS needs to match the information reports with filed tax returns.

As you know, Mr. Chairman, we have reported and testified extensively on the unreported income problem, including noncompliance by self-employed persons. On March 22, 1982, we testified before this subcommittee in support of S.2198, the Taxpayer Compliance Improvement Act of 1982, which, among other changes, would increase and strengthen the use of information reporting applicable to areas other than independent contractors. We also support S.2369 which is specifically targeted at independent contractors.

As with the information reporting requirements of S.2198, however, S.2369 will increase the number of information reports IRS receives, and IRS will thus have more reports to process and match against tax returns. That matching, in turn, could produce more unreported income cases to investigate. Both situations entail increased use of IRS resources which, as you know, Mr. Chairman, is a problem. In this regard, we have repeatedly stressed the importance of having payers submit information reports on computer tapes instead of on paper, and repeatedly supported the need for increased IRS resources.

S.2369 also provides various penalties designed to ensure the accuracy and completeness of information reports. Although we support the need for tougher penalties, we would like to make an observation concerning the bill's penalty provisions. While we have not had an opportunity to consider all the administrative implications, the penalty surcharge provisions of the bill may be somewhat cumbersome and time-consuming to administer--and thus less likely to be fully enforced by IRS. In this regard, in our testimony on the penalty provisions of S.2198, we pointed out that, while sufficiently high penalties are a necessary part of effectively promoting and enforcing compliance with information reporting requirements, IRS needs to more effectively identify and pursue payers who fail to submit all required information reports.

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In conclusion, Mr. Chairman, we support S.2369 and its principal concerns--clarifying the standards for determining worker

status for Federal tax purposes, and improving independent contractors' compliance with the tax laws. We too think it is time to end the moratorium and provide more certainty for businesses in deciding whether a worker is an employee or self-employed.

Even with the bill's safe harbor provision, some reclassifications and retroactive assessments will still occur. In this regard, we suggest that the Congress consider our recommendation for a FICA-SECA offset to avoid the double taxation which may result in some of these instances.

Although the bill will increase IRS' workload at a time when its resources are spread thin, S.2369, like S.2198, would enhance IRS' efforts to deal with the tax compliance gap. Perhaps more important than any of their specific compliance provisions is the message S.2369 and S.2198 would send to the public--the Congress and IRS are taking tough measures to reduce tax cheating and the burden it places on honest taxpayers.

This concludes my prepared statement, Mr. Chairman. We would be pleased to answer any questions.