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Information Return Requirements for Independent Contractors

Statement of
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Subcommittee on Commerce, Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives

INFORMATION RETURN REQUIREMENTS
FOR INDEPENDENT CONTRACTORS
STATEMENT OF PAUL L. POSNER
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The importance of employers filing required information returns on payments made to independent contractors cannot be overemphasized. IRS officials estimate that billions in taxes are lost because independent contractors do not report all income. When information returns are properly filed, IRS may detect such unreported income by matching those returns with tax returns. Moreover, IRS studies have shown that when information returns are filed, taxpayers report 97 percent of the income reported on the returns; when they are not filed, taxpayers report 83 percent of the income that should have been reported on such returns.

Also, IRS data shows that in 1984 an estimated $1.6 billion in tax revenues were lost because employers misclassified employees as independent contractors. Generally, tax losses from misclassifiction stem from employers not paying employment taxes and misclassified workers taking additional tax deductions that they otherwise would not be entitled to.

GAO found that (1) state and local governments were not complying with information reporting requirements, (2) businesses were not complying and IRS failed to identify this when examining tax returns, and (3) IRS did not have a systematic approach for identifying employers who misclassify workers.

GAO concluded that IRS needs to improve its enforcement of employers' compliance with information return requirements. GAO also concluded that IRS could use information returns to systematically identify employers who misclassify workers. By taking these actions, IRS would be in a better position to assess the billions of tax dollars owed the government because of unreported income and misclassified employees.

Although IRS can improve its ability to identify misclassified workers, Section 530 of the Revenue Act of 1978 restricts IRS from requiring certain employers to reclassify these workers in future years. The legislative history does not clearly indicate why Congress put this restriction on IRS. Given that over 10 years have lapsed and given the opportunities for providing more consistent treatment of taxpayers situated in similar circumstances, as well as enhancing tax revenues, Congress may wish to reconsider this part of Section 530.

IRS Examination and Collection officials agree that they need to improve information return enforcement. They also recognize the merits of using information returns to identify employers who misclassify employees. They have taken some actions, but more needs to be done.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our work for the Subcommittee on information returns used to report payments made to independent contractors. As you requested, we assessed (1) IRS' efforts to ensure that employers submit the required information returns, and (2) the merits of using information returns to detect employers who misclassify employees as independent contractors.

We have concluded that IRS could improve its enforcement of employers' compliance with information return requirements. We also concluded that IRS could use information returns to identify employers who misclassify workers. By taking these actions, IRS would be in a better position to assess the billions of tax dollars owed the government because of unreported income and misclassification. However, revenue gains from identifying misclassification will be limited unless statutory provisions are modified to allow IRS to prospectively correct misclassification.

We did this work for the Subcommittee in three segments. We have recently provided you the first report, which deals with the need for IRS to improve state and local governments' compliance with information reporting requirements. A second report will cover the adequacy of IRS' efforts to detect businesses' noncompliance with these reporting requirements; and a third report will provide details on how IRS could use information returns to identify employers who misclassify workers.

IMPORTANCE OF FILING INFORMATION RETURNS

Employers classify their workers as either employees or independent contractors. When employers classify workers as employees, they are to withhold income and social security taxes and pay these taxes, along with unemployment taxes, to IRS. On the other hand, when employers classify workers as independent contractors, they do not withhold or pay these taxes. Instead, employers are required to annually submit information returns to both IRS and the independent contractors. These returns are to report payments of $600 or more to independent contractors who are sole proprietors and partnerships.[1]

As your Subcommittee has stressed over the years, filing information returns is important to promote full reporting and voluntary compliance. IRS studies show that when information returns are filed, taxpayers report 97 percent of the income reported on these returns. When returns are not filed, taxpayers report 83 percent of the income that should have been reported on the information returns. In addition, IRS uses information returns to detect unreported income by computer-

[1]IRS guidelines exempt most payments made for material goods as well as most of those made to independent contractors who are corporations.

matching them with tax returns and following-up on apparent discrepancies.[2]

The filing of information returns for independent contractors is particularly important. IRS attributed an estimated $16 billion, or 34 percent, of the $48 billion individual tax gap in 1987 to sole proprietors who underreported their income.[3] According to IRS officials, many sole proprietors would be independent contractors whose income would be subject to information reporting. IRS studies show that independent contractors, as a group, tend to underreport their income because they do not have their taxes withheld.

Tax revenues are also lost when employees are misclassified as independent contractors. For example, employees misclassified as independent contractors can reduce their tax liability by deducting business expenses that they otherwise would not be entitled to. Employers can reduce their tax liability by not having to pay social security and unemployment compensation taxes for these misclassified employees. IRS data shows that in 1984 an estimated $1.6 billion in federal tax revenues were lost

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[2]This computer-match program is designed to identify unreported income of independent contractors organized as sole proprietors. IRS is currently exploring the feasibility of developing a similar program for businesses, which would include independent contractors organized as partnerships or corporations.

[3]IRS defines the tax gap as the difference between the amount of income taxes voluntarily paid by individuals and businesses and the amount of income taxes that are owed.

because employers misclassified employees as independent contractors.

IRS COULD BETTER ENFORCE COMPLIANCE WITH INFORMATION REPORTING REQUIREMENTS

Federal, state and local governments, as well as private sector businesses, have not fully complied with IRS' information return requirements, partly because IRS has done little until recently to promote compliance. IRS has not made a concerted effort to help government officials to understand information reporting responsibilities. Also, during income tax examinations, IRS has put a low priority on identifying businesses who did not submit required information returns.

Federal, State, and Local Governments' Noncompliance

In 1986, the Department of Treasury's Inspector General reported that, contrary to requirements, 12 of 14 federal agencies did not report about $9 billion in payments to independent contractors in 1984 and 1985. To obtain comparable information on state and local government compliance, this Subcommittee asked us to review the compliance of various state and local governments with the reporting requirements.

We visited 17 agencies in 6 states, as well as 10 local governments. Officials in these states estimated that in 1987

they paid about $5 billion for professional and consultant services which are usually performed by independent contractors; but they were unable to identify how much of this money was subject to information return reporting.

We found that policies and procedures in 16 of the 17 state agencies and 7 of the 10 local governments were not in full compliance with the reporting requirements. Moreover, in reviewing $9 million in payments to independent contractors that were subject to information reporting, we found that $8 million had not been reported.

Noncompliance occurred largely because many state and local government officials did not fully understand the reporting requirements. For example, officials said they misunderstood which types of business should receive information returns. While they generally understood that they must report payments made to individuals but not corporations, they mistakenly assumed that sole proprietorships and partnerships which operate under a business name were to be treated like corporations.

IRS Examination officials said that because of limited resources, they had not done more to ensure that state and local government officials understand and comply with the information return requirements. However, they believed that most state and local government officials probably have similar compliance problems. Our report recommended that IRS establish a focal point to help these officials understand their reporting responsibilities,

encourage state audit agencies to check for information return compliance, and develop a program to monitor and enforce state and local government compliance. IRS is working with the states, and plans to implement our recommendations.

Businesses' Noncompliance

We also reviewed IRS' efforts to identify businesses' noncompliance. IRS relies on revenue agents to do compliance checks of information return reporting during examinations of business income tax returns. The checks are done to identify businesses who fail to file required information returns. To see how well IRS agents did this task, we reviewed the examinations of business tax returns closed over a 5-month period in fiscal year 1988 in seven IRS districts. We screened the closed examination files to determine whether businesses were subject to the reporting requirements and had filed all required information returns. IRS helped us to make these determinations by contacting a random sample of these businesses and reviewing expenses which appeared to be subject to information reporting requirements.[4]

From these contacts, we estimate that businesses did not file at least one required information return in 467, or 50 percent, of

[4]Our review did not include about 29 percent of the closed examinations that we selected in 7 districts because IRS' files were not available or IRS was unable to complete its follow-up for various reasons. We do not know the extent to which these examinations differ from those included.

932 examinations closed by the 7 districts. Revenue agents who did the initial examinations did not detect these missing information returns, which involved about $6 million in payments made to independent contractors.[5] We could not isolate any single reason why the agents did not detect these missing information returns; however, we were able to identify several factors that may have contributed to this problem.

For example, while IRS' written policy recognizes the importance of compliance checks and requires that they be done, they have been given a low priority in actual practice. IRS Examination managers said they did not stress the importance of these checks because other issues, such as overstated deductions, have had higher priority during examinations. In addition, we found that IRS managers had not enforced workpaper standards that require revenue agents to document the scope and depth of the checks that were made. As a result, they did not know the extent to which checks were made.

Further, IRS did not provide revenue agents with specific procedures for doing compliance checks. For example, IRS did not, at a minimum, require revenue agents to (1) review the business' procedures for issuing information returns, and (2)

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[5]We are 95 percent confident that the (1) true percent and number of examinations that did not identify missing information returns are within 5 percentage points of the estimated 50 percent or 467 examinations from our sample in the 7 districts and (2) true amount of unreported payments made to independent contractors is within 10 percentage points of the estimated $6 million.

test the procedures by reviewing expense accounts that reflect payments which may require information returns.

In 1988, IRS closed about 200,000 business examinations, or about 2 percent of the business tax returns filed that year. If IRS does not detect information return noncompliance in doing examinations, even this limited amount of enforcement will be ineffective. Large amounts of payments will continue to go unreported, and examinations will be less of a deterrent.

IRS Examination officials recognize that better compliance checks need to be done. As a result of our review, IRS has developed a training guide for revenue agents which stresses the importance of doing compliance checks and requires agents to fully disclose in their workpapers the scope, depth and techniques used in doing compliance checks. While this guide should help to stress the importance of doing and documenting compliance checks, the guide does not provide agents with specific guidance on doing the checks, or require examination managers to monitor the adequacy of the checks and the workpapers. We are developing recommendations to improve the effectiveness of the examinations.

INFORMATION RETURNS CAN BE USED TO IDENTIFY EMPLOYERS WHO MISCLASSIFY WORKERS

IRS also can use information returns to identify employers who misclassify employees as independent contractors. IRS guidance provides employers with criteria for classifying workers as

either employees or independent contractors. The criteria include twenty common law factors, which basically revolve around the degree of control the employer has over the worker. The factors include issues such as control over a worker's hours, office space, and training. Because of the subjective nature of the classification criteria and the economic considerations that may be involved, misclassification of workers can occur.

IRS views misclassification as a growing problem. A recent IRS analysis of a sample from 5 million businesses indicates that, in 1984, about 14 percent of these businesses misclassified their employees as independent contractors. IRS' analysis showed that this misclassification resulted in an estimated $1.6 billion federal tax loss.

To identify employers who have misclassified workers, IRS has relied on employment tax examinations. Such examinations are done as a result of IRS' business examinations or leads from other IRS activities, other government agencies, or workers' complaints about their classification.

IRS Collection officials agree that IRS needs to supplement these efforts with a systematic method to identify employers who are most likely to misclassify workers. With IRS' help, we developed such a method using information returns. We believe this method shows considerable promise in helping IRS to identify instances of misclassification. Let me now discuss how we developed this method.

We reasoned that independent contractors who receive all their income from one employer are more apt to be employees than independent contractors. To test this hypothesis, we matched information returns for independent contractors receiving more than $10,000 with the income reported on their tax returns to identify those who received all of their income from a single-employer. Using 1985 tax data, this match identified about 190,000 workers who received all of their reported income from one of about 32,000 employers.

From these 32,000 employers, we selected a random, nationwide sample of 408. IRS interviewed these 408 employers and found that 157, or 38 percent, of them had potentially misclassified their employees as independent contractors. Projecting these sample results to the universe of 32,000 employers showed that about 12,000 had potentially misclassified workers.[6]

This potential misclassification was substantiated by IRS in examining 95 of the 157 employers. IRS examinations confirmed that 92 had misclassified workers and had additional tax liabilities. While we cannot project the tax liability of the 92 employers to the 12,000 employers, the examinations showed the tax liability for these employers alone would be $16.6 million for 1986 and 1987.

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[6]We are 95 percent confident that the true number of employers who had potentially misclassified workers is within 6 percentage points of the estimated 12,000.

As a result of these examinations, IRS revenue officers determined that the employers could be assessed about $10 million of the $16.6 million in taxes and penalties. However, according to the revenue officers, the remaining $6.6 million could not be assessed because Section 530 of the Revenue Act of 1978 restricts IRS' authority to require the reclassification of workers.

Section 530 specifies the conditions under which employers have a reasonable basis for continuing their classification practices, such as (1) a prior IRS audit that did not challenge their practices, (2) an established long-standing industry practice, or (3) an IRS revenue ruling or judicial precedent. To obtain the protections, employers must have consistently classified similar workers and filed required information returns.

Section 530 was enacted because Congress felt that IRS had become overly aggressive in identifying misclassified employees and assessing taxes on prior periods, making employers liable for large amounts of back-taxes. However, for any employer who has protection under Section 530, IRS is not only restricted from pursuing past tax liabilities, but also current and future liabilities. The legislative history does not clearly indicate why Congress chose to restrict IRS from requiring prospective reclassification. However, it does indicate that the restriction was to be temporary until controversies over classification could be resolved. This resolution has not occurred and the

restriction against requiring prospective reclassification has continued.

Our sampled data suggest that Congress may wish to revisit this restriction. While our sampled data does not allow us to comment on each of the Section 530 restrictions, we were able to do some analysis on the prior audit restriction. The prior audit restriction affected most of the sampled cases that IRS revenue officers said could not be pursued. Of the 95 audited employers, 25 claimed Section 530 protection. Of the 25 employers, 17 claimed a prior audit protection, including 6 employers who also claimed another protection, such as industry practice. In all these cases, because the revenue officers determined that the claimed protections were covered under Section 530, the employers could not be required to reclassify their workers, pay taxes owed for 1986 and 1987, or acknowledge future tax liabilities.

In an attempt to maximize the use of its resources, IRS usually concentrates its efforts on the tax compliance issues that caused the business income tax return to be selected for audit, such as potential unreported income and overstated deductions. IRS considers it neither feasible nor desirable to do a comprehensive audit of all potential issues for each selected business. According to IRS Collection and Examination officials, employers who have been audited have Section 530 protection, unless the prior audit successfully challenged their classification practices. Our analysis showed that none of the 17 prior audits

in our sample did so because they were essentially business income tax audits that focused on income tax issues and not employment tax issues, such as misclassification.

The prior audit protection not only results in lost tax revenue, but also provides employers who have the protection with an advantage over business competitors who do not. Unlike their competitors, these employers can classify their workers as independent contractors and do not have to assume the costs associated with having employees, such as withholding taxes and providing fringe benefits. If the prior audit restriction was modified to allow prospective reclassification, employers could be more consistently treated without penalties for past classification practices. Prospective reclassification is also an issue for the other protections afforded in Section 530.

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CONCLUSIONS

In an era of high budget deficits, it is especially important that all taxpayers pay the taxes they owe. Billions of dollars of taxes are owed due to independent contractors' unreported income and misclassification. With this compliance problem, enhanced IRS enforcement efforts are warranted.

Compliance with the information returns reporting requirements is critical to identifying taxes owed. But IRS is not receiving all

of the returns it should. IRS needs to do more to see that employers understand and act on their reporting responsibilities. This includes ensuring that IRS examination staff focus on these reporting requirements when doing business examinations.

In addition to identifying unreported income, IRS can use information returns to identify employers who misclassify employees. The method we developed provides IRS with a way to identify employers who have a high potential for noncompliance and allows IRS to better target its resources. IRS agrees that using information returns for this purpose has merit.

Although IRS can improve its ability to identify misclassified workers, Section 530 restricts from requiring certain employers to reclassify these workers in future tax years. The legislative history is not clear as to why Congress placed this restriction on IRS. However, given that 10 years have elapsed since then and given the opportunities for providing more consistent treatment of taxpayers situated in similar circumstances as well as enhancing tax revenues in the process, Congress may wish to reconsider the prospective reclassification provision of Section 530.

This concludes my statement and I would be pleased to address any questions about our work.