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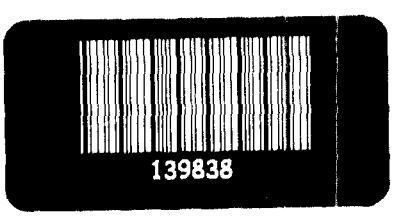
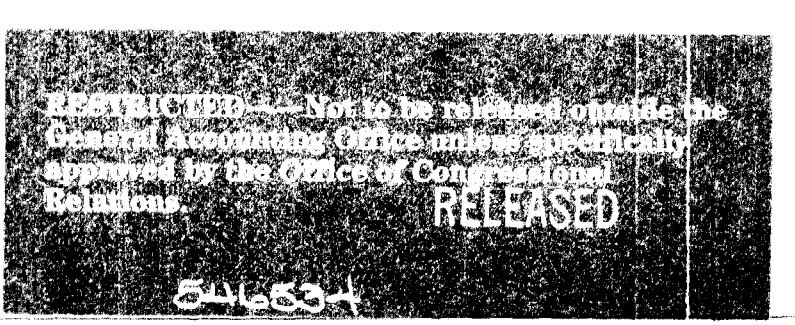
Report to the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations, House of Representatives

September 1989

TAX ADMINISTRATION

Information Returns Can Be Used to Identify Employers Who Misclassify Workers





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United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-229469

September 25, 1989

The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your January 1988 request that we determine whether the Internal Revenue Service (IRS) can use information returns[1] to identify employers who misclassify employees as independent contractors. Specifically, you wanted to know whether matching independent contractors' information returns with their tax returns would provide IRS with a systematic method for identifying these employers.

IRS views misclassification as a growing problem and recognizes the importance of identifying employers who misclassify employees as independent contractors because significant tax revenues are lost. IRS' most recent data show that in 1984 at least $1.6 billion in tax revenues were lost because employers misclassified employees as independent contractors.

Results in Brief

IRS can use information returns to identify employers who misclassify employees as independent contractors. By matching independent contractors' income on their information returns with income on their tax returns, IRS can make its identification process, which now relies primarily on leads from third-party sources, more systematic. This systematic method can help IRS to better identify the most noncompliant employers and to use its employment tax examination resources more effectively.

We reasoned that workers who receive all income from one employer are more apt to be employees than independent contractors. By matching independent contractors' income on information returns with income reported on their tax returns, we identified over 190,000 workers classified as independent contractors who received all income from one of 32,000 employers during 1985. IRS revenue officers interviewed a random sample of 408 of these employers. The interviews showed that an

[1]Forms sent to IRS by employers to report, among other things, payments made to independent contractors.

estimated 157 employers, or 38 percent, may have misclassified employees as independent contractors. Projecting the results to the universe of 32,000 employers showed that about 12,300 employers may have misclassified their workers. As of March 1989, these officers had completed detailed examinations on 95 of these employers, which confirmed that 92 had misclassified workers. As a result, the officers recommended taxes and penalties of about $17 million for 1986 and 1987.

Although IRS can use information returns to better identify employees misclassified as independent contractors, Section 530 of the Revenue Act of 1978 restricts IRS' authority to require certain employers to reclassify—or to classify correctly—these workers, even for future years. It also prohibits IRS from assessing back taxes that should have been withheld and paid. As a result, IRS could not assess about $7 million of the $17 million in our 1986 and 1987 sampled cases.

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. While Congress has resolved some issues, such as classifying certain workers as independent contractors, the restriction against prospective reclassification has continued.

IRS agrees that matching independent contractors' information returns and tax returns can help to systematically identify employers who are misclassifying employees as independent contractors. IRS has already received our computer program for this match and plans to test and implement a matching program. IRS also agrees with us that Congress may want to consider repealing the Section 530 restriction on IRS' authority to require employers to prospectively reclassify employees who have been misclassified.

Background

Employers decide whether to classify workers as independent contractors or employees. While both types of workers may provide similar services, employees do so under the direct control of the employer. Conversely, independent contractors, organized as sole proprietorships, partnerships, or corporations, provide services without the employers' direct control.

IRS guidance provides employers with criteria for classifying their workers, including 20 common law factors. (See app. I.) These factors revolve around the degree of, or right of, control an employer has over workers,

such as their hours, space, and training. However, in determining the proper classification, these factors can be subjective; each factor may not apply, and if a factor does apply, its degree of importance can vary both from occupation to occupation and with the related facts and circumstances. Because of the subjective nature of the classification criteria, misclassification of workers can occur.

Employers also have economic incentives to misclassify. When employers classify employees as independent contractors, they can reduce their tax liability by not having to pay social security and federal unemployment compensation taxes. They also may avoid the costs from withholding income taxes or providing fringe benefits, as they do for employees. Other incentives for not treating workers as employees include the costs associated with minimum wage laws, worker's compensation insurance, state unemployment taxes, and collective bargaining.

When an employee is misclassified, federal tax revenues are lost. IRS studies show that independent contractors tend to underreport their income because they do not have their taxes withheld. For 1987, IRS estimated that sole proprietors, many of whom are independent contractors according to IRS officials, accounted for $16 billion, or 34 percent, of the $48.3 billion tax gap caused by individuals who did not fully report their income.[2]

Revenues are also lost because noncompliant employers and misclassified employees pay less tax. As previously mentioned, employers who misclassify employees as independent contractors do not pay social security or unemployment compensation taxes. Also, employees misclassified as independent contractors can reduce their tax liability by deducting business expenses that employees are not usually entitled to deduct. For example, independent contractors can deduct expenses for automobiles, homes, medical insurance, retirement plans, and business trips. If employees are entitled to a deduction, they can only deduct limited amounts.

IRS relies primarily on third-party leads to identify employers who misclassify. Leads on apparent cases of misclassification come from such sources as (1) workers who complain about their classifications, (2) IRS' examinations of business income tax returns, and (3) referrals by other

[2]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.

federal and state agencies. To confirm whether the apparent misclassification exists, IRS must first interview employers on their classification practices, using the 20 common law factors. If misclassification seems evident, IRS then must do employment tax examinations to verify whether the employers misclassified workers.

IRS has historically relied on the Examination Division to do employment tax examinations but over the years the Division's examinations have declined. In 1979, Examination did about 109,000 examinations, or 0.43 percent, of the employment tax returns filed. In 1988, Examination did about 24,000, or 0.09 percent, of the returns filed. According to National Office Examination officials, the decline in these examinations occurred because of restrictions on IRS' authority to correct all misclassifications, due to Section 530 of the Revenue Act of 1978.

Because of the decline in examinations and IRS' belief that misclassification is a serious problem, IRS' Collection Division instituted a nationwide employment tax examination program in 1987, which generally focuses on employers whose assets are $3 million or less. In 1988, Collection did 1,120 examinations of which about 90 percent resulted in proposed tax assessments of over $50 million and in the reclassification of 46,258 workers as employees. Reclassification places these employees under the income tax withholding system, which increases the likelihood that their tax liabilities will be identified and paid.

While third-party leads that initiated these employment tax examinations have proven to be helpful in identifying misclassification and generating proposed taxes, Collection officials recognize that the leads do not systematically cover the universe of employers who may be misclassifying workers. For example, the leads may not be identifying certain types of employers who have been most noncompliant in classifying workers. These officials said they have been exploring various methods to more systematically identify such employers and believed that using information returns could improve the identification process.

Objective, Scope, and Methodology

Because of concerns about employers misclassifying employees as independent contractors, you asked that we determine whether IRS can use information returns to identify such employers.

To test the use of information returns in identifying misclassification, we matched independent contractors' income as reported on both information returns and tax returns to identify those who made more than

$10,000 from a single employer. Using 1985 tax data, the most recent available for matching, we identified a universe of 190,809 workers who received all of their income from one of 32,032 employers.

After we identified our universe of 32,032 employers, IRS revenue officers interviewed a random, nationwide sample of 408 to determine, using the 20 common law factors, whether these employers may have misclassified their workers. Where the interviews indicated misclassification, the revenue officers began a detailed examination. IRS finished 95 examinations by March 1989, the time when we completed our field work. Appendix II provides detail on our sampling methodology.

We also analyzed IRS' current enforcement efforts and reviewed IRS' policies and procedures for detecting misclassification, along with related IRS studies and Internal Audit reports. We also interviewed IRS officials responsible for employment tax compliance in the Offices of both the Assistant Commissioners for Collection and Examination. We did our work between July 1988 and April 1989 and in accordance with generally accepted government auditing standards.

Matching Information Returns With Tax Returns Can Systematically Identify Employers Who Misclassify

With IRS cooperation, we used information returns as part of a systematic method for identifying employers who misclassify workers. We reasoned that independent contractors who receive all 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 income from a single employer.

Of the 408 sampled employers interviewed, IRS revenue officers found indications that 157, or 38 percent, misclassified their employees as independent contractors. Projecting these results to the universe of 32,032 showed that 12,332 employers may have misclassified their workers.

The revenue officers substantiated this misclassification by examining 95 of the 157 employers, as of March 1989. These examinations confirmed that 92 employers had misclassified 17,347 employees as independent contractors. While the number of examinations was too few to allow any dollar projections, the revenue officers recommended for these 92 employers alone taxes and penalties of $16.7 million in 1986 and 1987.

These estimated taxes and penalties accounted for employers' liabilities for social security, income withholding, and unemployment taxes. The liabilities did not account for tax losses due to misclassified independent contractors' deductions of business expenses, which otherwise may not be available to them as employees. To gain perspective on the degree to which independent contractors take these deductions, we judgmentally selected 157 independent contractors—each of whom worked for one of the 157 employers who may have misclassified workers. While we do not know whether these independent contractors were actually misclassified employees, we found that the business expenses that they deducted offset about $2.6 million, or 46 percent, of the $5.6 million in income that they reported.

We believe that this matching process offers a more proactive way to identify misclassification than third-party leads do. IRS National Office officials have acknowledged that they need a more systematic identification method, such as this matching process, which would not necessarily be costly. For example, because IRS already matches information returns and income tax returns to identify unreported income, IRS would not have to create an entirely new matching process to identify employers who misclassify workers. Also, IRS already does employment tax interviews and examinations. With a more systematic approach, IRS can better target these employment tax resources on those employers who are most noncompliant across the universe of employers.

The criteria used in our matching process also could be refined to accommodate any changes in IRS' strategy for identifying employers who misclassify workers. For example, IRS could capture broader universes of employers by selecting information returns under our $10,000 criteria or by identifying employers who pay slightly less than 100 percent of an independent contractor's income. Also, while our analyses of the 92 IRS examinations did not show major differences in the types of employers who most often misclassified employees, IRS may wish to explore this issue. IRS' analyses of the types of employers that it identifies over a number of years as misclassifying workers, may provide criteria to further refine the method.

IRS Collection and Examination National Office officials said that using information returns as a method to identify employers who misclassify workers has merit. They also said that this method would supplement their current efforts and is worth pursuing.

IRS Cannot Require Certain Previously Audited Employers to Reclassify

Although IRS could use information returns to identify employers who misclassify employees as independent contractors, Section 530 of the Revenue Act of 1978, Public Law 95-600, restricts IRS' authority to require certain employers to reclassify these workers. It also prohibits IRS from assessing back taxes that should have been withheld and paid by qualifying employers. As a result, employers continue to misclassify workers and federal tax revenues are lost. According to IRS revenue officers, $6.7 million of the $16.7 million in recommended taxes and penalties for misclassification in 1986 and 1987 could not be assessed because of a Section 530 restriction in 25 of their 92 examinations.

Section 530 protects employers from IRS reclassification if they have a reasonable basis for classifying employees as independent contractors, such as (1) any past IRS audit that did not successfully challenge their classification practices involving similar individuals, (2) an established long-standing recognized industry practice, or (3) an IRS revenue ruling, a private letter ruling issued to the taxpayer, or a judicial precedent. Further, employers may claim such protection if they can show some other reasonable basis for their classifications. To obtain this protection, employers must file required information returns for payments made to these workers and consistently classify all similar workers as independent contractors. As long as employers meet these two basic conditions, along with having at least one reasonable basis, IRS cannot correct their misclassifications of workers or assess back taxes.

Table 1 shows our 25 sampled cases by type of Section 530 protection and tax revenue losses in 1986 and 1987.

Table 1: Number of Section 530 Protections by Type of Protection and Tax Revenue Lost in 1986 and 1987

Type of protection	Protections	
	Number	Tax revenue lost
Employers with one protection		
Past audit	11	$1,196,000
Industry practice	6	297,000
Judicial precedence	0	0
Other reasonable basis	0	0
Subtotal	17	$1,493,000
Employers with multiple protections		
Past audit and others[a]	6	$5,118,000
Other multiple protections[b]	2	85,000
Subtotal	8	$5,203,000
Total	**25**	**$6,696,000**

[a]Of the six employers, five also had an other reasonable basis, four had an industry practice, and one had a judicial precedent.

[b]Of the two employers, both had an industry practice and one also had a judicial precedent while the other also had an other reasonable basis.

While our data do not allow us to comment on each Section 530 protection, we were able to do some analysis on the past audit protection. As shown in table 1, this protection affected 17 of the 25 cases, as well as most of the $6.7 million for 1986 and 1987 that IRS revenue officers said could not be pursued.

According to IRS Collection and Examination officials, employers qualify for the past audit protection, unless the past audit successfully challenged their classification practices. Our analysis of the 17 cases showed that IRS could identify the type of past audit that created the protection in 13 cases. All 13 past audits were income tax audits, which usually focus on income tax issues and not on employment tax issues like misclassification.[3] With this focus, none of the 13 past audits successfully questioned classification practices. This protection applies even if the past audit did not intend to cover classification. It also applies even if the past audit occurred many years ago, as we found in one case where it had occurred in 1962.

[3]During business income tax audits, IRS employees usually concentrate only on the tax compliance issues, such as unreported income and overstated deductions, that caused the return to be selected for audit. In attempting to maximize their resources, Examination officials consider it neither feasible nor desirable to audit all potential issues, like classification, for each business selected.

Because Section 530 grants employers continued protection against IRS reclassification, IRS not only loses tax revenues, but employers who have the protection may have a distinct advantage over its competitors who do not. For example, if IRS identified two employers who provided similar services and misclassified employees as independent contractors, but one had protection due to a past audit, the employer without this protection would be required to reclassify these workers. As a result, this employer would have to pay employment taxes and assume the costs of withholding wages and paying for employees' fringe benefits, unlike the employer with the past audit protection.

Congress enacted Section 530 largely because it believed IRS had become too aggressive in pursuing employers who misclassified workers, and assessing those employers with large amounts of back taxes. For employers with Section 530 protection, however, IRS is restricted not only 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 (originally to expire at the end of 1 year) until controversies over classification could be resolved. While Congress has resolved certain issues, such as statutorily classifying real estate agents and direct sellers as independent contractors, the restriction against requiring prospective reclassification has continued.

Conclusions

IRS can use information returns to identify employers who misclassify employees. The method we developed provides IRS with a systematic way to identify employers whose classification practices are likely to be the most noncompliant. This allows IRS to better target its audit resources on such employers. IRS agrees that using information returns for this purpose has merit.

Although IRS can improve its ability to identify misclassified workers, Section 530 restricts IRS from requiring certain employers to reclassify these workers. While payment of back taxes imposed burdens on certain employers, the legislative history does not clearly indicate why Congress chose to restrict IRS' authority to require reclassification for future tax years. It was clear, however, that the restriction was intended to be temporary.

Recommendation

We recommend that the Commissioner of Internal Revenue match independent contractors' information returns with their tax returns to more systematically identify employers who are misclassifying employees as independent contractors and to better target audit resources for doing employment tax examinations.

Matter for Congressional Consideration

Section 530 of the Revenue Act of 1978 restricts IRS' authority to ensure that current and future classifications will be correct. In view of the equity issues and tax revenues involved, Congress may want to consider repealing this restriction against requiring employers to prospectively reclassify employees who have been misclassified as independent contractors.

Agency Comments and Our Evaluation

In a August 15, 1989 letter, the Commissioner of Internal Revenue provided written comments on a draft of this report, in which he agreed with our conclusion, recommendation, and matter for congressional consideration. (See app. III.) He said IRS plans to implement such a match as an annual check by January 1991. We support IRS' planned action that, if effectively implemented, should help to more systematically identify employers who misclassify workers.

As arranged with the Subcommittee, unless you publicly announce its results earlier, we plan no further distribution of this report until 30 days from the date of issuance. After this time, we will send copies of the report to the Commissioner of Internal Revenue and to other interested parties. We will also make copies available to others upon request.

Major contributors to this report are listed in appendix IV. If you have questions, please call me on 272-7904.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Associate Director
Tax Policy and Administration
Issues

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Abbreviation

IRS Internal Revenue Service

Common Law Factors Used to Determine Workers' Classification

IRS uses 20 common law factors to determine whether workers are employees or independent contractors (see Internal Revenue Manual, 4600 Employment Tax Procedure, Exhibit 4640-1). 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 intergrated 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. 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 materials.
15. Lack a major investment in facilities used to perform the service.
16. Cannot make a profit or suffer a loss from their 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 at any time without incurring liability.

Objective, Scope, and Methodology

This appendix describes our objective, scope, and methodology for this review. It also provides confidence intervals for the estimates cited in our report.

Our objective was to determine whether IRS can use information returns to identify employers who misclassify workers. To meet this objective, we asked IRS to interview a randomly selected sample of employers. To obtain this sample, we matched tax year 1985 information returns filed by employers on payments made to independent contractors with the independent contractors' income tax returns to identify those who made more than $10,000 from a single employer. We judgmentally chose $10,000 as our criterion. Our match identified 190,809 potentially misclassified employees, involving 32,032 employers.

We asked IRS to interview a sample of these employers to determine if any employees appeared to be misclassified as independent contractors. IRS staff interviewed a nationwide, random sample of 408 employers. To ensure that the interviews were consistent, we developed a data collection instrument for documenting IRS' interview information. This instrument conformed to IRS' procedures for determining whether an employer-employee relationship exists but required more documentation. We asked IRS to clarify any ambiguous or incomplete documentation, recontacting the employer if necessary.

IRS then did an employment tax audit on a random sample of 95 of the 157 employers where interviews uncovered evidence of misclassification. We had requested that IRS do 150 audits, but it was unable to finish them by March 1989 due to such reasons as insufficient time or resources or an ongoing criminal investigation or examination of the employer. For tax years 1986 and 1987, the audits identified whether misclassification occurred, the amount of additional taxes owed, and whether a Section 530 protection would restrict IRS from collecting these taxes. Because we were limited to 95 audits, we cannot project the results of this work nationwide.

Although we used tax year 1985 data to identify our universe of employers, IRS' interviews and audits focused on tax years 1986 and 1987 because IRS was still doing audits for these years. IRS officials agreed that employers who misclassified employees in 1985 probably had continued doing so in 1986 and 1987.

Because we used a random sample to develop our estimates, each estimate has a sampling error. The sampling error is a measure of an estimate's precision. We used sampling errors to construct the lower and upper limits of confidence intervals, at the 95-percent level, for key estimates in the report. Table II.1 presents the confidence intervals for the number of employers in our universe of 32,032 and our sample of 408 interviewed employers who may have misclassified workers.

Table II.1: Confidence Intervals for the Number of Employers Who May Have Misclassified Workers During 1986 and 1987

Misclassification among employers in the:	Estimate	Lower interval	Upper interval
Sample of 408	157	138	176
Universe of 32,032	12,332	10,827	13,838

Note: These confidence intervals were computed using 95-percent intervals and simple random sampling with replacement.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

AUG 15 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: Information Returns Can Be Used To Identify Employers Who Misclassify Workers".

We agree with the report's recommendation to match independent contractors' information returns with their tax returns. We believe this would enable us to use our employment tax examination resources more effectively by systematically identifying the most noncompliant employers. We have contacted your staff to secure the program used to develop the leads in their study and plan to implement it as an annual check. In order to allow sufficient lead time to properly develop and test this new program, we expect that the earliest possible implementation date will be January 1991.

In addition, we support your recommendation that Congress reconsider Section 530 of the Revenue Act of 1978. Although we will continue to seek improvements in our compliance programs, their effectiveness will be limited by the statutory restrictions of Section 530.

We hope you find these comments useful.

Best wishes.

Sincerely,

Fred T. Goldberg, Jr.

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