REPORT #852

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REFORMS TO
ADMINISTRATION AND ENFORCEMENT OF EMPLOYMENT TAX
AND INCOME TAXES ON INDIVIDUAL WORKERS

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TAX SECTION
New York State Bar Association

October 17, 1995

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20510

Re: Administration and Enforcement of Employment Taxes and Income Taxes On Individual Workers

Dear Mr. Chairman:

I am pleased to submit for your consideration the enclosed report on proposed reforms to the administration and enforcement of employment taxes and income taxes on individual workers. The principal authors of the report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau, a member of that Committee.

The report addresses an area of the tax law that is of real concern to enormous numbers of taxpayers, from individual workers, to small businesses, to the largest corporations. Over the years attempts have been made to rationalize this area, and as evidenced by various recent legislative proposals, this continues to be an area in which Congress and the Administration seek to establish some order. To date, however, there has been no comprehensive reform. As a result, the problems of worker classification, of noncompliance with employment and income tax responsibilities, and of the effective and equitable conduct of employment tax audits continue to bedevil the tax system.

The report makes a number of recommendations for reform, some of them legislative and some administrative. Among the most important, the report urges that Congress enact detailed and specific rules for classifying workers as either employees or independent contractors.

The report analyzes a number of recent legislative proposals for worker classification, but concludes that, while the proposals reflect some useful concepts, each fails to provide an adequate solution to the current problem. The report therefore proposes instead that Congress enact specific and practical safe harbor criteria for classifying workers as independent contractors or employees, and restrict the need for "common law" classification to those individuals who do not fall within either safe harbor. The report also recommends that section 530 (of the Revenue Act of 1978) be revised and incorporated into the Internal Revenue Code; that penalties be increased and various reporting requirements enhanced; that workers be specifically apprised of their rights and obligations as self-employed persons; and that the IRS establish an expedited audit or review process for worker classification. Finally, the report suggests that consideration be given to two more controversial and fundamental changes: the imposition of income tax withholding on payments to independent contractors, and the enactment of an amnesty to encourage employers to come into compliance with any new worker classification rules.

We emphasize that this is an area of the tax law that is of real practical significance to great numbers of businesses and individuals. We urge that this subject be given your prompt attention, and we would be gald to be of assistance in this process.

Very truly yours,

Carolyn Joy Lee
Chair

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* Copies of the enclosed report have also been sent, under a similar cover letter, to:

The Honorable Daniel P. Moynihan
United States Senate
Committee on Finance
The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives

The Honorable Sam M. Gibbons
House of Representatives
Committee on Ways & Means

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable Margaret M. Richardson
Commissioner

Internal Revenue Service

Mr. Kenneth J. Kies
Chief of Staff
Joint Committee on Taxation

Tax Report #852

TAX SECTION
New York State Bar Association

October 17, 1995

The Honorable Daniel P. Moynihan
United States Senate
Committee on Finance
464 Russell Senate Office Building
Washington, D.C. 20510

Re: **Administration and Enforcement of Employment Taxes and Income Taxes On Individual Workers**

Dear Senator Moynihan:
I am pleased to submit for your consideration the enclosed report on proposed reforms to the administration and enforcement of employment taxes and income taxes on individual workers. The principal authors of the report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau, a member of that Committee.

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TAX SECTION
New York State Bar Association

October 17, 1995

The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives
1236 Longworth House Office Building
Washington, D.C. 20515

Re: Administration and Enforcement of Employment Taxes and Income Taxes On Individual Workers

Dear Chairman:

I am pleased to submit for your consideration the enclosed report on proposed reforms to the administration and enforcement of employment taxes and income taxes on individual workers. The principal authors of the report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau, a member of that Committee.

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TAX SECTION
New York State Bar Association

October 17, 1995

The Honorable Sam M. Gibbons
House of Representatives
Committee on Ways & Means
2204 Rayburn House Office Building
Washington, D.C. 20515

Re: Administration and Enforcement of Employment Taxes and Income Taxes On Individual Workers

Dear Mr. Gibbons:

I am pleased to submit for your consideration the enclosed report on proposed reforms to the administration and enforcement of employment taxes and income taxes on individual workers. The principal authors of the report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau, a member of that Committee.

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TAX SECTION
New York State Bar Association

October 17, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20200

Re: Administration and Enforcement of Employment Taxes and Income Taxes On Individual Workers

Dear Secretary Samuels:

I am pleased to submit for your consideration the enclosed report on proposed reforms to the administration and enforcement of employment taxes and income taxes on individual workers. The principal authors of the report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau, a member of that Committee.

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TAX SECTION
New York State Bar Association

January 12, 1990

The Honorable Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Administration and Enforcement of Employment Taxes and Income Taxes On Individual Workers

Dear commissioner Richardson:

I am pleased to submit for your consideration the enclosed report on proposed reforms to the administration and enforcement of employment taxes and income taxes on individual workers. The principal authors of the report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau, a member of that Committee.

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TAX SECTION
New York State Bar Association

January 12, 1990

Mr. Kenneth J. Kies
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20220

Re: Administration and Enforcement of Employment Taxes and Income Taxes On Individual Workers

Dear Mr.Kies:

I am pleased to submit for your consideration the enclosed report on proposed reforms to the administration and enforcement of employment taxes and income taxes on individual workers. The principal authors of the report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau, a member of that Committee.

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSED REFORMS TO ADMINISTRATION AND ENFORCEMENT OF EMPLOYMENT TAX AND INCOME TAXES ON INDIVIDUAL WORKERS [1]

It has long been recognized that there is a need for clarification of the worker classification rules in the employment tax area. The continuing ambiguities in the rules determining worker classification have given rise to decades of dispute among employers, workers, and the Internal Revenue Service regarding proper worker classification. Furthermore, recent governmental studies have demonstrated an urgent need to improve independent contractor compliance in the reporting of income. The tax losses from non-compliance in this area now account for almost one-third of the total "tax gap" from underreporting of income by individuals. The purpose of this Report is to make recommendations for reform in these areas.

I. GENERAL BACKGROUND

The characterization of a worker as an "employee" or an "independent contractor" triggers a variety of federal income and employment tax consequences to both the worker and his employer. In addition, such characterization determines the status of workers for eligibility for fringe benefits provided by the employer (e.g., qualified health and retirement plans). Moreover, should Congress consider health care reform in the future, many issues related to health care coverage seem likely be to be determined by reference to whether the worker is an "independent contractor" or an "employee." Such was the case in

[1] The principal authors of this report are Sherry S. Kraus and Robert G. Nassau. Helpful comments were provided by David H. Brockway, Richard G. Cohen, Arnold Y. Kapiloff, Victor F. Keen, Carolyn Joy Lee, Robert J. Levinsohn, Richard L. Reinhold, David Sachs, Michael L. Schler, Eugene L. Vogel and David E. Watts.

the Health Security Bill (H.R. 3600), which was not enacted into law.

Where an employer-employee relationship exists, the employer is required to withhold income tax and the employee's share of social security taxes from payments of "wages" to the employee[2]. The employer is also required to pay the employer's share of social security and Medicare taxes[3], as well as federal unemployment taxes.3 On the other hand, where an employer-independent contractor relationship exists, the employer is required only to file an information return (Form 1099-MISC) with the independent contractor and the Internal Revenue Service (the "Service")[4]. The independent contractor is required to pay the full social security and Medicare taxes on his "net earnings from self employment[5]."

If an employer that is required to file information returns with respect to payments made to independent contractors[6] fails to file such returns, or files them incorrectly, the employer may be subject to a penalty of $50 per return, subject to a $250,000 annual limit.[7]

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[2] Sections 3102 and 3402 of the tatemal Revenue Code of 1986, as amended. Unless otherwise specified, all section references in this Report are references to the Internal Revenue Code of 1986, as amended

[3] Sections 3111 and 3301.

[4] Sections 6041 and 6041A

[5] Sections 1401 and 1402. The total employment tax rates for employees and independent contractors are the same; independent contractors themselves pay 15.3%; and the employer and employee each pays 7.65% with respect to the employee. In the absence of withholding by his employer, an independent contractor is also required to pay estimated taxes in order to avoid a penalty. Section 6654.

[6] The return requirement applies to an employer who receives services in the course of the employer's trade or business. Sections 6041(a) and 6041 A(a). Domestic employers of household workers who are independent contractors, for example, are not subject to the information return filing requirements regardless of the amount of payments made to the worker.

[7] Section 6721.

Form 1099-MISC is not required if a worker is paid less than $600 annually, or if the "worker" is a corporation or partnership. Because of the nominal penalties imposed by the Code upon employers who fail to file the required information returns, there has been little incentive for the Service to audit and enforce the information reporting requirements[8].

[8] House Government Operations Committee Report (H.Rept 103-861), The Administration and Enforcement of Employment Taxes - A Status Report, dated October 19,1994, at 9. (This Report is hereinafter referred to as the HGOC Report.)

In 1988, the Service established its Employment Tax Examination Program ("ETEP"), which targeted businesses with $3,000,000 or less in assets to determine the level of compliance in designation of workers' status and to assess taxes owed by reason of misclassifications. Based on these data, the tax gap (unpaid taxes) for misclassified workers for 1992 was estimated to be in the range of $2.1 billion[9]. The Service estimated that 15% of the 5.2 million businesses filing employment tax returns in 1984 had misclassified 3.4 million workers[10].

The magnitude of the problem with misclassification of workers is part of a larger problem; the Service has estimated that in 1992, there was an additional $20.3 billion of lost tax revenue from the underreporting of income by self-employed workers. This is approximately 32% of the total tax gap from individuals not reporting income in 1992.[11]

In testimony before the Commerce, Consumer, and Monetary Affairs Subcommittee in June of 1993, the Service presented the following further data:

• Workers who are classified as employees subject to income tax and social security tax withholding voluntarily report 99% of their wages.

• Independent contractors report 97% of the payments reported to the Service on Form 1099-MISC.

• Independent contractors report only 87% of payments not reported on Form 1099 MISC.[12]

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[9] Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23,1992) at 24. (This Report is hereinafter referred to as the GAO1992 Report.) We are not in a position to assess the accuracy of these statistics.

[10] *Id*..at24.

[11] *Id.* at 23-24.

[12] Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government operations, hearing entitled An Updated Review of Tax Administration Problems Involving Independent Contractors, June 8,1993, p. 14-27, cited in HGOC Report at 5. (This hearing is-hereinafter referred to as the Monetary Affairs 1993 Hearing.') Again, we are not able to evaluate the accuracy of these statistics.

A. Current Law. With very few exceptions, the term "employee" is not defined in the Internal Revenue Code[13]. Generally speaking, the determination of whether an individual is an employee or an independent contractor is made under a common-law test, which is summarized in the Employment Tax Regulations, as follows:

> Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control and direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing he result, he is not an employee[14].

[13] Congress has enacted several statutory provisions explicitly characterizing workers as independent contractors or employees. See Sections 3121(d), 3506,3508 and 7701(a)(20).

[14] Employment Tax Regulations Section 31.3401(c)-(l)(b).

Whether this common law test is met is determined based on the facts and circumstances of each relationship. To help in this determination, the Service has developed a list of twenty factors that may be examined in determining whether an employer-employee relationship exists, no one factor of which is stated to be determinative.[15]

Given the highly factual nature of whether an employer-employee relationship exists, employers sometimes find their classification of an individual as an independent contractor retroactively challenged by the Service. Where the Service prevails, the employer will be subject to back taxes and interest that often jeopardize the continued viability of the employer's business.[16] Even if the Service does not prevail, much time and expense must often be expended before the issue is resolved.

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[15] See Revenue Ruling 87-41,1987-1 C.B. 296

[16] *See, e.g.*, Sections 3403 and 3509. *See also* HGOCReport at 4; and GAO *1992Report* at 1-3.

In response to the problem of retroactive reclassification, Congress has enacted several relief provisions. (1) Section 3509 contains two formulas for assessing the tax, depending upon whether the business filed an information return on the payment to the misclassified worker. The provision limits the amount owed by the employer to 1.5% of wages and 20% of the social security taxes that should have been withheld on the misclassified employee's pay.[17] These percentages double if no information return was filed.[18] In either case, however, the business must still pay 100% of the employer’s share of social security taxes. (2) Section 6205(a)(l) allows, but does not appear to — ire, the government to waive interest on employment tax delinquencies. If less than the correct count of income and Social Security taxes has been paid with respect to an employee, an adjustment of such taxes may be made without interest in such manner and at such times as the Secretary may by regulations prescribe. However, it is rare for the Service to volunteer application of this interest elimination rule. Relief under this provision of the Code is usually reserved to taxpayers who have sufficiently sophisticated advisors to request application of the abatement provision.

The potentially broadest and most important of the relief provisions is Section 530 of the Revenue Act of 1978, P.L. 95-600 (hereinafter referred to as "Section 530"), which, with certain exceptions, generally permits an employer to treat an individual as not being an employee for Federal employment tax purposes - regardless of the individual's actual status under the common law test unless the employer has no reasonable basis for such treatment. As safe harbors, a reasonable basis is deemed to exist if the employer reasonably relied on: (1) judicial precedent, published rulings,

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17 Sections 3509(a)(l) and (2).

18 Sections 3509(b)(l) and (2).

technical advice to the employer, or a private letter ruling to the employer; (2) a past Service audit of the employer in which there was no assessment attributable to the employment tax treatment of persons holding similar positions; or (3) the long-standing recognized practice of a significant segment of the industry in which the individual was employed.[19] In order to qualify for relief under Section 530, the employer must have treated all similarly situated individuals as independent contractors, and must have filed all necessary information returns consistent with the employer's treatment of such individual as not being an employee.[20] Section 530 also bars the Treasury Department from publishing any regulations or revenue rulings classifying persons for purposes of Federal employment taxes under interpretations of the common law.[21]

While Section 530 has been extended several times, it has never been made a part of the Internal Revenue Code. As a result, where an employer qualifies for the safe harbor under Section 530, the worker may be characterized as an independent contractor for employment tax purposes, but as an employee for other Code purposes, such as fringe benefits and pension plans. Furthermore, "Section 530 employees" are only required to pay the employee half of Social Security taxes to fulfill their obligation to the Social Security and Medicare system. The employer half of Social Security and Medicare taxes is not being paid by anyone by virtue of the Section 530 protection to the employer.[22]

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19 Sections 530(aX2)(A),(B) and (C).
20 Sections 530(a)(l)(A) and (B).
21 Section 530(b)
22 See HGOC Report at 15.

A further consequence of Section 530 not being a part of the Code is the lack of Treasury Regulations and revenue rulings in implementation of the Section. Many have protested that the Service's interpretation of Section 530 does not follow the directive by Congress that the provision be interpreted liberally in favor of the taxpayer.[23] This is particularly true in the Service's restrictive application of the "industry standard" safe harbor.[24]

Over the years, there have been many calls for reform in the employment tax area. In 1977, the General Accounting Office reviewed the tax treatment of employees and self-employed persons and concluded that the rules were confusing and inconsistently applied.[25] It urged amendment of the law to exclude from the common law definition of an "employee" any workers who:

- had a separate set of books and records for their business;
- could suffer a loss or make a profit;
- had a principal place of business other than the employer's; and
- made their services generally available to the public as self-employed individuals.

Under this test, a worker was an independent contractor when all four conditions were met. If three conditions were met, the common law rules would apply. In all other cases, the worker was

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[23] HGOC *Report** 18; see also *HRepL No. 95-1748, 95th Cong., 2dSess.* 5 (1978), 1978-3 (Vol. 1) C.B. 629,633

[24] See *Monetary Affairs 1993 Hearing*, pp. 51 -55 and 86-89, *cited in HGOC* Report at 18. While the Internal Revenue Service has recently eased its position on the percentage requirement that must be satisfied for the "industry standard" exception to apply, the Service continues to apply the Section 530 safe harbor restrictively. See Letter, dated March 10,1995, from Commissioner Margaret Richardson to Representative Nancy Johnson, Tax Notes, June 5,1995.

[25] *See Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions* (GAO/GGD-77-88, Nov. 21,1977), *cited in GAO1992 Report* at 21. (This Report is hereinafter referred to as the *GA0 1977 Report*.)

an employee. Rather than undertake a clarification of the rules, however, Congress enacted the safe harbor provisions of Section 530 discussed above.

The General Accounting Office again reviewed this area in its Report published in July 1992. It found that the common law rules for classifying workers remained as unclear and subject to conflicting interpretations as they were in 1977 at the time of its earlier Report. The agency noted that in the intervening years, no final action had been taken to clarify the common law rules as its previous report had recommended.[26]

The Treasury Department and the Service have difficulty in applying the common law rules. In testimony given in 1982, and again in 1991, representatives of the Treasury Department stated that "applying the common law test in employment tax does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification."[27] The Service's interpretation of the common law has led to inconsistent and inequitable treatment of businesses. A November 1990 House Committee on Government Operations Report cited an example of two Florida dry wall companies with similar operations. The Service concluded that one company had to reclassify its workers while the other company did not. The inconsistent Service rulings were believed to have resulted from the fact that the businesses had different Service examiners who were applying the common law rules differently.[28]

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[26] *GAO1992 Report at 3.*

[27] *GAO 1977Report, cited in GAO 1992 Report at 22.*

[28] See Tax Administration Problems Involving Independent Contractors, House Committee on Government Operations (Washington, D.C.: Nov. 9,1990), cited in GAO 1992 Report at page 22.

Notwithstanding the repeated calls for reform, Congress has been reluctant to legislate in this area or to lift the moratorium on further Treasury guidance.[29] There is a concern that any change in the law that might solve the worker classification problem could create new and different burdens on taxpayers.[30] Recently, however, there have been some legislative efforts to address the problems of misclassification and lack of compliance.

B. Recent Legislative Action. Late in 1994, primarily in response to the unmasking of several high-visibility, low-tax compliance employers of nannies and other household workers, Congress enacted the Social Security Domestic Employment Reform Act of 1994 (P.L. 103-387) (the "Nanny Tax Act"). Under the Nanny Tax Act, which was effective starting in 1994, an employer and employee are exempt from Social Security and Medicare taxes if the cash remuneration paid to the worker is less than an applicable dollar threshold ($1,000 in 1994), and if the employee performs "domestic service in a private home of the employer."[31]

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[29] The sentiment is well summarized in one of die most recent governmental reports: "Due to the problems discussed throughout this report, difficulties in this area [worker characterization] have proved to be among the most contentious and complex features of the Federal tax system. The subcommittee is concerned about the burdens imposed on taxpayers, including small business owners, because of the confused and contradictory rules governing the classification of independent contractors. But the subcommittee would also be concerned about any changes in law which might remedy the classification problem only to create new and different burdens on taxpayers." *HGOC Report* at 1-2.

[30] HGOC Report at 2.

[31] Sections 3121 (aX?XB) and 3121 (x), as amended and added, respectively, by Sections 2(aXl)(A) and 2(a)(l)(B) of the Nanny Tax Act.

In an effort to ease the compliance burdens for the domestic employer, the reporting requirements were altered to allow an annual (rather than quarterly) reporting on the domestic employer's annual income tax return (Form 1040).[32]

C. Summary of Relevant Health Security Bill Proposals. During 1993 and 1994, the Clinton Administration and members of Congress introduced, as part of the stillborn health reform movement, a number of proposals intended to bring greater certainty to the classification of workers as employees or independent contractors. This certainty was deemed necessary in that an individual's status as an employee or independent contractor would, under then-pending health reform legislation, determine whether the employer had an obligation to pay that worker's health insurance premiums. Had the legislation been enacted, a new and potentially greater financial incentive for employers to characterize workers as independent contractors would have been created. The new rules of worker classification would have applied for income and employment tax purposes as well.

Although no health reform bill was enacted, the proposals relating to the classification of workers as employees or independent contractors were the first comprehensive legislative proposals in a number of years.

The health care bills would have addressed the need for clarification in the classification of workers as employees or independent contractors as follows: (1) repeal of Section 530, and codification, in new Section 3511, of a modified version of Section 530, which would have protected employers against retroactive reclassifications of workers as employees in certain cases; (2) lifting the moratorium on Treasury to define the term "employee" by regulation; and (3) increasing the penalty for

[32] Sections 3121 (aX?XB) and 3121 (x), as amended and added, respectively, by Sections 2(aXl)(A) and 2(a)(l)(B) of the Nanny Tax Act.

failure to file correct information returns with respect to independent contractors.

1. Modifications to Section 530.[33] Under "new" Section 3 511, if an employer treated a worker as not being an employee for any period, and, for that period, the employer met a "consistency requirement," a "return filing requirement," and a "safe harbor requirement," and the Service had not notified the employer in writing that it should treat such individual (or similarly situated individuals) as an employee, then such individual would be deemed not to be an employee of the employer.

In order to satisfy the "consistency requirement," the employer must have treated such individual, and all similarly situated individuals, as not being employees.

In order to satisfy the "return filing requirement," all Federal tax returns (including information returns) required to be filed by the employer for such period with respect to the individual and similarly situated individuals) must have been timely filed on a basis consistent with the ### treatment of the individual as not being an employee. For this purpose, if the penalty under Section 6721 (a) (Failure to File Correct Information Returns) were reduced or waived pursuant to Section 672 l(b) or 672 l(c) (relating to corrections within a specified period, and de *minimis* failures), such return would be considered timely filed; and if the aggregate amount which is timely and correctly reported on information returns for the calendar year were at least 97% of the amount which was required to be reported, the employer would also be deemed to have satisfied the return filing requirement.

In order to satisfy the "safe harbor requirement," the employer's treatment of the individual as not being an employee must have been: (1) in reasonable reliance on a written

[33] Section 7303 of the Health Security Bill(H.R. 3600).

determination regarding the taxpayer that addressed the employment status of the individual (or similarly situated individuals); (2) in reasonable reliance on a Service audit which was for a period during which the rules for determining employment status were the same as for the period in question, and in which the employment status of the individual (or similarly situated individuals) was examined and accepted; (3) in reasonable reliance on a long-standing recognized practice of a significant segment of the industry in which the individual is employed; or (4) supported by substantial authority (not including private letter rulings to other employers). The industry practice safe harbor would terminate for periods beginning after the date on which regulations were prescribed defining the term "employee."

2. Regulatory Authority.[34] "New" Section 3510 would have authorized the Secretary of the Treasury to prescribe regulations setting forth rules for determining whether a worker is an employee for employment tax purposes, and, to the extent provided in such regulations, income tax purposes. The regulations could have modified the existing rules for determining whether a worker is an employee, except that the regulations were to give significant weight to the common law applicable in determining whether an employer-employee relationship exists. The regulations could not have modified the provisions relating to statutory employees. The regulations would have been effective no earlier than six months after the date the regulations were finalized. The House Ways and Means Committee and the Senate Finance Committee mark-ups removed this provision and substituted a provision that Treasury submit proposed legislation on the classification of workers to the Congressional tax-writing committees on or before January 1,1995.

[34] Section 7301 of the Health Security Bill.

3. Increase Information Return Penalties.[35] Section 6721 (a) would have been amended to increase the penalty for failing to file information returns with respect to independent contractors from $50 per return, to the greater of $50 or 5% of the amount required to have been reported correctly but not so reported. This "greater of penalty would not have applied if the aggregate amount that had been timely and correctly reported with respect to independent contractors was at least 97% of the aggregate amount that was required to be reported. The $250,000 annual cap would remain in effect.

D. Current Legislative Proposals. So far in 1995, three separate Bills have been introduced in Congress relating to worker characterization.

Representative Tom Lantos (D-CA) introduced the Misclassification of Employees Act (H.R. 510). This Bill, which is co-sponsored by Representative Shays (R-CT), and which is similar in many respect to Section 530, would amend the Internal Revenue Code to provide for the waiver of employment tax liability for employers for any period if: (1) the employer did not treat a worker as an employee for purposes of employment taxes; (2) the treatment of the worker was based on a reasonable good faith misapplication of the common law rules used in determining worker classification; (3) federal tax returns were filed on a basis consistent with treatment of the worker as an independent contractor, (4) the employer did not treat any other worker holding a substantially similar position as an employee for employment tax purposes after 1977; and (5) the employer enters into a closing agreement with the Service with respect to treating such worker as an employee.

Representative Jay C. Kim (R-CA) introduced the Independent Contractor Tax Fairness Act of 1995 (H.R. 582). This Bill, which

[35] Section 7302 of the Health Security Bill.

has twelve co-sponsors from both sides of the aisle, would attempt a more comprehensive approach at resolving the problem of worker misclassification. The Bill would require a written "qualified agreement" in order for a worker to be treated as an independent contractor. This qualified agreement would: (1) specify which services were to be provided by the worker, and the duration of the services; (2) state that the worker is aware of his federal tax obligations; and (3) require the worker to maintain separate accounting with respect to the income and expenses derived from the agreement.

In addition to entering into a qualified agreement, one of the following conditions would have to be met in order for the worker to be classified as an independent contractor: (1) the worker can realize a profit or loss as a result of his services; (2) the worker maintains a separate principal place of business and has a significant investment in facilities and tools, which are not typically maintained by employees; (3) the worker makes his services available to the general public and the worker has performed services for at least one other employer during the current year or the previous calendar year, or (4) the worker is paid exclusively on a commission basis and maintains his principal place of business other than at the employer's premises, or pays fair market rental value for his premises at the employer's place of business.

Most recently, Representative Jon L. Christensen (R-NE) introduced the Independent Contractor Tax Simplification Act of 1995 (H.R. 1972). This Bill, which has over 100 co-sponsors (including Representative Kim) from both sides of the aisle (though primarily from the Republican Party), is similar to the Kim Bill, in that it sets forth objective criteria that must be met in order for one to be classified as an independent contractor. Specifically, the worker must satisfy three separate tests.

Under the first test, the worker must either: (1) have a significant investment in assets or training; (2) incur significant unreimbursed expenses; (3) agree to perform his services for a particular amount of time or to complete a specific result and be liable for damages for early termination without cause; (4) be paid primarily on a commission basis; or (5) purchase products for resale.

Under the second test, the worker must either: (1) have a principal place of business; (2) not primarily provide the service at the employer's place of business; or (3) pay fair market rent for use of the employer's premises. If none of these conditions is met, then the worker must either: (1) not be required to perform services exclusively for the employer, in the current, preceding or subsequent year, and have performed a significant amount of services for other employers; (2) have offered to perform services for others; or (3) provide services under a registered business name.

Under the third test, the worker and employer must enter an agreement that provides that the worker will not be treated as an employee.

These three Bills are only the most recent legislative initiatives that seek to unravel the worker characterization conundrum. Interestingly, two of the Bills deal primarily with the issue of worker characterization, and impose more objective criteria in the determination of worker status. Legislation in the past has essentially avoided the worker classification problem. For example, Section 530 established several limited safe harbors, but primarily left the common law test in place, merely shifting slightly the burden of proof. The Nanny Tax Act made no effort to address the problem of domestic worker characterization as an employee or as an independent contractor, choosing instead simply to raise the floor with respect to which

employment taxes would have to be paid, thus simplifying compliance.

Even the recent efforts in the Health Care Bill made no effort to direct Treasury on how to give greater clarity in this area other than directing Treasury to apply the common law rules. Perhaps symptomatic of the fear that a removal of the moratorium on Treasury to clarify this area will result in new and different problems, even that directive was eventually removed, and one substituted simply asking for a recommendation for legislative proposals on clarification of this area.

II NEED FOR REFORM

A. Ambiguity of Common Law Test. As noted above, the determination of whether one is an employee or an independent contractor is most often made on the basis of a fact-intensive common law inquiry. Given the myriad factual situations that arise in the world of employment, it is, in many cases, difficult - even for the most well-intentioned taxpayers - to characterize correctly the status of a worker as an employee or an independent contractor.

The "twenty-factor test" of Revenue Ruling 87-41, as currently applied by the Service, fails to give clear guidance in this area. The factors are, in many cases, not easily differentiated, and are highly subjective. The Ruling sets forth twenty areas that are deemed relevant to the characterization of a worker as an employee or an independent contractor without setting forth any rules or guidelines regarding the proper application and/or weighting of those factors. In addition, most employment situations possess elements both of an employer-employee relationship and an employer-independent contractor relationship. By way of simple example, a worker may be given the power to set his own working hours and come and go as he pleases,

while simultaneously being provided by his employer with tools and a place of work.

Compounding the problem are incentives both on the part of the Service and on the part of employers and workers to reach a certain characterization result. Given a "close case" (or even a not so close case), the Service's tendency is to characterize the relationship as one between employer and employee. Thus, the Service's application of its twenty-factor test and its interpretation of Section 530 are generally viewed as "biased" towards employee characterization.[36] This bias is understandable in light of the greater tax compliance that derives from characterization of a worker as an employee.

From the standpoint of an employer, there is a significant economic advantage in characterizing a worker as an independent contractor. First, the employer will not have to pay the employer's share of Social Security and Medicare taxes (7.65% of wages), or any FUTA tax, with respect to amounts paid to the independent contractor. Second, the employer will also have fewer record keeping, filing, and payment requirements. Third, characterization of a worker as an independent contractor may have other non-tax advantages, such as exclusion of the worker from the employer's health, pension and other benefit programs. Given the potential savings from characterization of a worker as an independent contractor rather than an employee, it is understandable that employers may resolve close cases (and perhaps not-so-close cases) in favor of independent contractor characterization.

From the standpoint of the worker, the preference is not so clear. There may be an income tax advantage to being characterized as an independent contractor in that it allows business expenses to be taken as above-the-line adjustments to gross income. There is, however, likely to be a significant

[36] HGOCReport at 13.

disadvantage to characterization as an independent contractor with respect to employment taxes, in that the independent contractor must pay the entire 15.3% Social Security and Medicare tax. The most significant "advantage" to characterization as an independent contractor may be to the unscrupulous worker who seeks to avoid tax compliance either through underreporting, or non-reporting of payments received, or to the cash-strapped worker who seeks to increase cash flow by avoiding income and employment tax withholding.

Because of the nominal penalties now imposed upon an employer for failure to file a Form 1099-MISC, and the current low rate of Service audit on self-employed workers,[37] some employers may enter into collusive agreements with their workers whereby the worker will accept a lower payment if the business agrees not to report the payment to the Service.[38] Where businesses deliberately misclassify workers to reduce their costs for services, they also enjoy an unfair competitive advantage over businesses that comply with the tax laws at a substantial additional cost by correctly treating their workers as employees[39].

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[37] There was a decline in audit coverage from 3.35% in 1981 to 2.14% in 1991. *See GAO 1992 Report at 23*.

[38] *GAO 1992 Report at* 6.

[39] *GAO 1992 Report at* 14-15.

The characterization — or mischaracterization — of workers is an everyday problem of staggering import to employers both large and small. Although the issue has traditionally been one that disproportionately affects small employers,[40] who are more likely to hire independent contractors and other shorter-term workers, it is increasingly evident that the problem is now extending into the highest reaches of corporate America. This is in part a consequence of corporate down-sizing and the economic advantages (both tax and non-tax) of hiring workers back as consultants with independent contractor status. The following recent article highlights the spread of the issue:

> The Internal Revenue Service is auditing I.B.M. to determine if it improperly paid thousands of workers as independent contractors instead of employees. * * * An I.B.M. spokesman said it regarded the inquiry, which covers the years 1986 through 1992, as routine.[41]

The problem, of course, is not limited to I.B.M. Demonstrative of how important the problem is to small businesses is the fact that the 2,000 delegates to the recent White House Conference on Small Business agreed that their "top tax concern" is the "complex system currently used to define independent contractors versus traditional employees for tax purposes."[42] Topping the Conference's policy agenda that will be submitted to President Clinton and Congress in the fall is a recommendation that Congress clarify the definition of and recognize the legitimacy of— independent contractors. The Conference called the twenty-factor test "too subjective," and recommended realistic

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[40] "Small Businesses Get Big Bills as IRS Targets Free-Lancers," The Wall Street Journal (August 24,1995, p.Bl.

[41] "I.R.S. Inquiry: Is Worker at I.B.M. Really a Contractor?" The New York Times (July 6,1995), p.D3.

[42] "Tax Relief Dominates Agenda Produced By White House Small Business Conference," *Tax Management Weekly Report* (June 19,1995), pp. 873-874.

and consistent guidelines for the Service, courts, employers and State agencies. Among the Conference's specific recommendations were: (1) the establishment of safe harbors; and (2) elimination of back taxes for mischaracterization where Form 1099 has been filed and there is no evidence of fraud.[43]

Highlighting (or compounding) the problem of worker mischaracterization is the Service's Employment Tax Examination Program. ETEP has targeted enterprises with $3,000,000 or less in assets to enforce the Service's view of proper worker characterization, and to assess the appropriate penalties in the event of mischaracterization. ETEP has generated numerous complaints from employers, including that:

• ETEP is focused on small business taxpayers who make good faith attempts to properly characterize their workers and who fulfill their reporting obligations (rather than focusing on those who do not even make the necessary Form 1099 filings).

• The twenty-factor test applied by the Service is vague, complex and subjective.

• The Service has an institutional preference for employee characterization.

• An ETEP audit can result in large — sometimes bankrupting — tax assessments.

• Employers who do not file Form 1099 have an advantage over those employers who do file Form 1099.[44]

The American Institute of Certified Public Accountants has also called for reform. The AICPA's Small Business Taxation Committee has recently proposed a new safe harbor for characterization as an independent contractor. This safe harbor would rely on a four-part test, and would require business to remit to the Service 20% of payments to such workers.[45]

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43 *Id.*

44 *HGOC Report* at 4.

45 "Independent Contractors," *Tax Management Weekly Report* (Feb. 20,1995), p.304.

B. Unlimited Statute of Limitations. One of the most devastating aspects of the worker characterization problem is that a mischaracterization — even an unintended mischaracterization can potentially bankrupt a small employer. This is because the deficiencies in tax and interest for failure to withhold can quickly build, particularly if the audit spans a large number of years. This is the case even where the employer has fully complied with its information reporting obligations.

It is the Service's position that the filing of Form 1099-MISC does not start the statute of limitations running on the characterization of a worker treated as an independent contractor,[46] and this position has been upheld in litigation.[47] In light of this apparently unlimited statute of limitations, employers can find themselves defending characterization of a worker who has been treated as an independent contractor on facts that have long since faded from memory, and records that may or may not be complete. In addition, the unlimited statute of limitations means that employers can face staggering assessments for back taxes. Whether the Services position is correct is subject to question, but clearly there appears to be no policy

[46] In contrast, there is a three-year statute of limitations period on adjustments to employment taxes for independent contractors reported on Form 941 orFormW-2. *See* Section 6501(a); Revenue Ruling 72-161,1972-1 C.B. 397.

47 See. Kenneth A. Ginter v. United States, 815 F. Supp. 1289 (W.D. Mo. 1993). In Ginter, an employer filed Form 1099 with respect to workers classified as independent contractors, but did not file Form 941 or Form W-2. The court ruled that the statute of limitations on the classification of the workers was still open because Form 1099 was the "wrong return," and, as such, did not trigger the statute. The court held that the filing of a Form 1099 was not sufficient because it did not provide enough information to the IRS to determine whether the worker was in fact an independent contractor. The court discussed Revenue Ruling 72-161, wherein an employer filed a Form 941 for a worker being treated as an independent contractor. Th employer listed "wages" as "none." This was held to be a valid return for purposes of starting the statute of limitations running regarding the characterization of the worker since it was complete and the Service would be able, based on the statements made on the return, to determine the tax due.

restraint to limit how far back the Service will go in auditing the worker characterization issue.[48]

C. Lack of Compliance. Clarification of worker classification is only a part of the needed reforms in the employment tax area. As evident from the statistics cited earlier, there is an urgent need to improve independent contractor compliance in reporting of income. Lost revenue from misclassification of workers ($2 billion) pales in comparison with the lost revenue from underreporting or non-reporting of income by independent contractors ($20 billion).

The major reasons cited for lack of compliance by independent contractors are as follows:

1. The minor penalty for an employer's failure to file an information return with respect to payments made to an independent contractor. Currently, the penalty for failure to file a Form 1099-MISC is a mere $50 per return. This penalty does not vary proportionately to the tax revenue lost as a result of the failure to report the payment on the information return. Only 50% of Service tax audits even bother to check for information return compliance.[49]

2. Businesses are not required to validate the tax identification numbers ("TINs") of independent contractors before making payments. Currently, the Service receives information returns in January and February of the year after which the payment has been made. It generally takes more than one year for

[48] Comments at Regional Commissioner Liaison Meeting at Boston, Massachusetts, June 13,1995. hi a situation discussed at that meeting, an employer had been sent a Form SS-8 in 1993 for a worker employed during the (Footnote continued) years 1981 through 1983. The worker had been treated as an independent contractor and a Form 1099-MISC had been filed. In 1994, the employer received a finding from the Service, based on the Form SS-8, that the worker had been mischaracterized as an independent contractor and should have been characterized as an employee.

[49] *GAO1992 Report* at 6-7.

the Service to check the validity of the TIN and notify the employer that an information return has an invalid taxpayer identification number. As a result, independent contractors can submit incorrect TINs to businesses and receive all their payments before the Service has an opportunity to review the returns and notify the business that the TIN on the information return is invalid. In many cases, it will then be too late for the business to begin Section 3406 backup withholding on the worker's pay.[50] It may also be too late for the business to obtain the correct TIN so that the Service can use the information return to check whether the worker has reported the income. In 1990, 7% of the 61.7 million Forms 1099-MISC sent to the Service could not be used in a computer match because the TINs were missing, incomplete or otherwise inaccurate.[51]

3. Employers are not required to report payments of less than $600 to workers classified as independent contractors. Continuation of this high reporting threshold undermines the effort to increase reporting compliance by independent contractors. Service data clearly demonstrate a dramatic increase in income reporting by independent contractors for payments reported on information returns (i.e., 97%). Furthermore, the discrepancy hinders the Service's ability to make computer matches of payments deducted on an employer's tax return as compared to payments reported on its information returns for workers. Many information returns have lower thresholds for reporting (e.g., $10 for unemployment compensation, royalties, state and local tax refunds, and certain types of interest and dividends)[52]

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[50] Section 3406 requires withholding at the rate of 31 %.

[51] GAO 1992 Report at 12.

[52] See Sections 6042 (dividends), 6049 (interest), 6050B (unemployment compensation) and 6050E (state and local tax refunds.

4. Information reporting is not required for payments to incorporated independent contractors. This exemption creates a major loophole for unscrupulous employers and independent contractors.[53] Independent contractors can incorporate to shield income from information reporting and more easily avoid voluntary compliance. Furthermore, some businesses prefer to use incorporated independent contractors to avoid the penalty for not filing information returns.

5. Businesses are not currently required to state separately on their tax returns the total amount of payments to independent contractors. In the high compliance area of employee salaries and wages, such payments are required to be separately stated.

6. Businesses are not currently required to provide independent contractors with a written explanation of their tax obligations and rights. In many cases, workers may not realize the tax (and other) ramifications of being employed as an independent contractor.[54] Many independent contractors are not informed of their ineligibility for fringe benefits such as health insurance and retirement plans. As a result, the worker ends up with a much reduced economic benefit from the employment and may not have set aside enough funds to pay employment taxes and to purchase needed benefits such as health and disability insurance. Workers may also be unaware that, as independent contractors, they will not qualify for unemployment compensation.

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53 *GAO 1992 Report* at 10.

54 *HGOC Report* at 22-23; and *GAO1992 Report at* 13.

III. RECOMMENDATIONS FOR REFORM

A. Clarify Worker Characterization Rules. A major reason for non-compliance in the employment tax area is the continued ambiguity in the rules regarding worker characterization. We believe there is a long-overdue need for detailed and specific rules in the area of worker classification - with objective safe harbors. The common law test and the "twenty factors" set forth in Revenue Ruling 87-41 result in enormous uncertainties regarding the proper classification of workers.

We believe that the most important goal for reform in worker characterization is to provide rules that are simple, clear and fair. This goal becomes more important each year, as employmenttaxes[55] and the costs of employee benefits increase. Any increased financial burden can only heighten the proclivity of employers either deliberately to misclassify their workers as independent contractors, or to resolve any ambiguity in favor of independent contractor characterization.

Accordingly, we favor legislation by Congress. Furthermore, we do not believe that the approach taken by the Health Security Bill was sufficient. Under that Bill, Congress delegated to Treasury the task of formulating rules and guidelines for employment classification with only the directive that its rules give "significant weight" to the common law. We do not believe that this sort of directive is adequate or that it conveys the need for rules that are simpler, clearer and fairer. Treasury Regulations that simply incorporate the present common-law uncertainties in classification of workers will neither provide the additional guidance needed nor cure the anticipated abuses in misclassification of workers. A general directive could also result in Treasury's wholesale adoption of the Service's flawed

[55] At the present time, the Social Security tax base is $61,200; the Medicare tax base has no limit.

"twenty-factor test" of Revenue Ruling 87-41, and the Service's institutional bias towards "employee" characterization in application of these factors.

We also do not believe that any of the approaches currently before Congress in the form of proposed legislation adequately addresses the problem: (1) the Lantos Bill (H.R. 510) concentrates only on retroactive tax relief to employers who have failed properly to classify their workers, and thus fails to address the worker classification issue at all. (2) the Kim Bill (H.R. 582) and the Christensen Bill (H.R. 1972) would impose such easily satisfied objective criteria for classification as an independent contractor that the bias would swing sharply from employee classification to independent contractor classification. Under the Kim Bill, all that is required to classify a worker as an independent contractor is an agreement between the employer and the worker and satisfaction of only one of four objective criteria. If, for example, there were an agreement and the worker could be shown to realize a profit or loss as a result of his services, such would be sufficient to allow independent contractor classification. In the Christensen Bill, classification as an independent contractor could again be easily obtained. Under that Bill, any well-trained worker with a d.b.a. and an agreement with his employer could be classified as an independent contractor since the worker would meet the criteria of (a) having a significant investment in training, and (b) providing services under a registered business name.

In summary, we believe that the objective criteria for classification of a worker as an independent contractor under those Bills could be so easily satisfied in the employer/worker relationship that there is a significant risk of undermining treatment of workers as employees, especially given the current

cost incentives to employers to classify their workers as independent contractors.

Nonetheless, we do concur with the approach of the Kim and Christensen Bills in seeking to impose more objective criteria in the classification of workers. We recommend that Congress direct the Treasury to review the common law criteria for characterization of workers and to submit proposed legislation, within six months of enactment of that directive, setting forth no more than four or five objective criteria which, if the worker satisfies all such criteria, would result in the worker's being classified as an independent contractor. A similar objective test should be developed for classification of a worker as an employee. Workers who do not fall within either the independent contractor safe harbor or the employee objective test would be classified under the common law rules. To assist in the latter determination, Treasury should also be given the authority to develop clearer and more easily administrable rules regarding classification of workers who will be tested under the common law rules.

By providing a statutory safe harbor for classification of workers as independent contractors and as employees, the disputes in this area should greatly diminish. As to selecting the four or five most important criteria for distinguishing independent contractors from employees, we recommend that the following objective criteria be considered for classification as an independent contractor:

(1) The worker could suffer a loss as well as make a profit in the performance of services. Employees are rarely exposed to risk of loss in the performance of their job. In contrast, independent contractors can suffer a loss if the job is underpriced, if there are unreimbursed expenses, or the job is not completed in accordance with the contractual arrangement.

(2) The worker maintains a principal place of business separate from the employer's and has a significant investment in facilities and tools that are not typically maintained by employees. Given the current restrictive interpretation of "principal place of business" under Section 280A,[56] we recommend development of a more liberal definition of "principal place of business" for satisfaction of this criterion.

(3) The worker makes his services available to the general public and the worker has performed services for at least one other employer during the current year or the previous calendar year.

(4)" The worker enters into a written qualified agreement with his employer that: (a") specifies the services to be provided by the worker and the duration of the services: (b) provides that the worker is aware of his employment tax obligations and will report and pay in accordance with independent contractor classification and: (c) requires the worker to maintain his or her own set of books and records with respect to the worker's business..

If the worker satisfies all of the above criteria, he or she would be classified as an independent contractor.

As to the objective criteria that must be satisfied for classification of a worker as an employee, we recommend that such classification be required if the worker meets two or fewer of the objective criteria required for classification as an independent contractor and works for the employer for twenty hours or more per week. Workers not meeting either the independent contractor safe harbor or the objective test for classification as an employee would be tested under the common law rules.

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[56] *See Commissioner v. Soliman,* 113 S.Ct. 701 (1993).

In summary, whatever the factors recommended by Treasury and codified by Congress, we believe that the proper approach to achieving the needed clarity and predictability in the worker classification area is: (1) to create a statutory objective test for classification of independent contractors and employees, even if such would yield a classification that, in a given case, might differ from the classification under a common law test; and (2) to authorize the Treasury to develop clearer and more objective rules for application of the common law test for workers that do not fall within the statutory independent contractor/employee classifications.

Given the feet that an employer may not know whether a worker satisfies all of the objective criteria for independent contractor or employee classification, we would further recommend creation of an Internal Revenue Service form that an employer could give to each new worker, asking questions sufficient to determine whether the worker should be treated as an independent contractor or an employee under the new safe harbors.

B. Revise Section 530. The modifications proposed to the Section 530 safe harbor in the Health Security Bill addressed many of the problems with the current application of Section 530. By incorporating the safe harbor into the Internal Revenue Code and removing the moratorium on Treasury guidance in this area, needed regulations and revenue rulings will be issued to help implement this relief provision. Codification will also eliminate the current anomaly of having certain workers classified as employees for some purposes (e.g., pension plans), but not for others. Currently, Section 530 only prevents the Service from reclassifying a worker for employment tax purposes.

Modification of Section 530 is also necessary to prevent an unduly broad application of the audit safe harbor. Under current Section 530, a taxpayer can receive perpetual protection from

worker reclassification as a result of an audit conducted many years earlier, even where the audit did not examine the employment tax status of the employer's workers. Where the worker is clearly misclassified, there is an enormous revenue loss, since the employer risks losing the Section 530 protection if he changes the status of the worker. Furthermore, only one-half of the social security tax is paid with respect to a "Section 530 employee."[57]

Under the Health Security Bill provisions, the audit safe harbor would have been modified to extend only to audits that determined the employment tax status of the individual in question or similarly situated individuals. To this proposed modification, we would add a recommendation that in the event the audit is not under ETEP, the Service should be required to make some form of affirmative statement in its audit report as to whether the employment status of the worker has or has not been specifically examined in the audit. Perhaps the addition of a box on the front of the Revenue Agent Report to be checked by the Revenue Agent hi cases where the audit included an employment classification review could be considered. Given the importance of this safe harbor, disputes could arise regarding the scope of an audit in cases where the taxpayer believed that the Revenue Agent reviewed an employment status issue, but there was no documentation of that finding in the Audit Report.

In summary, we are in favor of repeal and codification of the safe harbor provisions of Section 530 in conformity with the proposals made in the Health Security Bill, subject to the above modification to the audit safe harbor.

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[57] By reason of the safe harbor, the employer does not have to pay the *"employer"* half of the tax. See HGOCR Report at 15.

C. Increase Penalties for Failure to File Information Returns. We recommend increasing the penalty for an employer's failure to file information returns with respect to independent contractors from $50, for example, to the greater of $50 or 5% of the amount required to have been reported correctly but not so reported. We believe that increasing this penalty will result in greater compliance by employers in filing accurate and timely information returns with respect to the independent contractors that they employ. We also recommend raising the cap on the penalty from its current $250,000 level to a substantially higher amount. Again, we believe a higher penalty will provide an even greater incentive for employers to file the necessary information returns. Furthermore, we recommend inclusion of a de minimis rule under which the penalty would not apply if the aggregate amount that an employer timely and correctly reported with respect to independent contractors was at least 97% of the aggregate amount that was required to have been reported.

D. Lower the $600 Reporting Threshold for Payments to Independent Contractors. Independent contractors demonstrate a significantly higher level of compliance in reporting income for payments reported to the Service by their employers on Form 1099-MISC. Lowering the reporting threshold would bring the threshold more in line with other information return thresholds and will significantly improve independent contractor compliance for smaller payments. Lowering the threshold also improves the ability of the Service to computer-match the payments to the employer's and worker's returns.

We recommend giving Treasury the discretion to set the reporting threshold at some amount, not greater than $600, and to set the reporting threshold at different levels for different types of services. The reporting threshold should not be so low as to be unduly burdensome on payors. However, the threshold

should be low enough to increase the number of Forms 1099 that are filed each year.

Although we are not prepared at this time to recommend extending the information reporting requirement to non-business employers, we would endorse a study as to whether some form of information reporting should be required for payments for services exceeding a given threshold (e.g., $5,000). Much of the revenue loss from unreported income by independent contractors is attributable to services provided to domestic employers who are not required to submit an information return even for large payments made to the worker. If the reporting threshold were sufficiently high and the reporting sufficiently simple (e.g., attachment to the employer's Form 1040), such might not be unduly burdensome and would help increase reporting by independent contractors.

E. Require Information Reporting for Payments to Incorporated Independent Contractors. Unless this loophole is closed, independent contractors will continue to incorporate to shield income from information reporting, and employers will insist that their independent contractors incorporate to avoid the penalty for not filing information returns. If the penalty for failure to file Form 1099-MISC is significantly increased, incorporating will provide an easy avoidance mechanism to both the worker and the employer, and will undermine the intended effect of the law.

F. Establish a Quick Check System for Verifying TINs. Employers need to be able to rely upon and to verify a worker's social security number prior to making any payments to the worker. To discourage workers from deliberately falsifying TINs, the service recipient should be required to collect certified TIN statements as is the case with interest and dividend payers on Form W-9. Current Regulations do not require independent contractors to provide a certified TIN.[58]

To further confirm the accuracy of the TIN provided, the employer should have access to a telephonic, computer-based system provided by the Service through use of an "800" number to verify the TIN. The current TIN verification system is too cumbersome. Since it generally takes the Service more than a year to notify the employer that a TIN is invalid, it is often too late to begin backup withholding on the worker or to obtain a corrected TIN. Upfront TIN validation should lead to fewer after-the-fact notices and consequent losses in revenue. If independent contractors provide invalid TINs, they would not only be subject to penalties of perjury, but employers would be required to start backup withholding with the first payment rather than waiting for more than a year. The employer would continue withholding until the TIN has been validated.

G. Require Businesses To Report Separately on Their Tax Returns the Total Amount of Payments to Independent Contractors. This recommendation for reform was included in the 1992 GAO Report on improving independent contractor compliance.[59] The GAO noted that requiring businesses to report separately on their tax returns the total amount of payments made to independent contractors would parallel the reporting of salaries and wages to employees. Because businesses are subject to penalties of perjury

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[58] Treas. Regs. Sections 301.6109-l(b) and 35a.9999-2, Q&A-10.

[59] *GAO 1992 Report* at 10.

for filing false tax returns, separate reporting of such payments would better ensure that the payments to independent contractors are identified and accurately reported. Assuming that the recommendation to lower the $600 threshold is adopted, this would also allow the Service to improve computer matching of the total payments made to independent contractors with amounts reported on information returns. If there were any disparity between the payments reported on the business returns and the payments reported on information returns, the business could be asked to explain the discrepancy.

The GAO concluded that this requirement would increase compliance by employers required to file information returns, and improve the Service's ability to identify businesses that are attempting to hide payments to independent contractors.

H. Require Businesses To Provide Independent Contractors With a Written Explanation of Their Tax Obligations and Rights as Self-Employed Workers. By requiring businesses to provide independent contractors with a written explanation of their tax obligations and rights as self-employed workers, the worker can make an informed decision as to the benefits of working for one employer as opposed to another. In the case of workers who do not understand their tax obligations, this would improve the likelihood that those workers would set aside enough funds to pay their taxes.[60]

[60] As part of the Nanny Tax Act, the Treasury was required to prepare and make available to employers information regarding their federal tax obligations with respect to persons performing domestic services in their homes. Section 2(bX4) of the Nanny Tax Act It seems reasonable and profitable to extend this sort of information dissemination to workers as well as employers.

This recommendation was made in the 7992 GAO Report, wherein notification would be made on an IRS form that the business provides, with both the employer and the worker retaining a copy of the form in the event the IRS requests it.[61]

I. Require Attachment of the Form 1099-MISC to the Worker's Income Tax Return. While we lack the ability to evaluate this recommendation empirically, our experience suggests that compliance and audit coordination would be improved if independent contractors were required to attach to their income tax returns all Forms 1099-MISC received hi the same manner as employees who are required to attach Forms W-2. This would improve the IRS' ability to determine whether the independent contractor has included all payments for which information returns have been filed. Such would also result in a more cost effective audit by the IRS in the event there is a discrepancy between amounts reported by the worker and the information returns received.

J. Reduce or Eliminate the Low-Volume Filer Exception for Magnetic-Media Filing of Forms 1099-Misc.. In our experience, the Service has a much greater ability to process and crosscheck data provided on magnetic media than on paper Forms 1099. If the cost of requiring and allowing more magnetic-media filing of Forms 1099 is not too great in comparison to the benefit received, we believe it would be helpful to reduce or eliminate low-volume limitations on electronic filing, for this should improve compliance in reporting by independent contractors.

61 *GAO 1992Report* at 13.

K. Create New Form 1099-IC. We recommend creation of a new Form 1099 — Form 1099 IC - designed explicitly for use with independent contractors.[62] Segregating payments to independent contractors from other miscellaneous payments should make tracking of these payments easier for employers, workers and the Service.

L. Establish a Statute of Limitations. There is an urgent need to bring certainty and finality to the employer's exposure to assessment with respect to workers treated as independent contractors. Currently, there is no procedure, other than the private letter ruling program, for employers to obtain a ruling regarding the correct employment status of their workers. As discussed above, the Service has taken the position that the filing of a Form 1099-MISC by an employer for workers classified as independent contractors does not trigger the start of the statute of limitations. Accordingly, the Service is free to challenge an employer's classification of its workers treated as independent contractors many years after the feet unless retroactive reclassification is protected under the safe harbor provisions of Section 530. Given the significant liabilities that can accrue from an erroneous classification of an employee as an independent contractor, the consequences of misclassification can be financially ruinous for the employer if the tax audit does not occur until many years after the fact.

Consequently, we recommend the adoption of an expedited and inexpensive procedure (other than the private letter ruling procedure) available to employers who wish to limit their exposure to retroactive rectifications of their workers treated as independent contractors. This procedure could be in the form

[62] In this regard, we observe that Form 1099-MISC provides a box for reporting "Nonemployee Compensation." If entering an amount in that box is not sufficient for the Service's purposes, then new Form 1099-IC may suffice. We observe that the Service used to have a Form 1099-NEC for reporting non-employee compensation.

of an elective filing of a supplemental Form 1099 designed to provide sufficient information to the Service on the employer-worker relationship to allow for a meaningful review by the Service of whether the treatment as an independent contractor is the proper classification of that worker.[63] In filing the supplemental Form 1099, an employer will start the statute of limitations period for Service review of the proper employment classification of that worker. If the classification is in error, the employer will be permitted to correct the classification before incurring substantial employment tax deficiencies.

After the supplemental Form 1099 has been filed, the Service would be required to review, and, if warranted, to challenge this classification within a specified limitations period. Given the potential for quickly mounting employment tax deficiencies that could arise from a worker misclassification, we suggest a three-year limitations period for reclassification of a worker by the Service from the date of filing of the supplemental Form 1099. This limitations period is also justified since, unlike many returns filed with the Service, the supplemental Form 1099 will be more in the nature of a request for audit on a specific issue, and with respect to which relevant information has been provided by the taxpayer to the Service to assist in its review. If the Service does not challenge the classification of the worker within the limitations period, the Service may not retroactively reclassify that worker at a later date unless the employment relationship has not been accurately represented on the supplemental Form 1099.

[63] The supplemental Form 1099 could be a sworn-to questionnaire based upon the criteria determined by Treasury to govern classification.

We do not recommend that the filing of a supplemental Form 1099 be mandatory for all independent contractors, since this would impose an unnecessary burden of compliance on employers and an unnecessary burden of review on the Service.

M. Study Withholding on Payments to Independent Contractors. While clarification of the worker classification rules is an essential part of reform in the employment tax area, the major revenue losses result from underreporting or non-reporting of income by the self-employed. In contrast, the major reason for the high level of compliance for employees is the withholding system currently in place for collection and payment of income and employment taxes.

In 1979, Treasury drafted a proposal for a flat 10% withholding tax for payments made to independent contractors unless the worker: (1) normally worked for five or more businesses in a calendar year; or (2) expected to owe less tax than the withheld amount. This proposal was not implemented by legislation.

The extension of the withholding system to payments made to independent contractors has not been implemented primarily because of the difficulties in developing a withholding system that would withhold a tax equal to the approximate amount of tax due for the year. For independent contractors, it is difficult to devise a fiat-rate withholding system that takes into account the varying business expenses that reduce net profits, and, thus, taxes owed. For independent contractors who work for many employers, the possibility of over withholding and its consequent negative effect on cash flow is a real danger.

Designing a fair and effective withholding system for payments made to independent contractors is a significant challenge and one that we are not prepared to undertake at this time. Nonetheless, we believe that Congress should direct the

Treasury Department to prepare a report analyzing the viability of imposing income and/or employment tax withholding on payments to independent contractors. We also believe that a system should be devised whereby an independent contractor can electively direct an employer to withhold income and/or employment taxes on payments made to- the worker. This would allow an alternative to the current estimated tax system for payment of become and employment taxes of independent contractors.

N. Consider an Amnesty. As recommended by the GAO in its 1992 review of compliance in this area, consideration should be given to including an amnesty program as part of any legislation that substantially increases the penalties on employers for failure to comply with the Form 1099- MISC information reporting requirements. Because of the current nominal penalty for failure to comply, the Service has a poor record of audit and enforcement of the information reporting requirement. Given the potentially large number of non-complying employers, there could be a reluctance on the part of these employers to begin complying with the law unless there were assurances that the employer will not be subjected to prior audits with respect to information reporting for previous years.

While many states have implemented amnesty programs as part of changes in the law to increase tax penalties, Congress may be reluctant to grant a tax amnesty of the type described above for fear that taxpayers who have been in compliance with the information return filings in the past would feel that they were treated unfairly. Nonetheless, a waiver of the Form 1099 penalties may be necessary to achieve the compliance objectives expected from a substantial increase in penalties for non-filing of an information return. Since we have reservations regarding the use of amnesties, we take no position on this GAO recommendation.

O. Clarify Interest Abatement Rules. We believe that the scope of Section 6205(a)(l) should be legislatively clarified by Congress in order to ensure a more uniform application of this relief provision.