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STATEMENT OF
RICHARD L. FOGEL, ASSOCIATE DIRECTOR,
GENERAL GOVERNMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS
ON
[COMPLIANCE PROBLEMS OF
INDEPENDENT CONTRACTORS]

HSE 04107

W. L. Fogel

*Contract - noncompliance
Contractors
Tax Law
Taxpayer*

*Testimony
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We are pleased to be here to assist the Subcommittee in its deliberations over the need to clarify the rules as to whether workers will be considered employees or independent contractors for Federal employment tax purposes. The focus of our testimony is on the issue of whether evidence to date regarding the compliance level of independent contractors justifies the need to change the way the Government collects taxes from independent contractors.

The compliance problems of independent contractors are a part of the overall compliance problem of self-employed taxpayers. There is no generally accepted legal definition of "independent contractor." But, a generally accepted one relates to the common definition used to classify workers as employees or self-employed persons. Under the common law, if a person engaging the services of another 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 the result is to be accomplished," the relationship is considered to be that of an employer-employee.

As IRS began to increase its enforcement of the employment tax laws, the ambiguities of the common law definition were brought to light and controversy developed between taxpayers and IRS as to the correct classification of workers. The controversies affected a wide range of workers: barbers and beauticians, direct salespersons, opinion poll takers, insurance agents, real estate agents, and service station operators, to name a few. The public discussion over the need to change the way taxes are collected from persons whose employment status is uncertain has focused on the tax

burden effect of tax classification changes that might be made with respect to the above-mentioned type of workers.

Accordingly, it is appropriate to look at available information regarding the compliance problems of workers caught up in the controversy when considering whether to change the way the Government collects taxes from independent contractors.

COMPLIANCE PROBLEMS OF INDEPENDENT CONTRACTORS

The first data concerning compliance of independent contractors was developed in our November 21, 1977, report to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons by the IRS: Problems and Solutions." The main thrust of that report was to make recommendations to increase the amount of certainty for both taxpayers and the IRS regarding who should be considered as an employee or independent contractor. Such certainty would reduce the amount of retroactive assessments IRS would have to make and mitigate the financial impact placed upon payors whose workers are reclassified as employees.

Treasury's concern with our report recommendations was basically that it believed the compliance problem among independent contractors was more serious than for employees. It did not want to accept any criteria to reduce uncertainty as to classification of workers by allowing more to be classified as independent contractors without also developing a better mechanism for insuring that the Government could effectively collect the taxes owed by such workers.

The problem in 1977 was that we and Treasury could not agree on the extent of the compliance problem of this group of workers, and therefore

the extent to which certainty in classification needed to be accompanied by changes in the tax collection mechanism. The compliance data we used in our 1977 report was drawn from a relatively narrow universe. We concluded that the independent contractors we sampled reported between 89 and 92 percent of the amounts received by them as remuneration for services. But, we relied primarily on IRS' procedures for insuring that such individuals had reported all their income for tax purposes.

In response to our data, IRS did its own limited study in 1977 of the compliance level of independent contractors. Its sample was drawn from a somewhat larger universe than ours. As a result of its study, IRS determined that its own procedures for insuring that payees reported all income were inadequate. IRS therefore said our compliance rates were probably high. It stated that it determined its group of sample taxpayers only reported about 74 percent of the amounts received for their services. But IRS said its 1977 study was also not definitive because it did not audit all of the tax returns of the payees to verify the reported income.

Consequently, we noted that a more complete study of compliance among independent contractors would provide a better basis for assessing the type of legislative changes needed. In our 1977 report, we said

"The public purpose would be served if IRS could provide timely additional information on the extent of compliance by self-employed workers and employees in reporting earned income."

We also said in 1977

"If there is evidence that self-employed persons are much more likely to cheat on their income taxes than employees than perhaps stronger measures than now exist need to be taken to insure proper payment."

What do we now know about the compliance level of self-employed workers? One source is compliance data developed as a result of IRS' taxpayer compliance measurement program audits. These audits are the most comprehensive done by IRS. The results from them are used to develop the statistical formulas used to assess the tax change probability for all tax returns. However, even these audits are generally directed at verifying the correctness of information reported on the tax returns. Although the auditors are told to probe for unreported income, even IRS recognizes that it is difficult for its auditors to discover unreported income during audits. Thus, even the results for these audits are not indicative of the total amount of underreporting by taxpayers.

The latest complete information relates to returns filed in 1974 for tax year 1973. Those results showed that overall the compliance level of business taxpayers was less than the compliance level for nonbusiness taxpayers. (Compliance is defined as taxpayer reported liability divided by taxpayer reported liability plus recommended tax increases, all times 100 percent.) Business taxpayers are persons who attach a schedule C or F to the 1040 returns. Almost all self-employed workers and independent contractors would be in this category. A detailed breakdown of the compliance levels is in the table below.

Voluntary Compliance Estimates
 Tax Year 1973 Returns
Filed in 1974
 (Percent)

Audit Class

Nonbusiness

Under \$10,000	
Standard	94.2
Itemized	86.1
 \$10,000 - \$50,000	 96.1
 \$50,000 and over	 95.6

Business

Under \$10,000	57.2
 \$10,000 - \$30,000	 86.8
 \$30,000 and over	 91.2

A further perspective on the extent to which self-employed people comply with the tax laws can be seen by looking at the statistics we developed in our July 11, 1979, report to the Congress on people who are required, but did not file income tax returns for tax year 1972--the most current year for which reasonably complete data was available.

Overall, the nonfiler population does not differ substantially from those who do file tax returns. However, there were relatively more self-employed people in the nonfiler population than in the filing population. Seventeen percent of all nonfilers in 1972 were self-employed. The self-employed comprised only 8 percent of the filer population. Self-employed people were more than twice as likely to show up in the nonfiler population than in the filer population. Just looking at the nonagricultural self-employed, our data showed that 13 percent of all nonfilers were

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No one knows the total universe of independent contractors. Thus, it is not possible to draw a representative sample of all independent contractors. Treasury drew its sample from a group of employers being audited and for whom the question was raised as to whether the employers' workers were properly classified as self-employed. The universe consisted of 2,610 employers and 59,749 workers.

Using such a universe as a basis for trying to assess the compliance level of such workers appears reasonable. Both we and Treasury used similar universes to draw the samples which provided the results presented in our November 1977 report on the self-employed problem. From a practical standpoint, we believe definitive results from such samples can provide a sufficient basis for making a policy judgment about the compliance levels of independent contractors.

Generally, we have no problem with Treasury's sample of 5,152 being representative of its universe.

The critical issue was to make sure that the results obtained from analyzing the 5,152 cases would be representative of the 59,749. If the results were representative, we would have no problem concluding that the cumulative data available to date is sufficient for making a policy judgment that compliance among independent contractors and self-employed is serious enough to warrant use of withholding to collect part of the taxes owed by this group of workers.

Unfortunately, Treasury analyzed the data from its sample incorrectly. Therefore, the compliance statistics on the 5,152 cases are not necessarily representative of the universe from which they were drawn. Treasury took what is commonly called a stratified sample. When you do that you must weight the results. Treasury did not weight its results. It treated the results as if every case had the same chance of being selected.

Any other estimates or analysis that might show the extent to which the sampled results are representative of the total population of independent contractors should be based on compliance rates calculated from weighted data.

Even though none of Treasury's results are necessarily accurate, that does not mean Treasury's conclusions are incorrect. We just cannot say. To find out the correct answer, Treasury needs to weight the data and recompute the results. We have discussed this problem with Treasury officials who advised us that Treasury would recalculate the summary tables on a weighted basis.

We would like to note that, from a policy judgment standpoint, we do not believe even perhaps a 30 percentage point increase in the level of full compliance of independent contractors from about 48 percent to 78 percent, would be sufficient to conclude that compliance among independent contractors is at an acceptable level, thereby warranting no change in the ways taxes are collected from them.

In conclusion, I would like to note that, as we said in our 1977 report, it is important for the tax laws to be clear, unambiguous, and

not subject to arbitrary interpretation, both for the taxpayer and the Government. To that end, we still support the need to introduce more certainty into the law as to who should be considered an employee as opposed to a self-employed person. But we also believe that it is appropriate to change the way the Government insures that independent contractors report their income. The June 20, 1979, Treasury proposals relating to withholding at source a percentage of payments made to independent contractors and to strengthening the information reporting requirements of the present law accomplish that purpose. Treasury's proposal to impose a penalty of 10 percent of the amount of wages not withheld upon if workers are reclassified as employees is also a very reasonable approach to reduce the financial impact upon payors whose workers are reclassified as employees. A stronger case could be made for supporting the withholding portion of Treasury's proposal if it comes forth with valid compliance figures from its June 20, 1979, study.

This concludes our prepared statement. We would be pleased to respond to questions.