

AN EXCERPT FROM:

NATIONAL

TAXPAYER

ADVOCATE

2003 ANNUAL REPORT TO CONGRESS

To view the entire 506-page document, go to
http://www.irs.ustreas.gov/pub/irs-utl/nta_2003_annual_update_mcw_1-15-042.pdf

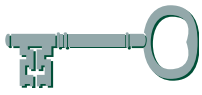


Department of the Treasury
Internal Revenue Service

www.irs.gov

Publication 2104 (Rev. 12-2003)
Catalog Number 23655L

December 31, 2003



2

TAX WITHHOLDING ON NON-WAGE WORKERS

The issue of how a worker is classified – as employee or independent contractor – has consequences for both the worker and the recipient of services. Many small businesses view the obligations that arise from treating workers as employees (Social Security, Medicare, federal and state tax withholding requirements, unemployment insurance, employee benefits) as overly burdensome. These businesses may treat workers who are technically employees as independent contractors, thereby not withholding taxes on payments to them. Where a worker or the IRS successfully challenges these classifications, the business can incur significant additional tax, penalties, and interest.

On the other hand, many non-employee workers, including independent contractors, discover an unwelcome “April 15th surprise” when the time comes to file their federal income tax returns. While they may wish to comply with filing requirements, they have a substantial tax bill to pay because no federal income tax or Federal Insurance Contributions Act (FICA) tax was withheld from their earnings.

Under current law, taxes generally are withheld over the course of the year from wages paid to workers classified as employees, but no tax is withheld from payments made to workers who are not classified as employees (i.e., independent contractors). Some workers hired as independent contractors are unaware of the tax consequences of accepting a non-employee job until they must file returns, and discover that no federal income tax has been withheld. Other workers are aware of the tax rules but do not save enough money to pay their taxes or make required quarterly estimated tax payments. Still others operate in the cash economy, in whole or in part.

The amount of unreported and underreported tax attributable to independent contractors (sole proprietors) – \$81.2 billion – is the largest single component of the tax gap.¹ The absence of a withholding mechanism leads to a balance due return, which in turn leads some taxpayers to underreport their income in order to avoid the balance due. This under- or non-reporting of income imposes a burden on compliant taxpayers who pay their tax obligations in full.

Employers who treat workers as employees are disadvantaged – their competitors can undercut them because the independent contractors can avoid paying tax and charge less for their services. Thus, employers are placed in the position of having to choose between being competitive and complying with the tax laws.

¹ The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely. The estimated size of the gross tax gap for tax year 2001 was \$310.6 billion. Tax Gap Map for tax year 2001 from IRS National Headquarters Office of Research, July 17, 2003. See Most Serious Problem # 2 - “Nonfiling and Underreporting by Self-Employed Taxpayers” for a detailed discussion of the impact of Schedule C taxpayer non-compliance on the tax gap.

EXAMPLE

Taxpayer A is a winery and employs 30 persons, 20 of whom tend the vineyards on a full-time basis. Taxpayer A controls the details and manner by which these workers care for the vines and produce the wine. The workers are required to follow detailed instructions and use the winery's equipment in discharging their duties. Taxpayer A, following the advice of its tax advisor, treats these workers as employees and withholds the appropriate tax amounts from their paychecks. The winery also pays federal and state unemployment taxes and worker's compensation. It factors the cost of payroll and related taxes and insurance into the price of its wine.

A neighboring winery, Taxpayer B, is of similar size and also employs 30 persons, over whom Taxpayer B has a similar degree and type of control. Taxpayer B also produces a similar wine to Taxpayer A's. Taxpayer B, however, is able to underprice Taxpayer A's wine because Taxpayer B treats its workers as independent contractors. Thus, Taxpayer B does not incur the employer share of FICA tax, unemployment tax, or other payroll-related costs.

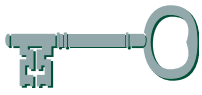
Taxpayer A's employees have their taxes withheld from their checks so they generally will not owe taxes by year-end. They are also earning credits toward Social Security and Medicare coverage. Taxpayer B's workers, on the other hand, are responsible for paying their own self-employment tax as well as their income tax. Because they are minimum wage workers, many of them cannot save and pay estimated taxes; thus they will have balance due returns and accrue penalty and interest. If they do not file their returns and pay taxes, they will not accrue Social Security and Medicare quarters toward coverage.

RECOMMENDATION

The National Taxpayer Advocate recommends extending a modified withholding scheme to certain payments made to independent contractors. The withholding rate would be five percent on payments to independent contractors not generally maintaining an inventory or receiving payments for materials and supplies. Further, Congress should authorize the Secretary to establish withholding rates specific to certain trades and industries that maintain inventories or receive payments for materials and supplies.² Where the Secretary does not establish such guidelines, the withholding rate would be 3.5 percent on payments to independent contractors that maintain inventories or receive payments for materials and supplies.

²The Secretary also could be authorized to enter into withholding rate agreements with specific independent contractors where they can demonstrate the appropriateness of another rate. This should be discretionary with the Secretary, since the benefits of these agreements may be outweighed by the demand on IRS resources to conduct the necessary analysis precedent to the agreement.





In order to implement this withholding regimen, The National Taxpayer Advocate makes the following legislative recommendations:

- ◆ Amend Internal Revenue Code section 3402(o)³ to expand withholding on certain reportable payments other than wages to include:
 1. Any payment aggregating \$600 or more during a calendar year made by a service recipient engaged in a trade or business to any person for services performed. The payment is required to be reported on a return under IRC § 6041A(a).⁴
 2. Any payment required to be shown on a return pursuant to IRC § 6050A relating to reporting requirements of certain fishing boat operators, but only to the extent such payment represents a share of the proceeds of the catch and is paid with money.⁵ In addition, withholding would apply to cash payments of up to \$100 per trip that are contingent on a minimum catch, are paid solely for additional duties for which cash payments are traditional in the industry, and are reportable on Form 1099-MISC.⁶
 3. Any payment required to be shown on a return required under IRC § 6041A relating to persons receiving contracts from federal executive agencies.
- ◆ Amend Internal Revenue Code section 3402(a) to establish the rate of withholding on certain reportable payments at five percent when the aggregate amount of payments for the calendar year reaches an amount that triggers the requirement to file Form 1099-MISC pursuant to IRC § 6041A and IRC § 6050A.
- ◆ Amend Internal Revenue Code section 3402(a) to establish the rate of withholding at 3.5 percent on payments to persons in certain trades whose 1099-MISC remuneration for services rendered includes payments when the aggregate amount of remuneration paid to any person for services rendered includes payments for parts or materials used to render the services, except as provided:
 - ◆ In the case of a person described in Proposed Regulations § 1.6041A-1(a)(2), the person may elect to enter into an agreement under IRC § 3402(p)(3)(B)⁷,

³ IRC § 3402 sets forth general requirements for income tax withholding on wages. Subsection (o) addresses the extension of the withholding requirements to certain payments other than wages.

⁴ IRC § 6041A(a) sets forth requirements for the filing of information returns showing remuneration for services by the person for whom the services were performed.

⁵ The aggregate amount that triggers the filing of Forms 1099-MISC is not uniform across the Internal Revenue Code. IRC § 6041A and IRC § 6050M require filing when payments aggregating \$600 or more during a calendar year are made, while IRC § 6050A requires filing Form 1099MISC on any payment representing a share of the proceeds of the catch. To avoid the need to address these differences, we are recommending simply that withholding begin at the point that Form 1099MISC filing is required. If cash payments contingent on a minimum catch exceed \$100 per trip, the payments are considered wages for employment. *See* IRC § 3121(b)(20)(a).

⁶ IRC § 3121(b)(20)(A).

⁷ IRC § 3402(p)(3)(B) provides guidance for withholding if the person making and the person receiving a type of payment other than wages agree to such withholding.

by furnishing the service recipient with a statement similar to the exemption certificate describing Form W-4 (withholding exemption certificate),⁸ which contains:

- ◆ A statement that the person described in Proposed Regulations § 1.6041A-1(a)(2) agrees to a withholding rate of 3.5 percent on the amount required to be reported on Form 1099-MISC; or
 - ◆ A statement by the person described in Proposed Regulation § 1.6041A-1(a)(2) of the gross profit percentage⁹ determined for the services provided that triggered the filing of Form 1099-MISC, and that the person agrees to a five percent withholding rate on the gross profit calculated by applying the gross profit percentage to the payments required to be reported on Form 1099-MISC; or
 - ◆ A statement that the person described in Proposed Regulation § 1.6041A-1(a)(2) falls within one of the specific industries for which the Secretary has established alternative gross profit percentages and agrees to a 5 percent withholding rate on the gross profit calculated by applying the gross profit percentage to the payments required to be reported on Form 1099-MISC.
- ◆ Upon receipt of the exemption certificate, the service recipient will either withhold at the 3.5 percent or industry-specific percentage rate on the amount required to be reported on Form 1099-MISC, or apply the gross profit percentage provided to subsequent gross reportable payments, and apply the rate of withholding at five percent to the gross profit calculated for this purpose.¹⁰

PRESENT LAW

Worker Classification

For purposes of income tax and payroll tax withholding, workers are classified into one of four categories:

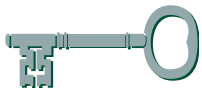
Statutory employees and statutory nonemployees. These are workers who are specifically designated in the Internal Revenue Code as employees or nonemployees for purposes of income tax and/or payroll tax withholding. For example, full-time life insurance salesmen

⁸ Treas. Reg. § 31.3402(p)-1(b)(1). The information required includes language directed to employees.

⁹ Gross profit is gross income minus materials and supplies. Gross profit percentage is computed by dividing gross profit by gross income.

¹⁰ Withholding agents will apply the 5 percent withholding rate to gross profit to eliminate the withholding disparity between those service providers who supply materials and supplies as opposed to those who provide services only.





are statutory employees for purposes of FICA (spell out) and Federal Unemployment Tax Act (FUTA) taxes.¹¹ Home workers are statutory employees for FICA purposes.¹² Direct sellers¹³ and companion home sitters¹⁴ are examples of statutory nonemployees.

Common law employees. A worker will be classified as a common law employee for purposes of income and payroll tax withholding if an analysis of the specific facts and circumstances of the employment arrangement under common law principles indicates that the worker is subject to another's control or direction not only as to the result of the work but also as to the details and means by which the work is accomplished (i.e, how the work will be done). The employer need not actually control the manner in which the work is done – it is enough that the employer has the right to control.¹⁵

Independent Contractors. If the worker does not satisfy either the common law tests for employee status and is not a statutory employee under the Code, then he or she is considered an independent contractor for purposes of income and payroll tax withholding. Workers who are independent contractors must pay self-employment tax on their net earnings.¹⁶

Section 530 Safe Harbor workers. Generally section 530 of the Revenue Act of 1978¹⁷ provides that, for purposes of employment tax withholding, a taxpayer does not have to treat a worker as an employee for any period after December 31, 1978 if:

- ◆ The taxpayer did not treat the worker as an employee for employment tax purposes for any period;
- ◆ The taxpayer files all required returns relating to that worker – including information returns – on a basis consistent with treating that worker as not being an employee; and
- ◆ The taxpayer has a reasonable basis for not treating that worker as an employee.¹⁸

Generally, the IRS uses three main categories of factors in its determination of worker status.

- ◆ Behavioral control: Does the worker receive extensive instructions on how, when and where to do the work, or what tools or equipment to use? Does the worker receive training about procedures and methods?
- ◆ Financial control: Does the worker have a significant investment in the work? Is the worker reimbursed for his expenses? Does the worker have an opportunity for profit or loss from the work?

¹¹ IRC § 3121(d)(3)(B).

¹² IRC § 3121(d)(3)(C).

¹³ IRC § 3505

¹⁴ IRC § 3506

¹⁵ Treas. Reg. § 31.3401(c)-1(b).

¹⁶ IRC § 1402(a) and (b).

¹⁷ Pub. L. No. 95-600.

¹⁸ Id. at sec. 530(a)(1). A taxpayer will be treated as having a reasonable basis for not treating a worker as an employee if he relies on: (a) judicial precedent or other certain other administrative rulings; (b) a past IRS audit not resulting in an employment tax assessment with respect to that worker or (c) others holding similar positions; or long-standing recognized practice in the taxpayer's industry. Id. at sec. 530(2).

- ◆ Relationship of the parties: Does the worker receive employee benefits such as insurance, pension, paid vacation and sick leave? Is there a written contract between the parties which shows the intent of the worker and the business?¹⁹

Consequences of Worker Classification

If a worker is classified as an employee, the employer is required to withhold income tax²⁰ and the employee's share of social security and Medicare taxes (FICA taxes)²¹ from the employee's wages.¹⁸ The employer must also pay unemployment taxes on those wages.²² Further, the employer is required to issue a Form W-2, Wage and Tax Statement, to the employee, reporting gross wages and withholding amounts for the calendar year.²³ An employee can deduct unreimbursed business expenses as miscellaneous itemized deductions on his or her individual income tax return.²⁴

A worker who is classified as an independent contractor is responsible for paying his or her own income tax and self-employment tax under the Self Employment Contributions Act (SECA).²⁵ Generally, the independent contractor computes his or her net taxable self-employment income on Form 1040, Schedule C, Sole Proprietorship Income, by deducting business expenses from business income. The business for whom the independent contractor works must furnish the worker with a Form 1099-MISC, Miscellaneous Income, on which it reports the income it paid to the independent contractor.²⁶

The classification of a worker as an employee or independent contractor has consequences other than tax withholding and the deductibility of business expenses. For example, employees may be eligible for unemployment compensation or worker compensation coverage. They may also be covered by and participate in an employer's retirement or other employee benefit plans.

¹⁹ Internal Revenue Service, *Independent Contractor or Employee*, Publication 1779 (Rev. 5-03).

²⁰ IRC § 3402(a)(1). For purposes of withholding from wages, an employer is defined as the person for whom an individual performs or performed any service as the employee of that person. IRC § 3401(d). Special rules apply to persons who do not have control over the payment of wages to the provider of services and to persons paying wages to nonresident alien individuals and certain other foreign entities. IRC § 3401(d)(1)-(2). Wages are defined as "all remuneration . . . for services performed by an employee for his employer." IRC § 3401(a).

²¹ IRC § 3121(a). Wages are defined as "all remuneration...for services performed by an employee for his employer." IRC § 3401(a).

²² IRC § 3301.

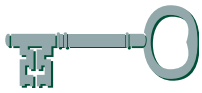
²³ IRC § 6051.

²⁴ See generally IRC §§ 162, 63(d), 67(a), 67(d).

²⁵ Pub. L. No. 83-591, 68A Stat. 1, 353 (Self-Employment Contributions Act of 1954).

²⁶ IRC § 6041A(a) requires any service recipient engaged in a trade or business to report payments of \$600 or more made in a calendar year to the person providing services. The IRS 2003 Instructions for Form 1099-MISC state that payments to a corporation are generally not required to be reported on the form. The following payments to a corporate service provider, however, must be reported on Form 1099-MISC: medical and health care payments; fish purchases for cash; attorneys' fees; gross proceeds paid to an attorney; payments by a Federal executive agency for services (vendors); and substitute payments in lieu of dividends or tax-exempt interest.





Withholding on Payments Other Than Wages

Certain non-wage payments are subject to mandatory or voluntary withholding. Internal Revenue Code section 3402(o) extends mandatory withholding to certain supplemental unemployment compensation benefits to the extent that the benefits are includible in gross income.²⁷ Any payment of an annuity or sick pay to an individual is subject to withholding if the payee makes a request for withholding.²⁸ Internal Revenue Code section 3402(p)(3)(A) and (B) provide for other voluntary withholding from any other appropriate type of payment.²⁹

Backup Withholding

Backup withholding on reportable payments is required under certain circumstances. These circumstances include instances when the payee does not provide a Tax Identification Number (TIN) to the payer, or the IRS notifies the payer that the TIN furnished by the payee is incorrect.³⁰ Payments subject to backup withholding include those made in the course of a trade or business to a person for services performed,³¹ and monies paid by certain fishing boat operators,³² which must be reported on information returns.

Federal Contractors

There is no provision in the Internal Revenue Code governing income tax withholding on federal contracts. The head of every federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor,³³ and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts) and their instructions.³⁴

²⁷ IRC § 3402(o)(1)(A).

²⁸ IRC § 3402(o)(1)(B) and (C).

²⁹ IRC § 3402(p)(3)(B) authorizes the Secretary to prescribe regulations that provide for voluntary withholding from other types of payments if the employer and employee, or the person making and the person receiving the other type of payment, agree to the withholding. In this circumstance, the payments would be treated as if they were wages paid by an employer to an employee.

³⁰ Treas. Reg. § 31.3406(a)-1.

³¹ IRC § 3406(b)(3)(B).

³² IRC § 3406(b)(3)(D). IRC § 6050A requires the operator of a fishing boat on which one or more individuals perform services to report the percentage of each person's share of the catch and share of the proceeds of the catch as well as any cash paid.

³³ IRC § 6050M.

³⁴ No information return is required for any contract of \$25,000 or less; any contract with a contractor who is acting in his or her capacity as an employee of a federal executive agency; any contract between a federal executive agency and another federal government unit; any contract with a foreign government; any contract with a state or local government unit; any contract with a person who is not required to have a TIN; any contract whose terms provide that all amounts will be paid on or before the 120th day following the date of the contract action; any contract under which all money (or other property) that will be received by the contractor after the 120th day after the date of the contract action will come from persons other than a federal executive agency or an agent of such an agency (e.g., a contract under which the contractor will collect amounts owed to a federal executive agency by the agency's debtor and will remit to the agency the money collected less an amount that serves as the contractor's consideration under the contract); or any contract for which the IRS determines that information described in Treas. Reg. § 1.6050M-1 will not facilitate the collection of federal tax liabilities because of the manner, method, or timing of payment by the agency under that contract. IRC § 6050A; Treas. Reg. § 1.6050M-1(c)(1).

Government agencies must report on Form 8596 the date the Federal contract was awarded and the aggregate amount of the contract (even where payments will span several years).³⁵

As noted above, IRC § 6041A(a) requires a service recipient to file an information return reporting payments of \$600 or more to a person for services performed. Section 6041A(d)(1) provides that a governmental unit is a person for purposes of that section, and IRC § 6041A(d)(3)(A) requires the filing of a return for payments made to a corporation by a government agency. Thus, in addition to filing Form 8596 reporting information about the contract award, government agencies must also file Form 1099-MISC reporting payments to individuals and corporations.³⁶

REASONS FOR CHANGE

The absence of a withholding mechanism on payments made to non-wage workers creates several significant problems: (1) it contributes to the substantial known tax gap for independent contractors; (2) it leads some businesses to incorrectly classify workers as independent contractors, which places employers who correctly classify their workers as employees at a competitive disadvantage, and forces the IRS and taxpayers to become mired in protracted worker classification audits and determinations; (3) it harms those non-wage workers who want to comply with the law but are fearful of filing because of a large balance due amount; and (4) it harms all compliant taxpayers because they pay their correct tax liability while others do not.

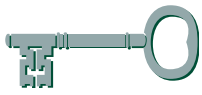
From the standpoint of the tax system, the lack of a withholding mechanism leads to substantial underpayments of tax each year by some taxpayers, while compliant taxpayers pay the full amount of tax due. This disparate treatment undermines the respect of law-abiding taxpayers for the fairness of the tax system.

For employers and other service recipients, the conundrum of worker classification and the multitude of reporting and payment requirements associated with employees can drive an employer to treat employees as independent contractors. Imposing a simple, flat-rate withholding requirement on independent contractor payments levels the playing field between businesses that are currently bearing the cost of complying with the law and those who are shifting that cost to others.

³⁵ IRC § 6050M.

³⁶ Prop. Reg. § 1.6041(d) lists exceptions to return requirements if a return is required under another section. IRC § 6050M is not listed as one of the exceptions. The IRS does not have the data on whether Federal agencies filing form 8506 on Federal contractors also file the required Form 1099-MISC reporting payments to those contractors.





From the standpoint of the worker, the main reason for instituting withholding is to avoid what we have termed the “April 15th surprise” and its downstream consequences. As the filing deadline approaches, many non-wage workers realize that no tax was withheld and the entire tax liability for the year will be due at one time. In some instances, taxpayers will face large tax liabilities that they did not budget for and cannot pay. In other cases, taxpayers knew that a large amount would be due and never intended to pay more than a nominal portion of tax, if any. Still others may assume they will face large tax liabilities, but due to their income levels and family circumstances, may actually be due a refund.

Workers who owe tax and do not file, regardless of their underlying motivation, pay no Social Security or Medicare taxes and therefore do not receive credit toward Social Security or Medicare benefits. Taxpayers who owe tax will also face penalties and interest charges that will continue to accrue on both the unpaid tax and the penalties. Taxpayers who are owed a refund simply will not receive it. Moreover, the IRS must divert its limited compliance resources to addressing these problems.

By contrast, workers who are classified as employees generally do not face these consequences because the withholding mechanism sharply reduces the likelihood of large, unpaid tax liabilities at the end of the year. A withholding mechanism applicable to non-wage workers would provide similar benefits for them.

Tax Compliance and Non-employee Payments

The General Accounting Office (GAO) has identified the absence of withholding on certain non-employee payments as a problem for many years. As long ago as 1979, GAO determined that the problem of compliance among independent contractors and self-employed individuals was serious enough to recommend withholding to collect part of the tax this group owed.³⁷ Again in 1992, GAO reported to Congress on “Approaches for Improving Independent Contractor Compliance,” recommending withholding on payments to independent contractors. The report describes withholding as “the cornerstone of our tax compliance system for employees It provides a gradual and systematic method to pay taxes and insures credit for social security coverage.”³⁸

In another report discussing tax gap strategies in May 1994, GAO recommended that “Congress consider requiring tax withholding on payments made to independent contractors.”³⁹ Panelists at a 1995 GAO-sponsored Tax Gap Symposium recommended

³⁷ Statement of Richard L. Fogel, Associate Director, General Government Division, GAO, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, on Compliance Problems of Independent Contractors, GAO #109909, July 17, 1979, p. 7.

³⁸ GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108, July 1992, p. 4.

³⁹ General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, May 11, 1994, p. 37.

mandatory withholding for non-wage earners. The panelists offered withholding as an alternative to clarifying the definition of independent contractor, noting that the right balance between levels of compliance and levels of tax system intrusiveness would have to be determined.⁴⁰

The IRS National Headquarters Office of Research periodically prepares estimates of the amount of tax liability for a particular tax year that is not voluntarily and timely paid. This amount is often referred to as the “tax gap.” The income tax gap consists of three main components: non-filing, underreporting, and underpayment.⁴¹ From 1992 to 1998, the income tax gap grew an estimated 61 percent to \$207 billion.⁴² Of that amount, an estimated \$132.5 billion – well over half – represents underreported sole proprietorship (Schedules C & F) returns that were or should have been filed.⁴³ This portion of the tax gap is partly but not entirely attributable to recipients of Forms 1099-MISC (Miscellaneous Income).⁴⁴

Non-filer estimates for tax year 2000 indicate:

- ◆ There were 9,062,194 non-filers.
- ◆ 2,002,678 of those non-filers received Forms 1099-MISC (NEC).
- ◆ \$48,174,172,032 in total unreported income was attributable to income of nonfilers that was reported on Forms 1099-MISC (NEC).⁴⁵

IRS research indicates that the problems associated with non-employee filing and reporting compliance are far-reaching. The GAO has noted that “tax reporting compliance for wage earners with withholding is approximately 99 percent, while tax compliance for individuals with income not subject to withholding is significantly less. In the case of self-employed taxpayers, IRS estimates that compliance is about 41 percent.”⁴⁶

⁴⁰ GAO Report to the Joint Committee on Taxation, U.S. Congress, *Reducing the Tax Gap: Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June 1995, pp. 7 & 8.

⁴¹ The tax gap does not reflect subsequent activity, such as abatements that reduce the gap, or penalty and interest assessments that increase it. The estimates also relate only to payment of tax on income earned in legal activities. For example, the income tax theoretically due but not paid on income from distribution of narcotics is not included. Small Business Self-Employed (SB/SE) Compliance Risk Assessment, March 16, 2001; SB/SE Strategy, Research and Performance Management (SRPM) Research Reports for 2001, p. 2.

⁴² The latest published income tax gap information is for 1992. National Headquarters Research has prepared partial estimates of the 1998 income tax gap in preparation for a draft report to Congress. SB/SE SRPM Compliance Risk Assessment, March 16, 2001. Appendix 1.

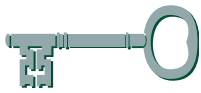
⁴³ SB/SE Strategy, Research and Performance Management (SRPM) Compliance Risk Assessment Research Report, March 16, 2001, p. 3.

⁴⁴ For a discussion of Sole Proprietor unreported and underreported income, see *infra*.

⁴⁵ Tax Year 2000 Nonfiler Data, SB/SE Research, September 25, 2003.

⁴⁶ GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners*, GAO/General Government Division (GGD)-96-165, Aug. 1996, p. 12.





In its August 2001 report on the IRS' ability to encourage accurate returns for non-employee compensation, TIGTA concludes "...a tax law change to require payers to withhold taxes from payments to independent contractors offers the best solution for increasing the accuracy of taxpayer identification number (TIN) information on Forms 1099-MISC (Miscellaneous Income) reporting non-employee compensation."⁴⁷ That is, taxpayers will be more likely to correct their TINs if they want to claim tax payments that have been withheld from payments.

In sum, we believe that withholding would offer the following benefits relative to current law:

- ◆ It would level the playing field between employers who correctly treat workers as employees, and those who do not, thereby eliminating an unfair business advantage.
- ◆ It would help non-wage workers avoid tax liabilities that they cannot pay.
- ◆ It would help bring non-wage workers into the tax system and thereby reduce the likelihood that they later will be subject to IRS enforcement and collection action.
- ◆ It would reduce the high rate of non-compliance among non-employee workers (by increasing reporting, payment, and filing) and thereby ensure that those who honestly pay taxes do not have to pay more than their fair share.

EXPLANATION OF RECOMMENDATIONS

Independent Contractors

Any person engaged in a trade or business, making payments of \$600 or more for services provided by an individual, is required to report those payments on an information return.⁴⁸ Examples include fees, commissions, prizes and awards for services performed as a non-employee, and other forms of compensation for services performed for a trade or business by an individual who is not an employee.⁴⁹

Our recommended change would require the service recipient not merely to issue information statements, but also to withhold federal taxes. Under our proposal, withholding would be imposed at a flat rate of five percent, except if the payment were partly in consideration of parts and materials, in which case the withholding rate generally would be 3 percent.⁵⁰ The payer would not be required to withhold tax if the aggregate amount of the payment is less than \$600.

⁴⁷ Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference # 2001-30-132, Aug. 2001, p. ii.

⁴⁸ IRC § 6041A(a).

⁴⁹ Instructions for Form 1099-MISC 2003, p. MISC-4, Box 7, Nonemployee Compensation.

⁵⁰ See *infra* for a discussion of how we computed these withholding rates.

⁵¹ As with Form W-4, Wage and Tax Statement, both civil and criminal penalties should apply for a substantial understatement or fraudulent statement of gross profit percentage. See, e.g. IRC §6682. IRC §6682 provides for a civil penalty of \$500 for a false statement with no reasonable basis. This is in addition to any criminal penalty provided by §7205(a) for willfully supplying false or fraudulent information ...be fined not more than \$1,000 or imprisoned not more than 1 year or both.

The recommendation to withhold at a rate of 3.5 percent includes an exception to allow the service provider to elect to provide a statement of gross profit percentage.⁵¹ The service provider is then required to withhold at the rate of five percent on the gross profit.

The National Taxpayer Advocate also recommends that the Secretary be authorized to develop industry-based recommended safe harbor gross profit percentages which the service provider can elect to apply for withholding tax purposes. It is anticipated that the IRS will work with industry associations and groups in developing these percentages.

Fishing Boat Proceeds

The operator of a fishing boat that normally carries a crew of less than ten⁵² is required to report certain monies paid to crew members, representing a share of the proceeds of the catch, on a Form 1099-MISC.⁵³ On the same form, the operators must also report cash payments which do not exceed \$100 per trip per person that are contingent on a minimum catch and paid solely for additional duties (such as mate, engineer, or cook) for which cash payments are traditional in the industry.⁵⁴

The recommendation to withhold federal taxes at a rate of five percent is directed at:

- ◆ payments that represent a share of the proceeds from the sale of a catch paid in money, and
- ◆ cash payments that do not exceed \$100 per trip, are contingent on a minimum catch, and are paid for additional duties described in IRC § 3121(b)(20)(A).

Federal Contractors

Internal Revenue Code section 6050M requires every federal agency head who enters into certain contracts to file a Form 8596 (Information Return for Federal Contracts) with the IRS to report information about persons with whom they have entered into contracts, including the date of contract action and the total amount to be paid under the contract. In addition, Internal Revenue Code section 6041A requires any service recipient engaged in a trade or business and paying for services to make a return according to regulations when the aggregate of the amount paid is \$600 or more. Government entities are specifically required to make an information return, reporting payments to corporations as well as individuals.⁵⁵

In the case of payments for services reported by heads of federal agencies on Forms 1099-MISC, we recommend, generally, a flat 5 percent withholding rate on the gross reportable payments. In those situations where the federal contractor provides materials and supplies, and the reportable payment includes reimbursement for those materials and supplies, the

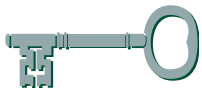
⁵² IRC § 3121(b)(20).

⁵³ IRC § 6050A.

⁵⁴ IRC § 3121(b) defines employment and lists certain exceptions to the term. IRC §3121(b)(20)(A) states that this type of payment to crew members cannot exceed \$100 and still be considered non-employment.

⁵⁵ IRC § 6041A(d)(3)(A).





withholding rate should be 3.5 percent of the gross reportable payments. The federal contractor can make an election to provide the gross profit percentage in a statement to the payer. The payer, on subsequent gross reportable payments, will apply the rate of withholding at 5 percent to the gross profit calculated for the purpose of withholding.⁵⁶

Businesses With Inventories

The National Taxpayer Advocate recommends that service recipients withhold federal income tax at the rate of 3.5 percent on gross reportable payments to service providers that maintain inventories. This rate would apply to businesses that provide services, parts, and materials when the total amount is reported on 1099-MISC as required by Proposed Regs 1.6041A-1(a)(2).

The National Taxpayer Advocate further recommends that service providers whose gross receipts include payments partly made for supplies and materials be permitted to make an election for withholding to apply to the service provider's estimated gross profit. In making the election, the service provider would be required to furnish the service recipient with a form that specifies the service provider's gross profit percentage. Upon receipt of the election statement, the service recipient will withhold tax at a rate of 5 percent on the gross profit, as computed by applying the gross profit percentage to subsequent reportable gross payments. Moreover, the Secretary should be authorized to create safe harbor gross profit percentages for specific trades and industries that, if used, would be grounds for not imposing a penalty for substantially understating the gross profit percentage.

Calculation of Withholding Rates

IRS data on sole proprietorships (Schedule C filers) indicate that businesses likely to have inventories based on North American Industry Classification System (NAICS) code descriptions include the following industries: construction; manufacturing; wholesale trade; retail trade; transportation and warehousing; barbers/beauty/nail salons; and funeral homes.⁵⁷ According to the IRS,

- ◆ The expenses of sole proprietorships with inventories are approximately 78 percent of gross receipts.
- ◆ The expenses of sole proprietorships without inventories are approximately 71 percent of gross receipts.⁵⁸

⁵⁶ The IRS does not have data on overall noncompliance by federal contractors. The Department of Defense, which has about two-thirds of all federal contractors, is only in the early stages of working with the Federal Payment Levy Program (FPLP), which offsets federal payments against liabilities. The National Taxpayer Advocate recognizes that withholding on corporate contractors raises difficult administrative issues. The FPLP was devised, in part, to address these issues. We recommend, however, that withholding apply to federal contractors who are sole proprietorships, regardless of whether they provide a social security number or an employer identification number to the federal agency.

⁵⁷ Tax Year 2000, Schedule C Gross Receipts to Profits for Taxpayers with 1099 MISC Non-Employee Income, Compliance Research Information System (CRIS), Model IFM 2002.

⁵⁸ Tax Year 2000, Schedule C Gross Receipts to Profits for Taxpayers with 1099 MISC Non-Employee Income, Compliance Research Information System (CRIS), Model IFM2002.

For sole proprietorships without inventories, we determined that an appropriate withholding rate against net income would be 15 percent at a minimum, in order to cover the 15.3 percent self-employment tax imposed under SECA. Using the IRS data for sole proprietorship expenses, we computed a general gross profit percentage of 29 percent (gross receipts – 71 percent expenses).⁵⁹ We applied a 15 percent tax rate against the 29 percent gross profit percentage to arrive at 4.35 percent. We rounded that rate up to five percent rate applicable to reportable gross receipts to cover withholding for both self-employment tax and some federal income tax.

For businesses with inventories, we computed a general gross profit percentage of 22 percent (gross receipts – 78 percent expenses, based on IRS sole proprietorship data). We then applied the 15 percent tax rate against this 22 percent gross profit percentage. We rounded up the resulting 3.3 percent rate to a 3.5 percent withholding rate applicable to reportable gross receipts for businesses with inventories.

In cases where a service provider bears out-of-pocket expenses to furnish materials or supplies, the theoretically “pure” approach would be to require the service recipient to determine, and then back out, the cost of these parts, materials, and other expenses, and thereby to compute the service provider’s net profit. We would then impose the desired 15 percent withholding rate on that profit. In practice, we are concerned that requiring that amount of additional work on the part of service recipients may prove overly burdensome. Thus, we have attempted to account for the additional cost of materials and supplies by applying a lower withholding rate to gross reportable payments for services and materials. We also recommend that the service provider be permitted to elect to provide a gross profit percentage to the service recipient, in which case withholding will be applied at the higher rate.

⁵⁹ We acknowledge that technically, in using the IRS sole proprietorship data, we should call this ratio the “net profit percentage.” We use the term “gross profit percentage” for purposes of simplicity. We anticipate that these proposed withholding rates will be (and should be) subjected to intense scrutiny and review in order to arrive at the appropriate level. We also expect these rates to be adjusted from time to time to reflect current data.

