PRESENT LAW AND ISSUES
RELATING TO
MISCLASSIFICATION OF EMPLOYEES AND
INDEPENDENT CONTRACTORS FOR FEDERAL TAX PURPOSES

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on July 23, 1992

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on July 23, 1992, on the issue of misclassification of employees and independent contractors for Federal tax purposes.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law and related issues concerning the classification of employees and independent contractors for tax purposes.

Part I of the document is a summary. Part II is a description of present-law rules relating to classification of workers, income tax withholding, employment taxes, reporting requirements, and penalties. Part III discusses consequences of a worker being classified as an independent contractor. Part IV sets forth some of the reasons workers are misclassified. Part V presents certain data regarding misclassification and compliance, and Part VI discusses certain issues and options associated with misclassification.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Issues Relating to Misclassification of Employees and Independent Contractors for Federal Tax Purposes (JCX-27-92), July 22, 1992.

I. SUMMARY

A variety of relationships and job classifications exist in the American workplace. However, for Federal tax purposes, there are only two classifications: a worker is either an employee of the service recipient or an independent contractor (i.e., self-employed).

Significant tax consequences result from the classification of a worker as an employee or independent contractor. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test that seeks to determine whether the service provider is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed. Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met.

There are two main sources of misclassification. First, because the test for determining whether a worker is an employee or an independent contractor is to some degree subjective, taxpayers attempting to classify workers may in good faith come to a different conclusion than the IRS. Misclassification may also be deliberate in order to take advantage of actual or perceived tax and nontax benefits of independent contractor status.

An IRS survey of 1984 employment tax returns found that nearly 15 percent of employers misclassified employees as independent contractors. When employers classified workers as employees, more than 99 percent of wage and salary income was reported. However, when workers were misclassified as independent contractors, 77 percent of income was reported

when a Form 1099 was filed, and only 29 percent of income was reported when no Form 1099 was filed.

One of the most significant issues associated with misclassification is the revenue loss to the Federal government that occurs when workers are classified as independent contractors rather than employees. One possible explanation for the revenue loss is that such workers are treated more favorably under the Internal Revenue Code than are employees. Another explanation is that there is revenue loss associated with lower compliance rates of independent contractors and service recipients compared to the compliance rates of employees and their employers. Possible solutions to the problem include increased penalties for misclassification and reporting violations, narrowing the present-law safe harbor provisions, conditioning the deductibility of payments to independent contractors on compliance with reporting requirements, and imposing withholding requirements with respect to payments to all workers.

II. PRESENT LAW

A. Classification of Workers

In general

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Under this test, an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished (Treas. Reg. sec. 31.3401(c)-(1)(b)). Whether the requisite control exists is determined based on all the relevant facts and circumstances.[2]

The IRS has developed a list of 20 factors that may be examined in determining whether an employee-employer relationship exists. Rev. Rul. 87-41, 1987-1 C.B. 296. The 20 factors were developed by the IRS based on an examination of cases and rulings considering whether a worker is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The 20 factors are designed as guides; special scrutiny may be required in applying the factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement.[3]

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[2] There are also some persons who are treated by statute as either employees or independent contractors. For example, full-time life insurance salesmen and certain travelling salesmen are treated as employees for purposes of employment taxes (sec. 3121(d)). Real estate agents and direct sellers are not treated as employees (sec. 3508).

[3] The factors are as follows: (1) whether the worker is required to comply with instructions about when, where, and how to perform the work; (2) whether the service recipient trains the worker; (3) the extent to which the worker's services are integrated into the business operations of the service recipient; (4) whether the services must be rendered personally; (5) whether the service recipient supervises the worker; (6) whether there is a continuing relationship between the worker and the service recipient; (7) whether the service recipient sets the hours of work of the worker; (8) whether the worker is required to devote substantially full time to the business of the service recipient; (9) whether the work is done on the premises of the service recipient;

(Footnote continued)

Section 530 of the Revenue Act of 1978

With increased enforcement of the employment tax laws beginning in the late 1960s, controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as independent contractors rather than as employees. In some instances when the IRS prevailed in reclassifying workers as employees under the common-law test, the employing business became liable for substantial portions of its employees' FICA and income tax liabilities (that the employer had failed to withhold and pay over), although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, the Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95-600). That provision generally allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Under section 530, a reasonable basis is considered to exist if the taxpayer reasonably relied on (1) past IRS audit practice with respect to the taxpayer, (2) published rulings or judicial precedent, or (3) long-standing recognized practice in the industry of which the taxpayer is a member. Under the prior-audit rule, reasonable reliance is generally found to exist if the IRS failed to raise an employment tax issue on audit, even though the audit was not related to employment tax matters.

This relief under section 530 is available with respect to an individual only if certain additional requirements are satisfied. One of these requirements is that the taxpayer (or a predecessor) must not have treated any individual holding a substantially similar position as an employee for

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[3](continued)
(10) whether the worker must perform services in the order set by the service recipient; (11) whether reports by the worker to the service recipient are required; (12) whether payment is by the hour, week, or month; (13) whether the service recipient pays the worker's business and/or traveling expenses; (14) whether the worker is required to furnish his or her own tools; (15) whether the worker invests in facilities used to perform the work; (16) whether the worker can realize a profit or loss as a result of the performance of the services; (17) whether the worker performs services for more than one service recipient; (18) whether the worker makes his or her services available to the general public; (19) whether the service recipient has the right to discharge the worker; and (20) whether the worker has the right to terminate the relationship without incurring liability.

purposes of employment taxes for any period beginning after 1977.

Section 530 also prohibits the issuance of Treasury regulations and revenue rulings on common-law employment status. Taxpayers may, however, obtain private letter ruling from the IRS regarding the status of workers as employees or independent contractors.

The relief granted by section 530, initially scheduled to terminate at the end of 1979, was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248), the Congress extended the section 530 relief indefinitely, pending enactment of further statutory rules regarding the classification of workers as employees or independent contractors. TEFRA also modified the penalties for misclassification of workers to reduce burden on employers where workers are reclassified.

Under section 1706 of the Tax Reform Act of 1986 (the 1986 Act), section 530 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. Thus, the determination of whether such individuals are employees or independent contractors is made in accordance with the common-law test.

B. Income Tax Withholding

The Code requires that employers making payments of wages to employees withhold Federal income taxes from those wage payments in accordance with tables or computational procedures prescribed by the IRS (sec. 3402). Each employee must file with his or her employer a Withholding Allowance Certificate (Form W-4) on which the employee claims a specific number of withholding allowances based on family size, employment status, itemized deductions, and other matters. The employer then utilizes tables issued by the IRS to compute the correct amount of Federal income tax withholding. This computation is based on the number of withholding allowances claimed, the taxpayer's wages, and the frequency of payroll payments. The amount of wages paid and the amount of income taxes withheld must be reported to the IRS and to the employee on Form W-2.

No income tax withholding is required on payments made to independent contractors.[4] Independent contractors are required to make quarterly estimated tax payments.

C. Employment Taxes

If an employer-employee relationship exists, the service recipient is subject to social security taxes under the Federal Insurance Contributions Act (FICA) (secs. 3101-3127) and unemployment taxes under the Federal Unemployment Tax Act (FUTA) (secs. 3301-3310), and is required to withhold and pay over FICA taxes imposed on the worker. On the other hand, if there is no employer-employee relationship, the service recipient is not subject to employment taxes; the worker pays self-employment tax under the Self-employment Contributions Act (SECA) (secs. 1401-1403) in lieu of FICA tax. Independent contractors are not subject to FUTA, but also generally are not entitled to related unemployment benefits.

Prior to 1990, the employment tax structure significantly favored independent contractors. Until 1983, the combined FICA tax rate on the employer and employee was significantly higher than the SECA tax rate. The Social Security Amendments Act of 1983 equalized the tax rates, but provided a credit for a portion of SECA taxes for years 1984 through 1989. For years after 1989, the tax rates are the same, and there is no SECA tax credit. A self-employed person is entitled to an income tax deduction for a portion of SECA taxes.

Some differences still exist between FICA and SECA taxes, primarily because the base for calculating the taxes differs.

D. Reporting Requirements With Respect to Independent Contractors

The Code contains a separate provision (sec. 6041A) specifically dealing with payments of remuneration for services. Under this provision, a service recipient engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the Internal Revenue Service an information return (Form 1099) reporting such payments (and the name, address, and taxpayer identification number of the payee) if the remuneration paid to the person during the calendar year is $600 or more. Also, the service recipient must furnish to the person receiving such payments

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[4] Payments to independent contractors may be subject to backup withholding under certain circumstances (sec. 3406).

a statement setting forth the name, address, and taxpayer identification number of the service recipient, and the aggregate amount of payments made to the payee during the year.

E. Penalties

1. Information reporting penalties

a. Failure to file correct information returns

Any person that fails to file a correct information return (such as Forms W-2 or 1099) with the Internal Revenue Service on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed (sec. 6721). If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return more than 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year. The Code also provides a special rule for de minimis failures to include the required, correct information.

In addition, the Code provides special, lower maximum levels for this penalty for small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent 3 taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

b. Failure to furnish correct payee statements

Any person that fails to furnish a correct payee statement to a taxpayer (such as a copy of a W-2 or a 1099) on or before the prescribed due date is subject to a penalty of $50 per statement, with a maximum penalty of $100,000 per calendar year (sec. 6722). If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, the penalty is generally $100 per statement or, if greater, 10 percent[5] of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year.

c. Failure to comply with other information reporting requirements

Any person that fails to comply with other specified information reporting requirements on or before the prescribed date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year (sec. 6723). The information reporting requirements specified for this purpose include any requirement to include a correct taxpayer identification number on a return or statement and any requirement to furnish a correct taxpayer identification number to another person.

d. Reasonable cause

The Code provides that any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect (sec. 6724). For this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements.

2. Accuracy penalties

a. Accuracy-related penalty

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement (sec. 6662).

If an underpayment of tax is attributable to negligence, the negligence penalty is to apply only to the portion of the underpayment that is attributable to negligence rather than to the entire underpayment of tax.

Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.

b. Fraud penalty

The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud (sec. 6663).

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[5] The penalty is 5 percent for several types of statements.

c. Reasonable cause

No accuracy-related or fraud penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith (sec. 6664).

3. Penalty for aiding and abetting the understatement of tax liability

The penalty for aiding and abetting the understatement of tax liability applies in cases where the person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result (sec. 6701).

4. Penalty for failure to make timely deposits of tax

The penalty for failure to make timely deposits of tax is a four-tiered penalty. The amount of the penalty varies with the length of time within which the taxpayer corrects the failure (sec. 6656). A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected within 5 days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is 5 days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303).

5. Employer's liability for certain employment taxes as a result of misclassification of workers

If an employer treats services performed by an employee as if performed by a nonemployee and fails to withhold income or social security taxes as required by the wage withholding provisions of the income tax and social security tax laws, the employer's liability for those amounts is determined as a fraction of the employee's wages subject to income tax withholding or a fraction of the social security taxes

required to be withheld (sec. 3509). The Code applies a lower fraction if the employer has complied with information reporting rules consistent with the treatment of the employee as a nonemployee.

The applicable amounts are 1.5 percent of wages (3 percent where no information returns are filed) where the employer erroneously treated the worker as a nonemployee for income tax purposes. The applicable amount where the employer erroneously treated the worker as a nonemployee for social security purposes is 20 percent of the social security taxes required to be withheld (40 percent where no information returns are filed). Even where this procedure applies, however, the employer is still liable for the employer's share of FICA and FUTA taxes.

These provisions do not apply if the employer treats the employee as a nonemployee with intentional disregard of the law. In this case, the employer is responsible for 100 percent of the income and FICA tax required to be withheld.

III. CONSEQUENCES OF INDEPENDENT CONTRACTOR STATUS

Federal tax consequences

Workers who are classified as employees are entitled to exclude from gross income certain employee benefits that cannot be excluded by workers classified as independent contractors. Thus, for example, benefits such as employer-provided health, dependent care, group-term life insurance, and pensions are excluded from gross income (and wages for FICA tax purposes) of employees.

If an individual is not an employee for income tax purposes, the individual is entitled to establish his or her own retirement plan (Keogh plan) and deduct contributions to the plan. The plan can be individually tailored to the desires of the individual. The amount of deductible contributions may be greater than the contributions that an employer would make under an employer-sponsored plan. Such flexibility generally is not available to individuals covered under an employer's plan. In some circumstances, an employer might wish to treat a worker as an independent contractor in order to avoid providing the worker with retirement and other employee benefits.

Independent contractors receive favorable tax treatment with respect to business expenses in several respects. For example, business expenses are deductible by independent contractors without regard to the amount of the expenses or whether they itemize deductions. On the other hand, an employee's ability to deduct business expenses without itemizing is very limited. Moreover, even for those employees who itemize, their miscellaneous business deductions for unreimbursed employee business expenses are subject to the two-percent-of-AGI floor on itemized deductions.

As discussed above, employment tax and withholding obligations also differ depending on whether a worker is an employee or independent contractor. Thus, for example, no withholding is required with respect to payment to independent contractors, but independent contractors are required to pay estimated taxes.

Other consequences

There may also be non-federal tax consequences of worker classification. For example, State income tax laws may follow the Federal classification rules. Also, coverage under Federal and State workers' compensation plans, wage and hour laws, and similar worker-related programs may depend on the classification of a worker as an employee.

IV. REASONS FOR MISCLASSIFICATION

Misclassification of workers can be either inadvertent or deliberate. At the extremes, it will be clear whether a worker is properly characterized as an employee or independent contractor. However, many work situations will involve the grey area in between -- some of the 20 factors may support employee status, while some indicate independent contractor status. Because the determination of proper classification is factual, reasonable people may differ as to the correct result given a certain set of facts. Thus, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by, for example, weighing some of the 20 factors differently than the taxpayer. Taxpayers wishing certainty can obtain private letter rulings regarding the status of workers. However, not all taxpayers may wish to undertake the expense of obtaining a ruling or may not be able to wait for a ruling from the IRS. Thus, the prohibition on issuance of general guidance by the IRS may make the likelihood of such errors greater; the IRS is not permitted to publish guidance stating which factors are more relevant than others. In the absence of such guidance, not only may taxpayers and the IRS differ, but different IRS agents may also reach different conclusions, resulting in inconsistent enforcement.

Misclassification of workers as independent contractors may also be deliberate. In some cases, workers and service recipients may prefer to classify workers as independent contractors, both for tax and nontax reasons. For example, the worker may wish to take advantage of the ability to contribute on a deductible basis to a pension plan or to deduct significant work-related expenses. A service recipient may wish to avoid administrative problems associated with withholding income and FICA taxes. The service recipient also may wish to avoid coverage and nondiscrimination requirements applicable to qualified retirement plans by classifying lower-paid workers as independent contractors.

Workers sometimes argue that they prefer independent contractor status because it gives them more control over their own lives. To the extent such reasons exist in particular cases, service recipients may feel compelled to classify workers as independent contractors rather than employees. In many instances, it may be very difficult to distinguish whether a misclassification was deliberate or inadvertent.

V. DATA REGARDING MISCLASSIFICATION AND COMPLIANCE

IRS audits of employment tax returns declined from over 100,000 in 1979 to about 24,000 in 1988.[6] This represented a decrease in audit coverage from approximately one half of one percent to less than one tenth of one percent of employment tax returns filed. Concerned with the decline in auditing of these returns, both the IRS and GAO undertook surveys to determine the extent of misclassification of employees as independent contractors and the effect that this misclassification had on compliance.

The IRS survey of 1984 employment tax returns found that nearly 15 percent of employers misclassified employees as independent contractors.[7] The section 530 safe harbor protected 2 percent of misclassified employees from being reclassified as employees. Of those returns using the section 530 safe harbor protections, nearly half relied on the prior audit provision.

When employers classified workers as employees, more than 99 percent of wage and salary income was reported. However, when workers were misclassified as independent contractors, 77 percent of income was reported when a Form 1099 was filed, and only 29 percent of income was reported when no Form 1099 was filed.

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[6] United States General Accounting Office, Information Returns Can Be Used to Identify Employers Who Misclassify Workers, GAO/GGD-89-107, September 1989.

[7] Internal Revenue Service, "Strategic Initiative on Withholding Noncompliance (SVC-1) Employer Survey Report of Findings", June 1989.

VI. ISSUES

A significant issue with respect to misclassification is the effect that it has on Federal budget receipts. There are at least two ways that misclassification could result in revenue loss, each with a different set of possible solutions.

A. Enforcement

Treatment under the Code

It is possible that there is a reduction in net Federal budget receipts attributable to the misclassification of employees as independent contractors because independent contractors are treated more favorably under the Internal Revenue Code than employees. For example, independent contractors are permitted to deduct business expenses pertaining to meals and entertainment, a home office, and transportation, and they are not subject to the 2-percent floor on miscellaneous itemized deductions imposed on unreimbursed employee business expenses. Independent contractors also are permitted to establish individual pension plans (Keogh plans) to which they can make an annual deductible contribution of $30,000 or more. This treatment under the Code may permit an independent contractor to reduce his or her taxable income below the level that a similarly situated employee could, resulting in less Federal income tax revenue.

However, the revenue loss resulting from this favorable treatment under the Code may be at least partially offset by other factors associated with independent contractor status. For example, independent contractors are not eligible for excludable fringe benefits, such as employer-provided health and life insurance coverage, that often make up a significant portion of an employee's total compensation. To the extent that direct (taxable) compensation to independent contractors is substituted for tax-favored fringe benefits paid to employees, Federal income tax revenues will increase (assuming full compliance).

If there is a net loss in tax revenues associated with the classification of employees as independent contractors, then no solution to the problem can be complete unless steps are taken to ensure that employees are properly classified as such. One way to do this would be to increase enforcement efforts by increasing penalties for misclassification and stepping-up audit rates, possibly coupled with an amnesty program to encourage reclassification (see discussion below). To be fair to businesses, this approach could be coupled with statutory amendments to clarify the definitional standards used to determine the proper classification of workers. In

addition, the Internal Revenue Service could be permitted to issue guidance on proper classification, which they are now prohibited from doing by statute.

Another way to increase the number of employees that are properly classified would be to modify the existing safe harbor in section 530 of the Revenue Act of 1978. Such modifications could include removing the ability of employers to classify workers as independent contractors merely because such classification reflects the long-standing recognized practice of an industry or because an audit was performed on an tax issue unrelated to the proper classification of workers.

Voluntary compliance might be improved if the perceived economic incentive to misclassify was removed or reduced. For example, relief could be provided to employers to ease the burden of complying with labor (and other) laws that apply only to employees (e.g., minimum wage laws, workers' compensation, unemployment taxes). However, it is unclear what form such relief would take. Alternatively, such laws could be broadened to include independent contractors to equalize the treatment of such workers. The Federal tax consequences of worker status could also be equalized.

Compliance

It is clear that there is revenue loss associated with lower compliance rates of independent contractors and service recipients compared to the compliance rates of employees and their employers. Tax data indicate that service recipients often fail to file requisite Forms 1099 for payments made to independent contractors, and that independent contractors more often than not fail to report the unreported payments as income. Even when Forms 1099 are issued, compliance is less than when workers are classified as employees and withholding is required.

One way to address this problem would be to minimize the number of workers that are classified as independent contractors by encouraging businesses to classify workers as employees (since compliance rates for employee compensation is high). Possible methods to achieve this result are discussed above. Of course, if increased compliance rates are the only goal, consideration should be given to whether this can be achieved more efficiently by means other than by encouraging businesses to classify workers as employees. For example, a more efficient way to reduce revenue loss might be to increase compliance by service recipients with the Form 1099 reporting requirements.

One way to increase business's compliance with the reporting requirements might be to increase the penalties for failure to file a Form 1099, possibly coupled with an amnesty

program (see discussion below). However, unless audit rates are significantly increased, it is not clear that increased penalties would have a substantial effect.

Another option might be to condition the deductibility of payments made to independent contractors on the filing of Forms 1099. This could be achieved by requiring payments made to independent contractors to be aggregated and reported on a separate line on a business's tax return, which amount could be no greater than the sum of the payments made to independent contractors reported on bona fide Forms 1099 for the year. An IRS matching program could then check to see that individuals reported the payments reflected on the Forms 1099 on their income tax returns for the year.

The minimum amount to which the reporting requirements with regard to independent contractors apply also could be reduced so that Form 1099s are filed with regard to a larger number of payments.

Another way to increase compliance would be to require businesses to withhold income and employment taxes from payments to independent contractors, just as such taxes are withheld from wages paid to employees. Businesses may object to the administrative burdens associated with such a new requirement.

B. Tax Amnesty

Some have suggested that reforms with regard to the misclassification of employees as independent contractors should be coupled with a limited amnesty program to encourage contractors and businesses to comply with the new law without fear of incurring penalties for past noncompliance.

Background and present law

The Federal Government has never instituted a program that provided amnesty from both civil and criminal penalties for taxpayers who both voluntarily disclosed that they had underpaid their taxes and then paid those amounts.

The IRS had an administrative policy, discontinued in 1952,[8] that in effect provided amnesty from criminal prosecution (but not from civil penalties or interest) for taxpayers who voluntarily disclosed that they had underpaid their taxes. In 1961, the IRS issued a news release suggesting to taxpayers that, since the IRS was then

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[8] It appears that this policy was officially terminated because of failure to pay the taxes once amnesty had been granted, increased litigation, and lack of uniformity in administering the program.

installing new data processing equipment, it might be a propitious time for taxpayers to disclose voluntarily any underpayments of tax. The news release also noted that the likelihood of criminal prosecution was not high in instances of voluntary disclosure, although the news release offered no assurances that amnesty from criminal prosecution would be granted. A more recent policy statement of the IRS includes voluntary disclosure of tax underpayments as one criterion to be considered in determining whether a case warrants criminal prosecution.

The press has reported that the IRS may currently have a policy (called "Fresh Start") of encouraging individuals who have never filed tax returns to do so, coupled with providing amnesty from criminal prosecution (but not from civil penalties or interest).

Frequency of amnesty

Most advocates of a Federal tax amnesty propose that the program be offered only once and suggest that it be made clear that amnesty will not be offered again. Opponents of amnesty are concerned that, once a Federal tax amnesty is offered, the public will expect it to be offered again, despite official announcements to the contrary. Opponents are concerned that this expectation of future amnesty programs may decrease current voluntary compliance.

Arguments pro and con

Proponents of tax amnesty raise the following points in favor of their position. First, they argue that amnesty might raise a significant amount of revenue. Second, they argue that amnesty would place on the tax rolls individuals and entities that previously had escaped taxation. Third, they argue that the success of tax amnesty in several States suggests that amnesty should be utilized on the Federal level.

Opponents of tax amnesty raise the following arguments. The first is fairness. They argue that amnesty is inherently unfair, and would be widely perceived as unfair, to taxpayers who have fully paid their taxes for others who have not fully paid to escape punishment for, and profit from, their evasion. In addition, it may be unfair that a tax evader discovered by the IRS (or who voluntarily disclosed the evasion prior to the amnesty period) is fully subject to interest, civil penalties and criminal penalties, while a tax evader not discovered by the IRS may take advantage of the amnesty.

Another argument raised by opponents is that tax evaders who have not yet been caught by the IRS may choose not to participate, in that they might expect that, since they have

not yet been caught, there is little likelihood that they would be caught in the future, and that there is therefore little benefit to them in participating in amnesty.

Opponents of amnesty also argue that the State experience is neither uniformly positive nor a good predictor of success at the Federal level. They note that some States that have had an amnesty program have raised very little revenue.[9] Also, some States have encountered serious difficulties in administering their amnesty programs. They also note that State compliance efforts prior to amnesty have not been as extensive as those of the IRS and that State penalties for noncompliance and evasion have not been as severe as those under the Code.[10]

In fact, the IRS believes that the success of State amnesty programs is tied to the use of stepped-up enforcement tactics or of broadened compliance powers to State revenue agencies. The IRS has stated that the increased enforcement efforts that made some State programs successful are not possible at the Federal level because of the IRS history of consistent and effective enforcement.[11]

Finally, opponents express concern that continued discussion of Federal amnesty may have an adverse effect on current compliance, in that some taxpayers may be unwilling to comply or to disclose voluntarily noncompliance if they anticipate that a Federal amnesty might be offered. Thus, opponents believe that a Federal amnesty will not raise a significant amount of revenue, particularly over the long term, because they argue that amnesty will cause a decrease in, rather than an enhancement of, future voluntary compliance. Some believe that this decrease in compliance may in fact cause amnesty to lose revenue over the long term.

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[9] Out of 13 total State amnesty programs, 6 raised less than $1 million; only 3 raised more than $15 million. Source: IRS, "Study of Recent Tax Amnesty Programs" (May 1985 draft), p. 8.

[10] For example, prior to its amnesty program, tax evasion was not a felony in Massachusetts.

[11] IRS "Study of Tax Amnesty Programs" (August, 1987).