



*While Actions Have Been Taken to Address
Worker Misclassification, an Agency-Wide
Employment Tax Program and Better Data
Are Needed*

February 4, 2009

Reference Number: 2009-30-035

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 4, 2009

**MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT**

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – While Actions Have Been Taken to Address
Worker Misclassification, an Agency-Wide Employment Tax Program
and Better Data Are Needed (Audit # 200730001)

This report presents the results of our review to evaluate the effectiveness of actions the Internal Revenue Service (IRS) had taken and planned to take to address the misclassification of employees as independent contractors. This audit was part of our risk-based audit coverage and was included in the Treasury Inspector General for Tax Administration Fiscal Year 2007 Annual Audit Plan.

Impact on the Taxpayer

The misclassification of employees as independent contractors is a nationwide issue affecting millions of workers that continues to grow and contribute to the tax gap.¹ The IRS has taken and plans to take many positive actions to address worker misclassification. However, it does not have an agency-wide employment tax program to coordinate the decision-making process and efforts among its business divisions. The limited data available indicates that the worker classification issue is growing significantly. When an employee is misclassified, tax revenues are not reported or paid and the burden of uncollected taxes shifts to other taxpayers.

¹ The tax gap is the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time. It is composed of underreporting of tax liabilities on tax returns, underpaying taxes reported on filed returns, and nonfiling of required tax returns altogether or on time.



While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed

Synopsis

IRS research indicates that employers often misclassify workers as independent contractors for various reasons. They might do so unintentionally because of a lack of knowledge or because of poor advice received. Some employers might have Section 530² protection and, as a result, can legally treat workers as independent contractors who would otherwise be employees. Finally, there are employers who deliberately misclassify workers to cut costs and to gain a greater competitive edge. These employers avoid paying their share of employment taxes as well as other expenses such as workers' compensation, unemployment insurance, and other benefits. Misclassifying employees as independent contractors and not incurring the related costs can give these employers a competitive advantage over employers who treat their workers as employees. The IRS' interest in this issue is not to reclassify workers from independent contractors to employees. Rather, it is to ensure that employers are making the proper determination and that workers are being treated appropriately. The IRS has dedicated resources to educate taxpayers regarding employee classification as well as to enforce tax laws related to this issue. Despite the many positive actions that the IRS has taken and plans to take to address the misclassification of employees as independent contractors, more needs to be done.

IRS business divisions communicate and coordinate with each other regarding employment tax issues. However, there is no single point of accountability for employment tax below the IRS Deputy Commissioner level, and there is no agency-wide strategy to coordinate the decision-making process and efforts among the divisions.

Misclassified workers are a significant portion of the employment tax gap. However, because studies of the impact of worker misclassification on the tax gap are over 20 years old, the IRS does not know the size of the problem today and is unable to determine the overall effectiveness of its actions to address this issue. The IRS' most recent estimate³ of the tax gap is approximately \$345 billion. The employment tax portion of this figure due to underreporting is estimated to be about \$54 billion with an estimated \$1.6 billion being attributable to worker misclassification. However, the \$1.6 billion estimate is based on Tax Year 1984 data. The IRS conducted a preliminary analysis of Fiscal Year 2006 operational and program data and found that underreporting attributable to misclassified workers is likely to be markedly higher than the \$1.6 billion.

² Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2885-86 (current version at Internal Revenue Code Section 3401 note).

³ The National Research Program was a comprehensive compliance study of Tax Year 2001 individual income tax returns that was completed in Calendar Year 2006. It estimated the overall gross tax gap for Tax Year 2001 to be \$345 billion, including \$285 billion from underreporting, \$33 billion from underpaying, and \$27 billion from nonfiling.



While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed

Recommendations

We recommended that the Deputy Commissioner for Services and Enforcement develop and implement an agency-wide employment tax program to address the issue of worker classification to improve coordination among the business divisions, improve compliance, and reduce the tax gap. The Deputy Commissioner for Services and Enforcement should also consider conducting a formal National Research Program reporting compliance study to measure the impact of worker misclassification on the employment tax gap.

Response

IRS management agreed with all of our recommendations. The Director, Specialty Programs, Small Business/Self-Employed Division, will coordinate an effort with all business divisions, the Criminal Investigation Division, and the Office of Chief Counsel to develop an agency-wide employment tax plan that addresses worker classification along with other employment tax issues. The Director, Specialty Programs, Small Business/Self-Employed Division, will also work with the Research function to coordinate a study that addresses worker classification and other employment tax issues. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



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Abbreviations

CSP	Classification Settlement Program
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed



While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed

Background

The misclassification of employees as independent contractors is a nationwide issue affecting millions of workers that continues to grow and contribute to the tax gap.¹ When an employee is misclassified, tax revenues are not reported or paid and the burden of uncollected taxes shifts to other taxpayers.

Social Security and Medicare taxes are paid to the Department of the Treasury from two primary sources: 1) employment taxes consisting of amounts withheld from employees and matching amounts paid by employers; and 2) self-employment taxes. Employers are generally required by law to withhold from their employees' income the employees' shares of Social Security and Medicare taxes.² One-half of the calculated tax amount is withheld from the employee's wages and the employer pays a matching amount. Self-employed taxpayers must pay the entire amount of Social Security and Medicare taxes themselves in the form of self-employment taxes (currently 15.3 percent of self-employment income). Therefore, the classification of workers as employees or as independent contractors has a significant effect on the tax liabilities of the workers as well as the employers.

Internal Revenue Service (IRS) research indicates that employers often misclassify workers as independent contractors for various reasons. They might do so unintentionally because of a lack of knowledge or because of poor advice received. Some employers might have Section 530³ protection and, as a result, can legally treat workers as independent contractors who would otherwise be employees. Finally, there are employers who deliberately misclassify workers to cut costs and to gain a greater competitive edge. These employers avoid paying their share of employment taxes as well as other expenses such as workers' compensation, unemployment insurance, and other benefits. Misclassifying employees as independent contractors and not incurring the related costs can give these employers a competitive advantage over employers who treat their workers as employees.

¹ The tax gap is the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time. It is composed of underreporting of tax liabilities on tax returns, underpaying taxes reported on filed returns, and nonfiling of required tax returns altogether or on time.

² Certain members of the clergy are considered to be employees but are subject to the self-employment tax. Certain State and local government employees covered by qualifying retirement plans are not subject to either Federal Insurance Contributions Act or self-employment tax.

³ Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2885-86 (current version at Internal Revenue Code Section 3401 note). This section permits a taxpayer to treat workers as other than employees for employment tax purposes when certain requirements are met. It also prohibits the IRS from issuing guidance clarifying the employment status of individuals for purposes of employment taxes.



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An employer-employee relationship generally exists when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result, but also as to the details and means by which the result is accomplished. The IRS has the responsibility to administer this significant and sometimes politically sensitive area of the tax law.

This review was performed at the IRS Campuses⁴ in Ogden, Utah; Covington, Kentucky; and Holtsville, New York, during the period May 2007 through May 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁴ Campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed

Results of Review

The Internal Revenue Service Has Taken and Plans to Take Many Positive Actions to Address Worker Misclassification

The IRS has dedicated resources to educate taxpayers regarding employee classification as well as to enforce tax laws related to this issue. The IRS' efforts to educate employers and workers on employment tax issues include the following:

- The Form SS-8 Worker Status Determination program. This program was established to allow a business or worker to request a determination letter from the IRS regarding a worker's Federal employment tax status as an employee or an independent contractor. Either the worker or the employer, or both, can submit a Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding (Form SS-8) to request the determination.
- Online services and other publications. The IRS has emphasized worker classification issues in its Headliner, Fact Sheet, e-News for Tax Professionals, and IRS Newswire publications. It has also created pages on its web site, IRS.gov, with links dedicated to employment taxes for businesses and independent contractors. Other publications include (*Circular E*), *Employer's Tax Guide* (Publication 15); *Employer's Supplemental Tax Guide* (Publication 15-A); *Independent Contractor or Employee...* (Publication 1779); *Are You an Employee?* (Publication 4445-E); and *Do you Qualify for Relief under Section 530?* (Publication 1976). Each of these publications discusses various aspects of employment taxes and worker classification issues.
- Uncollected Social Security and Medicare Tax on Wages (Form 8919). In response to a previously issued Treasury Inspector General for Tax Administration report,⁵ the IRS created Form 8919 for Section 530 employees⁶ and misclassified workers to report their share of employment taxes. Workers who are employees but are treated as independent contractors by their employer can report their income on Form 8919 and pay only their half of employment taxes rather than the full 15.3 percent they would pay for self-employment tax.

⁵ *Social Security and Medicare Taxes Are Not Being Properly Assessed on Some Tips and Certain Types of Wage Income* (Reference Number 2007-30-062, dated March 30, 2007).

⁶ A Section 530 employee is one who was determined to be an employee by the IRS prior to January 1, 1997, but whose employer has been granted relief from payment of employment taxes under Section 530 of the Revenue Act of 1978.



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- Tax Talk Today⁷ and presentations to professional associations such as the American Bar Association and the American Payroll Association⁸ on employment taxes and worker classification. The IRS also discussed employment tax issues including worker classification at its Nationwide 2008 Tax Forums.

Although all of the primary IRS business divisions are involved in the processing, assessment, collection, and enforcement of employment taxes, the Small Business/Self-Employed (SB/SE) Division⁹ is assigned the responsibility for providing leadership on all of the IRS' employment tax matters, including the development of programs, policies, and procedures regarding worker classification. The SB/SE Division Employment Tax function administers employment tax policy including the enforcement of those policies through worker classification audits.

The IRS' other enforcement efforts related to employment taxes and worker classification issues include:

- The Questionable Employment Tax Practices program.¹⁰ The program is a collaborative effort which seeks to identify employment tax schemes and illegal practices and increase voluntary compliance with employment tax rules and regulations. The Questionable Employment Tax Practices program consists primarily of Federal-State agreements which allow the IRS and State workforce agencies to share and exchange employment tax information. Within the past 3 years, the IRS has signed agreements with State workforce agencies in 32 States to share employment tax compliance information. About 90 percent of the information shared between the IRS and the States is related to worker classification issues.
- The Employment Tax Examination Program is an annual computer extract which analyzes Miscellaneous Income (Form 1099-MISC) and Wage and Tax Statement (Form W-2) forms filed by employers. The extracted data are analyzed for indications of a worker classification issue.
- The Classification Settlement Program (CSP). This is an optional program that provides some relief from liability associated with worker classification issues and allows

⁷ Tax Talk Today is a free, live, monthly interactive web cast aimed at educating tax professionals on the most contemporary and complex tax issues. It provides tax professionals with the opportunity to interact directly with representatives of the IRS and practicing professionals on current tax issues.

⁸ The American Payroll Association conducts more than 300 seminars each year—anywhere from 1 day to a full week of seminar training programs. Most of the seminars include instruction on the proper classification of workers (independent contractor versus employee).

⁹ The SB/SE Division services all fully or partially self-employed individuals and corporations and partnerships with assets of \$10 million or less.

¹⁰ Questionable employment tax practices are employment schemes or tax practices which have no basis other than to evade State and/or Federal employment or unemployment taxes.



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employers to resolve worker classification cases early in the administrative process of an audit, provided they agree to begin treating their workers as employees from the point of the agreement forward.

- The Specialist Referral System allows a revenue agent¹¹ to make an online referral to the agent's manager through the IRS Intranet.
- The Service Wide Employment Tax Research System. The IRS plans to implement the system in Fiscal Year 2009. The Service Wide Employment Tax Research System is a web-based inventory selection and delivery system that will provide a scoring system for employment tax returns. Its goal is to increase workload efficiencies and provide a standardized method of case selection. It will extract data from existing systems to optimize the case selection process of employment tax returns to provide a uniform and systematic method of employment tax case selection. It will be used for worker classification, nonfiler, and tip cases. The Service Wide Employment Tax Research System will enable the IRS to identify patterns of employment tax noncompliance and to select the best cases for examination for all business divisions.

IRS interest in this issue is not to reclassify workers from independent contractors to employees. Rather, it is to ensure that employers are making the proper determination and that workers are being treated appropriately.

Despite the many positive actions that the IRS has taken and plans to take to address worker classification issues, more needs to be done.

The Internal Revenue Service Does Not Have an Agency-Wide Employment Tax Program to Address Worker Classification

IRS business divisions communicate and coordinate with each other regarding employment tax issues. However, there is no single point of accountability for employment tax below the IRS Deputy Commissioner level, and there is no agency-wide strategy to coordinate the decision-making process and efforts among the divisions.

Office of Management and Budget Circular A-123¹² states that management is responsible for establishing and maintaining internal control. The *Standards for Internal Control in the Federal Government*¹³ further states that internal controls should provide reasonable assurance that the objectives of the agency are being achieved in the following areas: effectiveness and efficiency of operations, including the use of the entity's resources; reliability of financial reporting,

¹¹ A revenue agent is an IRS employee who conducts examinations of individuals, small businesses, corporations, partnerships, tax-exempt entities, and/or government entities, using accounting, auditing, and investigative skills to determine compliance with Federal income tax laws.

¹² OMB Circular A-123, *Management's Responsibility for Internal Control* (revised December 21, 2004).

¹³ *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1, dated November 1999).



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including reports on budget execution, financial statements, and other reports for internal and external use; and compliance with applicable laws and regulations.

The IRS has indicated that it is committed to reducing the employment tax gap. An agency-wide employment tax program is needed to achieve this goal. Prior efforts, including one initiated in Calendar Year 2003, were not implemented. In the most current initiative, the Employment Tax function has been developing an agency-wide employment tax program since Calendar Year 2006 to coordinate employment tax-related activities throughout the IRS to reduce redundancy, improve efficiency, and reduce the employment tax gap. To date, these efforts have resulted in an agency-wide employment tax program letter and business plan. The business plan includes collaborative initiatives to address employment tax noncompliance. While all of the affected business units are involved in these plans and actions, the program has yet to be approved for agency-wide use and implemented.

Each IRS business division makes its own determination on priorities, develops work plans, identifies work, and sets goals and objectives based on issues and factors unique to taxpayers within the particular division. The processes vary significantly between divisions, and there is limited coordination among the divisions to ensure that the employment tax program is administered in a consistent, efficient, and effective manner.

For example:

- Business divisions lack a uniform method of tracking worker classification field audits and results. The SB/SE Division tracks both employment tax audits and the subset of worker classification audits. The Large and Mid-Size Business Division¹⁴ has the capability of tracking worker classification issues through its Issue Management System, allowing it to track issues and employment tax audits. However, it does not typically track worker classification audits, reportedly due to the recurring nature of many of these audits. The Tax Exempt and Government Entities Division¹⁵ only tracks employment tax audits. Even the types of cases that are classified as worker classification cases sometime differ among the divisions.
- Procedures regarding the monitoring and followup of CSP Agreements vary by business division. The SB/SE Division has centralized its CSP Agreement monitoring and follow-up activities. The Large and Mid-Size Business Division maintains copies of its CSP Agreements in a centralized location, but monitoring and follow-up activities are decentralized. CSP Agreements within the Tax Exempt and Government Entities Division are decentralized. Due to the relative number of CSP Agreements within each

¹⁴ The Large and Mid-Size Business Division services corporations and partnerships with assets greater than \$10 million.

¹⁵ The Tax Exempt and Government Entities Division services a large and unique economic sector of organizations, which include pension plans, exempt organizations, government entities, and tax-exempt bond issuers.



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of the divisions, the Large and Mid-Size Business and the Tax Exempt and Government Entities Divisions might choose to keep the monitoring and follow-up activities of their CSP Agreements decentralized. However, all of the divisions could benefit from sharing best practices, particularly in what to maintain in the followup case files.

- Each of the business divisions maintains a database of the CSP Agreements within the division, but no overall database is kept. Having one combined database of all CSP Agreements would be beneficial, particularly when the Service Wide Employment Tax Research System is implemented.

Without an approved agency-wide employment tax program, there is no cohesive and consistent approach for determining which employment tax issues are the most critical; which programs or initiatives have the greatest potential to address these issues to improve filing, reporting, and payment compliance; which programs are most effective in bringing about improvements in compliance at the lowest cost; and whether the programs are reducing the employment tax gap.

The Questionable Employment Tax Practices program and the Form SS-8 Worker Status Determination program previously discussed are both examples of the good that can be achieved by a high level of coordination of resources. The Form SS-8 Worker Status Determination program is a good example of a centralized program that functions well and provides data to all of the business divisions. Similarly, the Questionable Employment Tax Practices program is a good example of coordination between the IRS and State workforce agencies.

Recommendation

Recommendation 1: The Deputy Commissioner for Services and Enforcement should develop and implement an agency-wide employment tax program which specifically addresses the issue of worker classification to improve coordination among the business divisions, improve compliance, and reduce the tax gap.

Management's Response: IRS management agreed with the recommendation. The Director, Specialty Programs, Small Business/Self-Employed Division, will coordinate an effort with all business divisions, the Criminal Investigation Division, and the Office of Chief Counsel to develop an agency-wide employment tax plan that addresses worker classification along with other employment tax issues.



While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed

The Internal Revenue Service Has Limited Data Regarding the Overall Impact of Worker Misclassification

The IRS' most recent estimate¹⁶ of the tax gap is approximately \$345 billion. The portion of that figure attributed to the underreporting of employment tax is estimated to be \$54 billion. Federal Insurance Contributions Act and Federal Unemployment Tax Act taxes were estimated to be about \$15 billion of the \$54 billion. However, the \$15 billion estimate is based on Tax Year 1984 data that has not been recently updated.

The IRS also estimated¹⁷ that approximately 15 percent of employers (756,000 of 5.15 million) misclassified 3.4 million workers as independent contractors in Tax Year 1984. The estimated tax loss was \$1.6 billion in Social Security tax, unemployment tax, and income tax that should have been withheld from wages. This was the last comprehensive estimate of the impact of worker misclassification on tax revenues and the tax gap. In a report issued in July 2006,¹⁸ the Government Accountability Office adjusted the \$1.6 billion estimate to \$2.72 billion in inflation-adjusted 2006 dollars.

An agency-wide employment tax program, as recommended in the previous section, which addresses worker classification is crucial to developing current data on the impact of worker misclassification on the tax gap. The Government Performance and Results Act of 1993¹⁹ requires that plans have general goals and objectives, including outcome-related goals and objectives. Under the Act, performance measurement is the ongoing measuring and reporting of program accomplishments. The IRS needs to update its measurement of the underreporting employment tax gap, of which worker classification is a major segment.

In a prior report,²⁰ we reported that the reliability of tax gap projections is affected by the age, completeness, and accuracy of the data used. We have also previously reported²¹ that the IRS did

¹⁶ The National Research Program was a comprehensive compliance study of Tax Year 2001 individual income tax returns that was completed in Calendar Year 2006. It estimated the overall gross tax gap for Tax Year 2001 to be \$345 billion, including \$285 billion from underreporting, \$33 billion from underpaying, and \$27 billion from nonfiling.

¹⁷ The Strategic Initiative on Withholding Noncompliance Study was designed to determine the extent of noncompliance in the withholding area. It involved thorough examinations of Tax Year 1984 employment tax returns of 3,331 employers and follow-up employee surveys of certain individuals identified in the employer surveys. The study addressed various aspects of withholding compliance, including the classification of workers as independent contractors or employees.

¹⁸ *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification* (GAO-06-656, dated July 11, 2006).

¹⁹ Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

²⁰ *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections* (Reference Number 2006-50-077, dated April 2006).

²¹ *Additional Work Is Needed to Determine the Extent of Employment Tax Underreporting* (Reference Number 2005-30-126, dated August 2005).



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not know the current level of reporting compliance because the current employment tax underreporting data for employment tax returns were unreliable and had a significant adverse impact on developing an effective overall employment tax strategy. The Government Accountability Office issued a report²² with similar findings. The IRS agreed with the findings and recommendations in our report and the Government Accountability Office report. In addition, the Department of the Treasury issued a report²³ outlining a comprehensive strategy for addressing the tax gap. The IRS then issued a report²⁴ that built upon the strategy outlined by the Department of the Treasury and provided details on the steps it planned to take to increase voluntary compliance and reduce the tax gap.

The IRS is considering new research projects in several areas, including a National Research Program employment tax reporting compliance study, to update and provide more comprehensive data on the magnitude and sources of noncompliance. This research is critical in helping the IRS understand behavior, develop strategies, and measure progress. The National Research Program has been approved but has not yet been implemented.

The SB/SE Division Employment Tax function conducted a preliminary analysis of Fiscal Year 2006 operational and program data to determine whether the \$15 billion figure was still accurate. Initial results indicated the underreporting tax gap attributable to the Federal Insurance Contributions Act and Federal Unemployment Tax Act portion of employment taxes is likely to be markedly higher than the most recent tax gap estimates suggest.

Misclassified workers are a significant portion of the employment tax gap. However, because the IRS only has limited data on the impact of worker misclassification on the tax gap, it is unable to determine the overall effectiveness of its actions to address this issue. Periodic measurements directed at the worker classification issue should be taken to evaluate the effectiveness of programs and to determine progress.

Recommendation

Recommendation 2: The Deputy Commissioner for Services and Enforcement should consider conducting a formal National Research Program reporting compliance study for employment taxes that includes measuring the impact of worker misclassification on the tax gap.

²² *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (GAO-05-753, dated July 18, 2005).

²³ *A Comprehensive Strategy for Reducing the Tax Gap* (dated September 26, 2006).

²⁴ *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (dated August 2, 2007).



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Management's Response: IRS management agreed with the recommendation. The Director, Specialty Programs, Small Business/Self-Employed Division, will work with the Research function to coordinate a study that addresses worker classification and other employment tax issues. They have already started the planning for the effort, which will begin early in Fiscal Year 2009.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the effectiveness of actions the IRS had taken and planned to take to address the misclassification of employees as independent contractors. To accomplish this objective, we:

- I. Interviewed IRS management to identify the major issues involved; the actions, programs, and initiatives taken and planned to address those issues; and the financial impact that worker misclassification has on tax administration.
- II. Conducted research to identify the major issues involved and the financial impact that worker misclassification has on tax administration by identifying, reviewing, and evaluating relevant material from the following sources:
 - A. IRS publications, including web site information.
 - B. IRS studies, including National Research Program data.
 - C. Treasury Inspector General for Tax Administration audit reports.
 - D. Government Accountability Office audit reports.
 - E. Department of the Treasury reports.
 - F. Congressional legislation hearings and testimony including any related to the modification of Section 530.¹
- III. Identified the actions taken to educate employers and workers regarding employee classification and to enforce employment tax and worker classification laws.

¹ Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2885-86 (current version at Internal Revenue Code Section 3401 note) provides businesses with relief from Federal employment tax obligations if certain requirements are met. In general, it allows an employer to treat a worker as an independent contractor for employment tax purposes regardless of the individual's actual status under the common-law standard.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List


Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Tax Exempt and Government Entities Division SE:T
Deputy Commissioner, Large and Mid-Size Business Division SE:LM
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Specialty Programs, Small Business/Self-Employed Division SE:S:SP
Chief, Employment Tax Operations, Small Business/Self-Employed Division SE:S:SP:ET:C
Program Manager, Employment Tax Policy, Small Business/Self-Employed Division
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Commissioner, Tax Exempt and Government Entities SE:T



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Appendix IV

Management's Response to the Draft Report


DEPUTY COMMISSIONER

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

RECEIVED
JAN - 7 2009

January 7, 2009

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Linda E. Stiff *Linda E. Stiff*
Deputy Commissioner Services and Enforcement

SUBJECT: Draft Audit Report – While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed (Audit No. 200730001)

Thank you for the opportunity to review the draft report titled, "While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed."

We appreciate your acknowledgement of our efforts in this area and agree with the recommendations in the report. The Enterprise-Wide Employment Tax Program has already made significant strides to develop an agency-wide employment tax program to improve coordination among the business operating divisions, improve compliance, and reduce the tax gap. We have also started planning for a formal National Research Program reporting compliance study to measure the impact of worker misclassification on the employment tax gap.

Attached is a detailed response outlining our corrective actions.

If you have any questions, please call me or John H. Imhoff Jr., Director, Specialty Programs, Small Business/Self-Employed Division, at (202) 283-2150.

Attachment



While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed

Attachment

RECOMMENDATION 1:

The Deputy Commissioner for Services and Enforcement should develop and implement an agency-wide employment tax program which specifically addresses the issue of worker classification to improve coordination among the business operating divisions, improve compliance, and reduce the tax gap.

CORRECTIVE ACTION(S)

The Director, Specialty Programs will coordinate an effort with all business operating divisions, Criminal Investigation and Counsel to develop an agency-wide employment tax plan that addresses worker classification along with other employment tax issues. The goals of the effort are to improve filing, payment and reporting compliance and reduce the employment tax portion of the tax gap, including that portion attributable to worker misclassification. The Enterprise-Wide Employment Tax Program team has already made significant strides towards accomplishing this goal.

IMPLEMENTATION DATE

The Enterprise-Wide Employment Tax Plan is scheduled for implementation by December 31, 2009.

RESPONSIBLE OFFICIAL(S)

Director, Specialty Programs, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN

The Chief, Employment Tax Programs, SB/SE will advise the Director, Specialty Programs, SB/SE of any delays in implementing this corrective action.

RECOMMENDATION 2:

The Deputy Commissioner for Services and Enforcement should consider conducting a formal National Research Program reporting compliance study for employment taxes that includes measuring the impact of worker misclassification on the tax gap.

CORRECTIVE ACTION

The Director, Specialty Programs will work with Research to coordinate a study that addresses worker classification and other employment tax issues. To accomplish this goal, SB/SE Employment Tax will coordinate efforts with the Large and Mid-Size Business Division and the Tax Exempt and Government Entities Division. We have already started the planning for this effort, which will begin early in FY09.



*While Actions Have Been Taken to Address Worker
Misclassification, an Agency-Wide Employment Tax Program and
Better Data Are Needed*

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IMPLEMENTATION DATE

Cases will be selected and examinations started by March 31, 2010. (This date ensures we have adequate time to gather the necessary information.)

RESPONSIBLE OFFICIAL(S)

Director, Specialty Programs, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN

The Chief, Employment Tax Programs, SB/SE will advise the Director, Specialty Programs, SB/SE of any delays in implementing this corrective action.