

**Tax and Policy Implications
of Changes to Reporting Requirements
for Construction Services**

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Research Question

Should New York and other states consider adopting laws requiring that businesses file information reports with the state tax department reporting all payments for construction services, to both incorporated and unincorporated businesses, and perhaps also payments for other types of services? ¹

Conclusion

New York and other states could increase revenue and improve their tax systems by requiring information reporting for all payments by businesses for construction services, utilizing a form similar to the Federal form 1099. The state could also advance other important policy goals including an increase in the fairness of the tax system and a reduction of the misclassification of workers as independent contractors.

Discussion

Policy implications

New York State, like many other states, relies on an income tax for much of its revenue to pay for essential public services. The personal income tax applies to individual income, while the corporate franchise tax applies to income of incorporated businesses. In either case the tax system is based on laws requiring the taxpayers to report their income and to pay taxes based on the reported income.

While most taxpayers comply with the law by reporting their income and paying the taxes due, there is a persistent problem of underreporting of income and underpayment of taxes. The difference between the taxes that should have been paid and the taxes that are actually collected each year is known as the “tax gap”. The tax gap is substantial. For tax year 2006 the Internal Revenue Service estimated that net tax gap nationally at \$385 billion. This indicates a taxpayer noncompliance rate of more than 16%. ²

Most of this tax gap is due to the underreporting of income. While the federal and state tax authorities try to address this problem through auditing and enforcement, those activities are relatively costly and time-consuming, and only improve the overall collection rate by about 2%.³

¹ This expansion of information reporting has been recommended in the Federal tax system by the U. S. Government Accountability Office, IRS could do more to promote compliance by third parties with miscellaneous income reporting requirements, GAO -09-238, January 2009.

² IRS releases new tax gap estimates, IR-2012-4 January 6, 2012

³ Ibid.

The best way to reduce the tax gap is to increase the amount of information that is reported to the tax authorities. When taxpayers know that a third party is reporting payment information directly to the IRS, the voluntary compliance rate is dramatically higher. For example, since all wages are reported directly to the IRS and to the states on form W-2, only 1.2% of wage income subject to this reporting is underreported. On the other hand, 57.1% of non-farm sole proprietor income, which is subject to little or no information reporting, was underreported.⁴ In 2010, Congress estimated that requiring form 1099 information reporting of all payments by businesses in amounts over \$600.00 would increase tax collections by an average of \$1.7 billion per year.⁵ Significantly, these increased revenues would be achieved not by raising taxes, but by collecting taxes that are due, but not being paid.

Current law requires information reporting by businesses of some payments for services in amounts over \$600.00 on form 1099-MISC. New York and other states then get copies of this data, allowing both federal and state governments to use these information reports to check the income reported by the payees. There are, however, major gaps in the current 1099 reporting, most significantly that payments to incorporated businesses are not required to be reported. The proposed expansion that was considered by the federal government and which should be considered by New York and other states would require all payments by businesses for services in amounts greater than \$600.00 to be reported regardless of the type of payee.

New York State also has a tax gap for reasons similar to the federal tax gap. The New York State Department of Taxation and Finance estimated the net tax gap at \$4.0 billion in 2009. New York estimates that about 13.3% of income is underreported. “The largest single underreported income item is business (non-farm) income which is 57.1% underreported at the federal and state level. This translates into \$36.4 billion in underreported income in the state with \$2 billion in unpaid tax.”⁶

Increased tax revenue

It is important to note that New York State, like many states, uses a definition of income that is similar to the federal income tax law. Therefore by comparing the size of the New York tax gap to the federal tax gap, it is possible to produce an estimate of how much revenue the state could collect by expanding information reporting. Utilizing this method, we estimate that if New York adopted form 1099 information reporting similar to that studied by the Congressional Joint Committee on Taxation in 2010, the state

⁴ Keightley, M. Economic analysis of the enhanced form 1099 reporting requirement, Congressional Research Service, Report 41400, January 21, 2011

⁵ Joint Committee on Taxation, U.S. Congress, Report JCX-17-10 March 20, 2010.

⁶ New York State Department of Taxation and Finance, Estimate of New York State’s personal income tax gap, 2012.

could collect \$20 million per year of increased tax revenue. Again, this would be done not by raising tax rates but by collecting taxes that are not currently being paid.⁷

This potential tax revenue increase is supported by the experience in Canada, which implemented a similar information reporting system for the construction industry in 2001. In Canada, since 2001 contractors have been required to report what they pay to their subcontractors. As a result, from 2001-2007, 182,148 more income tax returns were filed, and an additional \$1.2 billion of taxes were assessed.⁸

While increased revenue is very important, there are also other reasons to consider expanded information reporting by taxpayers, especially businesses.

Worker misclassification has become a well-recognized problem across the nation in recent years. A 2007 study estimated that an average of 14.8% of the construction workforce in New York State is misclassified.⁹ When workers are misclassified as independent contractors, employers avoid the responsibility of paying taxes such as Unemployment Insurance, Workers' Compensation, FICA and others. Another form of tax avoidance employed by unscrupulous businesses is to pay workers "under the table" or "off the books," thereby failing to acknowledge that those workers are employed altogether. In the former case, workers are provided with 1099 forms to report their income; in the latter case, no reporting is done at all. The result in both cases is a considerable underreporting of wages paid, estimated to be in excess of \$4 billion annually across the state of New York.¹⁰ In 2012 alone, the New York State Joint Enforcement Task Force on Employee Misclassification found nearly \$67.6 million in unreported wages, assessed over \$1.8 million in additional Unemployment Insurance contributions, uncovered over \$640,000 in unpaid worker compensation, and revealed over 6,400 misclassified workers.¹¹

⁷ The methodology for this estimate is based on comparing New York's tax gap to the federal tax gap. The IRS estimates the net federal tax gap at \$385 billion, and the Joint Committee on Taxation estimated that enhanced 1099 reporting would reduce the tax gap by 0.5%, netting \$1.7 billion per year of increased revenue. Applying the same 0.5% estimate to New York's \$4 billion tax gap produces an estimated revenue gain of \$20 million per year. The actual gain might be higher if this reporting increases the rate of voluntary compliance. This estimate would apply if 1099 reporting is required for all industries. The amount would be less if the requirement only applied to construction services.

⁸ Organisation for Economic Co-Operation and Development, *Forum on Tax Administration: Compliance Sub-Group, Companion Note, Managing and Improving Compliance: Development in Compliance Risk Treatment, a Catalogue of Revenue Body Initiatives*, January 31, 2009 at 113

⁹ Donahue, L. et al. *The Cost of Worker Misclassification in New York State*, Cornell ILR, February 2007.

¹⁰ Ibid.

¹¹ Annual Report of the Joint Enforcement Task Force on Employee Misclassification, New York State Department of Labor, February 1, 2013.

In recognition of the serious consequences of misclassification, The Questionable Employment Tax Practices Initiative (QETP) was formed in November 2007 to better enable the IRS and state agencies to share information and increase compliance with federal and state tax laws. As of April 2011, 37 states, including New York, had agreed to participate; their QETP referrals from the IRS had yielded almost \$1,321,000,000.00 in reclassified wages and a total of \$20,873,017.00 in assessments.¹²

The NYS Task Force and the QETP results offer strong evidence that the underreporting of employee wages is of sufficient magnitude as to warrant new methods of oversight. Tax evasion by some increases costs to all responsible taxpayers. In construction, contractors who evade the law can discount labor costs and unfairly underbid those contractors who accurately account for their labor expenses. State unemployment and worker compensation systems are shortchanged, hurting states' ability to provide the assistance to which workers are entitled.

Requiring the reporting of payments for services in excess of \$600.00 would provide the state with an additional mechanism for uncovering tax dollars that are, in fact, due and will likely help to discourage the misclassification of employees.

Tax fairness

One of the main policy goals of a tax system should be fairness and equal treatment. When some taxpayers evade the payment of taxes, the burden of paying for public services falls more heavily on those who pay the amount they owe according to the law. In addition, when taxpayers perceive that others who should be paying taxes are able to get away with underpaying by failing to report all their income, this has a corrosive effect on public trust of the tax system and the state government. When the risk of getting caught is perceived to be low, it may cause others to consider avoiding taxes as well. While few people like paying taxes, their resentment and reluctance increases if they see that others are able to avoid paying the amount they owe.

In the construction industry the current lack of effective enforcement disadvantages law-abiding contractors who accurately report their income and properly classify their workers by allowing dishonest contractors who evade taxes to unfairly underbid their competitors.

Possible arguments against expanded information reporting

Increased differentiation between New York State and Federal tax systems: New York State has a policy of basing its income tax system largely on the Federal tax system.

¹² The Questionable Employment Tax Practices Initiative Progress Report, April 2011.

This is seen as having advantages for both the state and taxpayers. For example, on New York personal income tax returns, the taxpayer fills in much of the required information by simply entering the figure from corresponding lines on the federal tax return. Employers and taxpayers are also able to report income using the same W-2 forms for both state and federal taxes. For the currently required 1099 reporting, the state simply gets the same data that is reported to the IRS. If New York expands the type of payments required to be reported on a form similar to form 1099 this will require the state and taxpayers to incur added time and effort to comply.

However, New York's preference for conforming its tax system to the federal system has never been absolute, and has often been overridden by other important policy goals. There are many examples of items that New York has chosen to treat differently for tax reporting than the federal tax system, including pension and annuity income, public employee retirement contributions, interest on state and local bonds from other states, differences in the tax status of certain married taxpayers, among other items. In fact the New York tax return Form IT-201 has a section listing New York additions and subtractions to facilitate taxpayers' reporting of items in ways that differ from federal tax reporting. Likewise, New York has opted to set its estate tax exemption at a level substantially lower than the federal exemption.

In all these cases, New York decided that the policy reasons for these differences from federal taxes were important enough to justify the added effort required to comply with different rules. The same reasoning should apply to the decision about 1099 reporting.

Increased administrative costs for the state and taxpayers: Since the proposal would require taxpayers to file additional form 1099 information reports, it would add to the time and effort required of both taxpayers and the state tax department. However, Federal studies of the cost to businesses to comply with this type of information reporting indicate that the costs would not be large and would be likely to fall over time.¹³ The GAO studied the costs to businesses of complying with the current form 1099 reporting requirement and found that the costs in time and money were modest. For example a small business reported spending three to five hours of staff time per year preparing forms. The unit costs dropped significantly with the volume of reports prepared for those businesses that use a third party vendor.¹⁴ New York State already has in place a data processing system that receives massive numbers of documents from taxpayers. The incremental resources needed to process these additional reports are not likely to be large compared to the possible tax revenue gain as well as additional

¹³ Keightley, M. Economic analysis of the enhanced form 1099 reporting requirement, Congressional Research Service, Report 41400 January 21, 2011.

¹⁴ Costs and uses of third-party information returns, Government Accountability Office, November 2007, GAO Report GAO-08-266.

revenues to the unemployment insurance and workers compensation systems, which will tend to reduce the burden on all businesses covered by those systems.

Suggested policy option - require form 1099 information reporting in the construction industry only.

Several other states that have considered adopting this policy through legislation have focused on the construction industry.¹⁵ This has the advantage of allowing the state to implement the expanded reporting on a somewhat smaller scale, and in the process gather useful information about how to make it work most efficiently. While this more targeted approach would raise less revenue, it would be easier and less costly to implement.

The experience in Canada also supports the option of targeting the construction industry. The Canadian government found that the rate of voluntary compliance in the construction industry was low, but they were successful in achieving a substantial increase in compliance and revenue by implementing information reporting.¹⁶

The construction industry has also been identified as one of the industries most prone to practices such as misclassifying workers as independent contractors and “paying under the table” in cash to avoid taxes. An information reporting requirement targeted at payments for construction services would be likely to significantly change the incentives that lead to these practices. If so, most of the gain in compliance would likely be accomplished by voluntary compliance as taxpayers realize that the risk of getting caught is much higher.¹⁷

By requiring form 1099 reporting of all payments by both incorporated and unincorporated businesses for construction services in amounts over \$600.00, the state could increase revenue and also advance important public policy goals. A targeted approach focusing on construction, which is known to be an industry where compliance is an issue, would allow a state to demonstrate the benefits of this policy while mitigating the costs.

¹⁵ Examples of proposed state legislation: Oregon bill number HB 2464-C (2013); Connecticut bill number SB-1075 (2013); Washington bill number HB 1473; New Jersey bill number A3859; Minnesota bill number H1062-0.

¹⁶ Organisation for Economic Co-Operation and Development, *Forum on Tax Administration: Compliance Sub-Group, Companion Note, Managing and Improving Compliance: Development in Compliance Risk Treatment, a Catalogue of Revenue Body Initiatives*, January 31, 2009

¹⁷ Keightley, M. Economic analysis of the enhanced form 1099 reporting requirement, CRS Report 41400 January 21, 2011. General Accounting Office, Benefits of a corporate document matching program outweigh the costs, GAO/GGD-91-118 September 1991.

Conclusion

New York and other states should consider adopting expanded form 1099 information reporting of payments for services by businesses in amounts greater than \$600.00.

Our analysis leads us to conclude that a state government can achieve important policy goals by requiring information reporting of payments by businesses for services in amounts greater than \$600.00 for both incorporated and unincorporated businesses. These goals include: increased tax revenue, reducing the incidence of worker misclassification, strengthening the unemployment insurance and workers' compensation system, and increasing the fairness of the tax system by leveling the playing field among businesses.

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