



## Treasury Inspector General for Tax Administration Office of Audit

### WHILE ACTIONS HAVE BEEN TAKEN TO ADDRESS WORKER MISCLASSIFICATION, AN AGENCY-WIDE EMPLOYMENT TAX PROGRAM AND BETTER DATA ARE NEEDED

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## Highlights

Highlights of Report Number: 2009-30-035 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

### IMPACT ON TAXPAYERS

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. 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. 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.

### WHY TIGTA DID THE AUDIT

This audit was initiated as part of TIGTA's risk-based audit coverage. 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.

IRS research indicates that employers often misclassify workers as independent contractors for various reasons. They may do so unintentionally because of a lack of knowledge or because of poor advice received. Some employers may have the protection of Section 530 of the Revenue Act of 1978 and, as a result, can legally treat workers as independent contractors who would otherwise be employees. Finally, there are employers who deliberately misclassify workers as independent contractors to cut costs and to gain a greater competitive advantage over employers who correctly treat their workers as employees. These employers avoid paying their share of employment taxes as well as other

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expenses such as workers' compensation, unemployment insurance, and other benefits.

### WHAT TIGTA FOUND

The IRS has dedicated resources to educate taxpayers regarding employee classification as well as to enforce tax laws related to this issue, but more needs to be done.

The 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 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 estimate from Tax Year 1984 indicates.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS 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. TIGTA also recommended that the IRS consider conducting a formal National Research Program reporting compliance study to measure the impact of worker misclassification on the employment tax gap.

In their response to the report, IRS officials agreed with the recommendations. The Director, Specialty Programs, Small Business/Self-Employed Division, plans to coordinate an effort with all business operating divisions, the Criminal Investigation Division, and the Office of Chief Counsel to develop an agency-wide employment tax program that addresses worker classification along with other employment tax issues. The Director, Specialty Programs, Small Business/Self-Employed Division, also plans to work with the Research function to coordinate a study that addresses worker classification and other employment tax issues. The IRS has already begun addressing both issues.

### READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2009reports/200930035fr.pdf>.

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