

# Follow-Up Analysis for 2005 report - Independent Contractor Withholding March 2006

## Executive Summary

This analysis is provided as a follow-up to the 2005 report, Independent Contractor Withholding, which was prepared by the Franchise Tax Board. In particular, this analysis improves upon the estimate of the compliance for receipts reported on Form 1099-MISC.

Our overall estimate of compliance for those receiving Forms 1099-Misc has dropped from 89 percent to 88 percent. This revised compliance estimate raises our estimate of the impact on state revenue of the imposition of withholding at two percent of gross receipts paid to sole-proprietor independent contractors. This change is shown in the following two-part table.

### Base Scenario – Sole Proprietors Only, Withholding at Two Percent Revenue Impact (in millions of dollars)

#### Compliance Estimate from 2005 Report – 89%

	2005-6	2006-7	2007-8	2008-9	2009-10
Compliance Effect	20	60	70	80	80
Acceleration Effect	330	-50	-110	-40	10
Total Revenue Impact	350	10	-40	40	90

#### New Compliance Estimate – 88%

	2005-6	2006-7	2007-8	2008-9	2009-10
Compliance Effect	25	65	75	90	90
Acceleration Effect	330	-50	-110	-40	10
Total Revenue Impact	355	15	-35	50	100

Our new estimate of current compliance raises our estimate of the revenue gain for the base withholding scenario (applied to sole proprietors only) from the compliance effect in the first year by \$5 million, in the second and third years by \$5 million, and subsequent years by \$10 million. The new compliance estimate increases the revenue estimate attributable to the compliance effect by about 10 percent each year. The new compliance estimate would also affect our estimate of the revenue gain from the alternate withholding scenario (applied to all independent contractors) discussed in the 2005 report. The compliance effect for this scenario would also increase by approximately 10%. For example, our estimate of the revenue impact of a scenario in which we withheld on all independent contractors, attributable to the compliance effect, would increase by approximately \$10 million in fiscal year 2005-06 and approximately \$35 million in fiscal year 2009-10.

This study does not consider noncompliance that may be related to gross receipts that should be reported on a Form 1099-MISC, but are not.

## **Follow-Up Analysis for 2005 report -Independent Contractor Withholding**

### *Introduction*

In January of 2005, the staff of the Franchise Tax Board (FTB), in consultation with the Employment Development Department and the Legislative Analyst's Office, prepared a report regarding withholding on independent contractors. One of the issues critical to the fiscal impact and policy attractiveness of an independent contractor withholding program is the current level of compliance of independent contractors. In an attempt to address this issue, FTB staff estimated the current level of compliance for independent contractors who receive Forms 1099-MISC. This estimate is described in Appendix 1 of the report and is used in the estimates of the fiscal impact of various withholding schemes included in that report.

A significant portion, almost one-third, of the gross receipts reported on Form 1099-MISC were not thoroughly analyzed for the 2005 report, due to a lack of data at that time. FTB staff have been asked to reassess compliance for that portion of gross receipts that were not thoroughly analyzed for the 2005 report. This follow-up analysis reports the results of that effort.

### *Overview of Appendix 1 of the 2005 Independent Contractor Withholding Report*

In Appendix 1 of the 2005 report, we describe the methodology and results for our analysis of compliance on Form 1099-MISC. Our first step was to identify "the Forms 1099-MISC in which the individual payee could be matched with a record from FTB's Integrated Nonfiler Compliance reference file".<sup>1</sup> For tax year 2001, this represented \$47.6 billion of the \$166.4 billion gross receipts that were reported in boxes 6 or 7 of Form 1099-MISC.<sup>2</sup> We estimated a compliance rate of 91 percent for these taxpayers.

Our next step was to perform a second matching procedure using less strict matching criteria. Using these less strict matching criteria, we were able to match to an additional \$24.5 billion in Form 1099-MISC gross receipts to individuals. When preparing our 2005 report, we did not have data available to separately calculate the compliance rate for this group. Therefore, we assumed this group would have the same compliance rate (91 percent) as the group matched using the more strict criteria.

In the 2005 report, we also estimated that there was an additional \$2.2 billion in gross receipts reported on Forms 1099-MISC in which the payee was an individual but which we were unable to match with a PIT taxpayer using either the more-strict or less-strict matching criteria. It was assumed that this \$2.2 billion in gross receipts was never reported on a tax return.

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<sup>1</sup> This file contains information on all taxpayers who have filed an individual tax return (i.e., Form 540) since 1999, or have been identified through filing enforcement efforts.

<sup>2</sup> Boxes 6 and 7 are the boxes on the Form 1099-MISC in which gross receipts for non-employee compensation and medical payments are reported. These two types of payments were the focus of the estimate in the 2005 report as well as the withholding proposals discussed in that report.

We, thus, had accounted for \$74.3 billion in gross receipts as having been paid to an individual and reported on a Form 1099-MISC<sup>3</sup> out of a total of \$166.4 billion in gross receipts reported on Forms 1099-MISC. Our overall estimate of compliance for this \$74.3 billion was 89 percent.

### *Methodology for Current Study*

For this study, we have focused on the group of Forms 1099-MISC that were matched using the less-strict criteria. Our approach was to draw a stratified-random sample of gross receipts reported on Forms 1099-MISC and analyze that sample. Our sample size was about 1,500 unique payees, and was selected such that our sampling error was less than 3 percent at the 95 percent confidence level. The first step in our analysis was to determine if the payee of the Form 1099-MISC was in fact an individual. Since we had used less-strict matching criteria, it was possible for a Form 1099-MISC in which the payee was a corporation, LLC, or other type of business entity to be matched with an individual. We found that almost half of the gross receipts matched with individuals fell into this category. Therefore, these gross receipts were deemed to not be a proper subject of this study. That left us with \$13.4 billion in gross receipts from Forms 1099-MISC in which the payee was an individual.

Of this \$13.4 billion in gross receipts, \$12.2 billion was attributable to individuals who filed 2001 PIT tax returns. Using the same approach we applied in our 2005 study, we checked the 2001 PIT tax returns for these taxpayers to determine if the gross receipts reported on the Form(s) 1099-MISC were reported on the taxpayer's tax return. This analysis showed that \$12.1 billion of the gross receipts were reported on tax returns. The remaining \$1.2 billion in gross receipts attributable to taxpayers who did not file tax returns was assumed to be noncompliant. The estimated compliance for these two groups was 90.5 percent, slightly lower than the 91 percent that we had assumed in the 2005 report.

Finally, there was, as with the prior study, a group of taxpayers who could not be matched with an individual or a business entity using either the strict or less-strict (automated) matching criteria. The gross receipts on these Forms 1099-MISC totaled \$3.9 billion. We analyzed the largest (in terms of gross receipts) of these Forms 1099-MISC manually and determined that slightly more than one-half, or \$2.1 billion, of the gross receipts could be attributed to individuals. This group was assumed to be noncompliant.

### *Summary*

The estimate of compliance for receipts reported on 2001 Forms 1099-MISC can be divided into three components. These components are shown in the following table.

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<sup>3</sup> The remainder of the gross receipts reported on Forms 1099-MISC was matched with entities other than individuals (corporations, partnerships, LLCs, etc.) It is much more difficult to track the compliance on receipts earned by these taxpayers, because it often involves tracing the passthrough of income through two or more entities. We limited the scope of this analysis (as well as the analysis in 2005 Independent Contractor Withholding report) to gross receipts reported on Forms 1099-MISC to individuals.

**Summary of Results**  
**Tax Compliance for Gross Receipts Reported on 2001 Forms 1099-MISC**

Gross receipts reported on Forms 1099-MISC matched to individuals using	Total Form 1099-MISC receipts (Billions of Dollars)	Compliance Amount (Billions of Dollars)	Compliance Rate
more-strict matching criteria	\$47.6	\$ 43.3	91.0%
less-strict matching criteria	\$13.4	\$12.1	90.5%
neither the more-strict nor the less-strict matching criteria.	\$2.1	\$0.0	0.0%
<b>Total</b>	<b>\$63.0</b>	<b>\$55.4</b>	<b>87.9%</b>

First, there is the \$47.6 billion attributable to the Forms 1099-MISC matched using the more-strict criteria. For this group we estimated compliance of \$43.3 billion, for a compliance rate of 91 percent. Next, there is the \$13.4 billion in gross receipts attributable to the Forms 1099-MISC matched using the less-strict criteria. We estimated compliance for this group at \$12.1 billion, for a compliance rate of 90.5 percent. Finally, there is the \$2.1 billion of gross receipts attributable to the Forms 1099-MISC which, though considered to be ones for which the payee was an individual, could not be matched with any individual on the FTB's Integrated Nonfiler Compliance reference file. This group has a compliance rate of 0.0 percent. Overall, the estimated compliance rate for gross receipts reported on boxes 6 and 7 of Forms 1099-MISC for 2001 is 88 percent. This is just below the compliance rate estimated in the 2005 report of 89 percent. Although it is a relatively small decline in the compliance rate, it does have an impact on our revenue estimates of withholding on independent contractors. This impact can be seen by comparing the following two-part table.

**Base Scenario – Sole Proprietors Only, Withholding at Two Percent**  
**Compliance Estimate from 2005 Report – 89%**  
**Revenue Impact (in millions of dollars)**

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Compliance Effect	20	60	70	80	80
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**New Compliance Estimate – 88%**

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Taking into account our new estimate of current compliance raises our estimate of the revenue gain from the compliance effect in the first year by \$5 million, in the second and third years by \$5 million, and subsequent years by \$10 million. The new compliance estimate increases the revenue estimate attributable to the compliance effect by about 10 percent each year. The new compliance estimate would also affect our estimate of the revenue gain from the alternate withholding scenario (applied to all independent contractors) discussed in the 2005 report. The compliance effect for this scenario would also increase by approximately 10%. For example, our estimate of the revenue impact of this alternate scenario, attributable to the compliance effect, would increase by approximately \$10 million in fiscal year 2005-06 and approximately \$35 million in fiscal year 2009-10.

The limited scope of this study should be noted. The focus of this study was the compliance rate for receipts that are reported on Forms 1099-MISC. There is likely to be additional noncompliance for income that should be reported on Forms 1099-MISC, but is not. This study does not account for this phenomenon.