

INDEPENDENT CONTRACTOR WITHHOLDING

OMB No. 1545-0115

2004

Miscellaneous Income

**Copy 1
For State Tax
Department**

VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.

PAYER'S Federal identification number RECIPIENT'S identification number

RECIPIENT'S name

Street address (including apt. no.)

City, state, and ZIP code

Account number (optional)

15

Form **1099-MISC**

1 Rents	\$	4 Federal income tax withheld	\$
2 Royalties	\$	6 Medical and health care payments	\$
3 Other income	\$	8 Substitute payments in lieu of dividends or interest	\$
5 Fishing boat proceeds	\$	10 Crop insurance proceeds	\$
7 Nonemployee compensation	\$	11	
9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>	\$	12	
13 Excess golden parachute payments	\$	14 Gross proceeds paid to an attorney	\$
16 State tax withheld	\$	17 State/Payer's state no.	\$
	\$	18 State income	\$

Department of the Treasury - Internal Revenue Service

Franchise Tax Board
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In consultation with the
 Employment Development Department and
 the Legislative Analyst's Office

Prepared by California Franchise Tax Board Staff

INDEPENDENT CONTRACTOR WITHHOLDING

**A report to the Chair of the Joint Legislative Budget Committee
Chair of the Senate Appropriations Committee
Chair of the Assembly Appropriations Committee
Chair of the Senate Budget and Fiscal Review Committee
Chair of the Assembly Budget Committee**

**Pursuant to
Supplemental Report of the 2004 Budget Act, 2004-05 Fiscal Year
Item 1730-001-0001**

Prepared By Franchise Tax Board Staff

In Consultation with the Employment Development Department and
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INDEPENDENT CONTRACTOR WITHHOLDING

Request For Study

The Legislature requested FTB, in consultation with EDD and LAO, to prepare a report on withholding on payments made to independent contractors subject to reporting on Form 1099-MISC.

FTB was asked to provide a detailed description of the processes and procedures necessary to administer a withholding program at the state level and address the administrative and policy issues, including the agency that would administer the program. The report includes analysis of (1) withholding rates, (2) threshold levels, (3) overwithholding, (4) failure to withhold penalties, (5) waiver processes, (6) affected businesses and workers, (7) estimated revenues due to compliance and acceleration, and (8) federal and other state withholding policies.

Findings

Independent contractor withholding:

- Would increase compliance.
- Would be costly and complex for the government and private sector.
- May be perceived as detrimental to business climate.

Executive Summary

The purpose of withholding on independent contractors is to increase tax law compliance. This study finds that an independent contractor withholding program would increase compliance and, therefore, tax revenues, but at a substantial cost to both government and the private sector.

Revenue and cost estimates may vary considerably depending on the design of the withholding program and should be evaluated with caution. The reaction of businesses and workers to a new program is subject to speculation and is difficult to accurately forecast.

Withholding on payments subject to reporting in box 6 or 7 of federal Form 1099-MISC is estimated to generate a first-year revenue gain of approximately \$1.3 billion (at 2 percent with no waiver process). However, only 6 percent of the first-year gain represents increased compliance. The balance is acceleration – either payments received earlier than they otherwise would have been or excess payments that would be refunded. By the third year, due to a reversal of acceleration, the combined revenue effect is estimated to be a loss of \$200 million. By the fifth year, the combined revenue effect is estimated to be a gain of \$400 million.

Withholding on payments to independent contractors would require the state to implement complex and costly systems. One-time and annual operating costs are estimated to be about \$21 million and \$22 million, respectively. Businesses would also bear substantial costs. Such costs are difficult to quantify, but could be in the order of hundreds of millions of dollars. Additional costs would arise if the program were perceived as detrimental to California's business climate.

An undesirable feature of a withholding system is the potential for unwanted overwithholding. This is a potentially severe complication for independent contractors because gross receipts are a poor predictor of tax liability. This problem could be addressed by allowing for different withholding rates. Adding such flexibility would, however, substantially increase administrative costs, invite noncompliance through improper claims for reduced withholding rates, and reduce revenue gains from acceleration.

Former Governor Pete Wilson introduced a similar plan in his 1991 budget. It stirred intense opposition and was apparently dropped when business groups indicated that higher taxes would be preferable to withholding.

A new withholding program would be more practicable for California if the federal government adopted such a program first. The additional costs to businesses and taxpayers of implementing a California program would be substantially reduced if a federal program were implemented first.

The IRS Commissioner has promised to report to the U.S. Senate Finance Committee by the end of March 2005 on ways to deal with cash business noncompliance and the size of the tax gap, based on the preliminary results of a new taxpayer behavior study. It may be useful to review these results before committing resources to a new and controversial program.

INTRODUCTION

Request For Study

The Supplemental Report of the 2004 Budget Act, Item 1730-001-0001,¹ contains a statement of intent requesting the Franchise Tax Board (FTB), in consultation with the Employment Development Department (EDD) and the Legislative Analyst's Office (LAO), to submit to the chair of the Joint Legislative Budget Committee and the chairs of the fiscal committees of both houses of the Legislature, a report on withholding on payments to independent contractors subject to reporting on federal Form 1099-MISC, *Miscellaneous Income*. This report is intended to satisfy this request.

Report Overview

The report begins by discussing the motivation for considering an independent contractor withholding program. Presumably, an independent contractor withholding program would increase compliance with tax laws. Increased compliance would result in increased revenues to the state. By “leveling the playing field” between already compliant taxpayers and those brought into compliance, independent contractor withholding would increase the fairness of the tax system.

The potential gains from an independent contractor withholding program must be compared to the costs. Administration of independent contractor withholding would require the development and implementation of new systems, processes, and procedures by both the government and the private sector. Depending on the specific policy parameters chosen for the independent contractor withholding program, some of these systems may be quite complex. In addition, past attempts to institute similar programs have faced stiff opposition from industry and taxpayer groups. And, there are various policy concerns that must be considered in designing a withholding program. Each of these subjects are discussed in detail in the body of the report.

Finally, in recognition of potential drawbacks associated with independent contractor withholding, this report concludes with a brief presentation of alternative programs that would tackle some of the tax gap problems intended to be addressed by independent contractor withholding at a lower cost to both the government and private sector.

Motivation: The Tax Gap

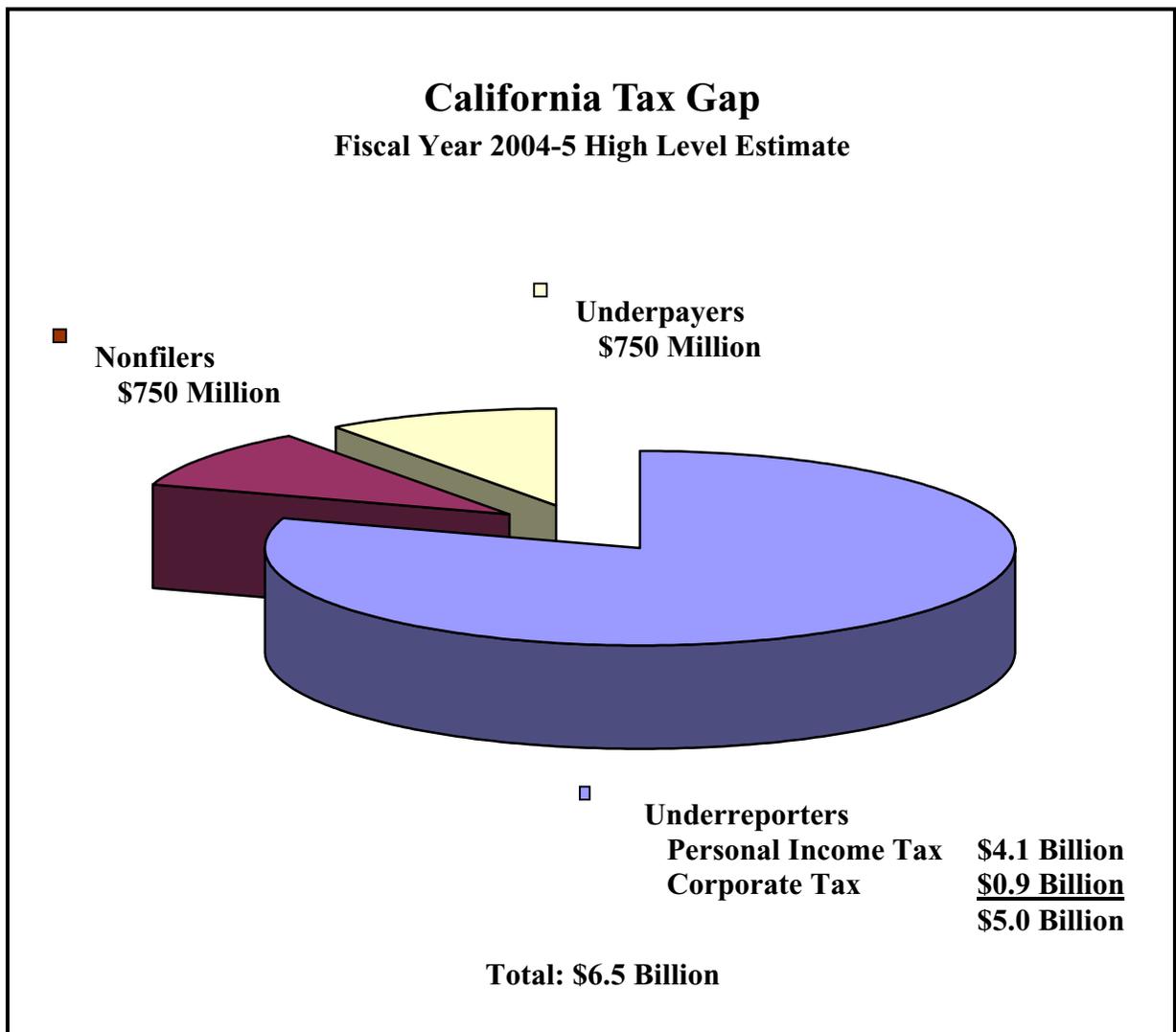
It is presumed that the motivation for this request to study independent contractor withholding is a desire to reduce the tax gap. The tax gap is generally defined as the amount of tax that is imposed by law for a given tax year but is not paid voluntarily. A recent OECD² report

¹ See Appendix A for report language.

² The Organization for Economic Cooperation and Development (OECD) consists of 30 industrialized nations, including the U.S., sharing a commitment to democratic government and the market economy. The OECD is best known for its publications and statistics covering economic and social issues.

estimates the U.S. tax gap for 2002-2003 at 8.6 percent of the gross domestic product. For the 2001 tax year, the Internal Revenue Service (IRS) estimates the gross tax gap to be \$310.6 billion, comprised of \$30.1 billion due to non-filing, \$248.8 billion due to underreporting, and \$31.8 billion due to underpaying, for an overall “noncompliance” rate of 15 percent. Individual income taxes account for \$196.3 billion, or 63 percent, of the gross tax gap. Enforced and other late payments of \$55.4 billion result in a net tax gap of \$255.2 billion for tax year 2001, a net noncompliance rate of 12 percent.

The California gross tax gap is estimated to be about \$6.5 billion per year. As illustrated by the following chart, almost 80 percent of the gross tax gap is attributable to underreporting of income or overreporting of deductions, primarily by individuals.



The IRS describes the income tax gap as consisting of three components:

1. Failure to file required tax returns. The revenues lost from nonfilers are estimated to account for about 10 percent of the federal tax gap.
2. Underreporting of income, which accounts for about 80 percent of the federal tax gap. This component includes, but is not limited to:
 - Failing to report certain income such as barter and cash transactions.
 - Overreporting business expenses and other deductions.
 - Minimizing taxable income through abusive tax shelters.
3. Underpayments, which account for about 10 percent of the federal tax gap. Underpayments generally represent a failure to pay the balance due with a tax return.

Independent contractors that operate as sole proprietors generally report income and expenses from their business on federal Schedule C.³ IRS analysis of the tax year 1998 income tax gap indicates that taxpayers who file Schedule C were responsible for 64 percent of the estimated federal income tax gap, and 40 percent of the estimated federal employment tax gap.⁴ An IRS analysis of tax year 1999 filing compliance shows that Schedule C filers have the lowest filing compliance rates among small business taxpayers, with 6.1 percent filing late, and 9.3 percent not filing at all. These analyses suggest there is much to gain from policies aimed at improving tax law compliance by independent contractors.

Tax Law Enforcement Tool Kit

Tax administrators have a variety of approaches available for improving tax law compliance, including third-party information reporting, withholding, and auditing.

Third-Party Information Reporting

Tax law requires business payers to file with the government and payees information reports on many types of payments that generally produce taxable income. The most common example is wage information reported on the federal Form W-2, *Wage and Tax Statement*. Other prominent examples include the various federal Forms 1099, which are used to report various types of income such as nonemployee compensation, interest and dividends, or brokerage proceeds. In general, the penalty for each failure to file an information return with the government or furnish a statement to a payee is \$50, with an annual maximum of \$250,000 and \$100,000, respectively. If the failure is due to intentional disregard, the penalty is the greater of \$100 or 10 percent of the total amount of the items that should have been reported with no maximum. Both penalties may be waived for reasonable cause.

Information reporting is effective because the information is shared with the government, and this reporting encourages taxpayers to include this reported income on their voluntarily filed returns. If the income is not reported on the tax return, it is more likely the government will detect its absence. On the other hand, information reporting requirements generate

³ IRS Form 1040, Schedule C, *Profit or Loss From Business*.

⁴ IRS Small Business/Self-Employed Operating Division, *Compliance Risk Assessment Document*, FY 04-05 Strategic Planning Cycle, p. 28.

administrative costs for both the entities issuing the information reports and for the government agencies collecting the reports. Also, the government incurs costs to enforce information reporting requirements.

Withholding

Withholding programs require the payer of potentially taxable income to remit a portion of that income to the government rather than to the income recipient. Again, the most common example is wage withholding, in which employers deduct a portion of wages from their employees' paychecks and transfer the money deducted to the government. Withholding reduces the tax gap in several ways:

- Since the government needs to know to whom the withholding should be attributed, any withholding program contains within it an information-reporting program. Therefore, all of the benefits from information reporting also follow from withholding.
- Withholding encourages filing of returns by would-be nonfilers to claim amounts withheld.
- Withholding limits the ability of taxpayers to underpay taxes shown on filed returns to the difference between the amount owed and the amount withheld.

Withholding programs generate administrative costs similar to those generated by information reporting. In addition, such programs generate administrative costs related to handling the money remitted to the government and in assigning that money to the correct taxpayer accounts.

Another concern arising from withholding programs is overwithholding. Under most withholding programs, the amount of withholding exceeds the amount of tax ultimately due for a substantial number of taxpayers. This results in an interest free loan from the taxpayer to the government from the time of the withholding until a refund is issued. If the overwithholding amounts are large, some taxpayers will view this as unfair. Also, for some poorer taxpayers, the delayed access to their income will impose a financial hardship.

Auditing

The most intensive tool available for tax law enforcement is the audit process wherein government personnel closely examine a taxpayer's source documents and tax calculations. The audit process is very costly in terms of both government resources to conduct the audit and taxpayer resources to respond to the audit. As a result, relatively few taxpayers are audited, and even for those taxpayers that do get audited, the audit may not reveal all of a taxpayer's misreported or unreported income. While costly, completed audits are able to eliminate tax losses due to nonfiling of returns and underreporting of income for those issues that are audited.⁵

Information reporting, withholding, and auditing have all helped improve the collection of taxes owed to the government. The results of an IRS study⁶ were discussed by Alan Plumley,

⁵ This is not strictly true since the government sometimes settles audit claims with taxpayers for less than the full amount claimed by the audit in order to avoid litigation costs.

⁶ Source: Internal Revenue Service (1996), *Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992*, IRS Publication 1415 (Rev. 4-96), Washington DC. The underlying study was

Technical Advisor to the Director of IRS's National Headquarters Office of Research, at the Income Tax Gap Symposium, hosted by State Controller Steve Westly and FTB on April 7, 2004, in Sacramento. Plumley described the following compliance rates that increase with the level of reporting and withholding.

Level of Income Reporting	Percent of Income Voluntarily Reported
Information reporting with withholding	99%
Substantial information reporting	96%
No information reporting	68%

referred to as the Tax Compliance Measurement Program (TCMP). The IRS is currently conducting the National Research Program (NRP) to update compliance information.

LEGISLATIVE HISTORY

Former Governor Pete Wilson's first budget submission (for fiscal year 1991-1992) contained a proposal to institute an independent contractor withholding program. Seeking office during a period when the state was facing a large budget deficit, Governor Wilson made a campaign promise not to raise income taxes. In conjunction with other proposals, independent contractor withholding was seen as a way to raise revenue without raising taxes.

The initial proposal included the following program elements:

- EDD would administer the program (and generally piggyback off of existing employer rules).
- A single rate (1.5 percent) would be applied to payments subject to withholding.
- The withholding rate would be adjusted annually by the FTB for application in the next calendar year. The adjusted rate was to be reasonably equivalent to an independent contractor's expected tax liability.
- Withholding would be required on payments made in the course of a payer's trade or business.
- A payer would not be required to withhold until aggregate annual payments exceeded \$2,500.
- Payments subject to withholding would be those required to be reported in boxes 6 and 7 of federal Form 1099-MISC.
- Withholding would be extended to payments to certain entities not required to be reported on Form 1099-MISC (i.e., personal service corporations, "S" corporations, and temporary services agencies) that provide personal services and that may be in substantial competition with sole proprietorships and partnerships.
- The proposal did not provide for a waiver process.

When this proposal was later introduced in a bipartisan bill (SB 267, Deddeh and Maddy, 1991-1992), the extension of the withholding on payments to entities not reported on Form 1099-MISC was excluded, as were certain brokers (e.g., real estate or cemetery) and direct salespersons. The final amended version of the proposal contained these substantive changes:

- Three withholding rates, starting when payments to a service-provider exceeded \$600:
 - 2.25 percent for payments made to providers of medical or health care services.
 - 1.25 percent for payments made to all other service-providers.
 - An alternate rate for service-providers (excluding medical or health care providers) of the greater of one-tenth of one percent of the payment, or \$25, after providing certification that the standard withholding rate would exceed the expected tax due.
- Or, the payer (except a health insurance company making payments to medical or health care providers) could choose to withhold on all payments at a rate of 2 percent.

This bill, initially opposed by many Republican legislators, faced growing opposition. Opponents – including contractor and consultation associations, the California Building

Association, the California Chamber of Commerce, and the California Taxpayers' Association – pointed to the extra burdens withholding would place on independent contractors. “This bill is a gimmick to advance tax collections by a fiscal year by putting an extra burden on contractors,” said Dave Ackerman, a lobbyist for the Associated General Contractors of California. “It reaps a one-time benefit for the state, but forces contractors to put costly, permanent bookkeeping programs in place...Profit margins are often so small with independent contractors that even a 1 percent withholding rate can lead to significant cash flow problems,” Ackerman said.⁷

An attempt to head off this criticism resulted in an amendment establishing a minimum rate of \$25 or one-tenth of one percent of gross receipts, whichever was greater, for service-providers who could certify that they would not make a profit on a specific project or client. In an effort to address concerns about additional burden on service-recipients, payers were given the opportunity to withhold at a flat rate of 2 percent.

Another proposed amendment would have created a payer threshold for service-recipients not having employees and whose total payments for personal services did not exceed \$100,000. This proposal was not actually amended into the bill. The bill was last amended for an unrelated purpose on September 10, 1991, long after the independent contractor proposal was removed from consideration.

A newspaper article reported that then Senate President Pro Tem David Roberti said he was surprised by the power that independent contractors have shown in trying to kill a provision in one of the tax bills that would require them to submit to income tax withholding. “All we have done is say they have to pay withholding, so they cannot debate a tax. It is not even a new tax on them...a lot of other groups have been hit with a real tax, “ said Roberti.⁸

In an attempt to end a budget impasse that had dragged on into July, Governor Wilson, with the support of business groups, changed his position and agreed to support a temporary income tax increase by adding two new top brackets in exchange for dropping the independent contractor withholding proposal and a proposed utilities tax. The Governor is reported to have changed his mind when business groups backed income taxes as less painful than other new levies under consideration, such as a tax on telecommunication services or withholding taxes on independent contractors.⁹

⁷ Source: Orange County Register, May 27, 1991.

⁸ Source: Los Angeles Times, July 2, 1991.

⁹ Source: San Francisco Chronicle, July 2, 1991.

CURRENT ENVIRONMENT

This section describes existing practices in tax law enforcement that are relevant to the analysis of independent contractor withholding, including the differences between employees and independent contractors, current independent contractor reporting requirements, and existing California withholding programs. For comparative purposes, this section also briefly describes independent contractor withholding programs (or lack thereof) administered by the federal and other state governments.

Employee v. Independent Contractor

For purposes of income tax and payroll tax withholding, workers are classified as either employees or independent contractors. For employees, the employer is required to withhold income tax and the employee's share of social security and Medicare taxes from the employee's wages. The employer must also pay unemployment taxes, the employer's share of social security and Medicare taxes, and worker's compensation insurance. Further, the employer must issue a Form W-2 to the employee, reporting gross wages, and withholding amounts for the calendar year.

A worker classified as an independent contractor is responsible for paying his or her own income tax (generally through quarterly estimated tax payments), and self-employment tax including social security and Medicare. An independent contractor may deduct business expenses related to the income generated, but is usually not eligible for unemployment benefits. Also, an independent contractor must arrange for his or her own health insurance, retirement, and other traditional employee benefits. If a business makes payments aggregating \$600 or more to an independent contractor, the payments must be reported on IRS Form 1099-MISC.

In an arm's length transaction, an independent contractor will factor these costs into the price of the services, but some unscrupulous employers take advantage of unwary employees by incorrectly classifying them as independent contractors and transferring the tax burdens to the misclassified employee.

Personal Income Tax Withholding Program For Employees

EDD administers California's wage withholding program. Unless specifically excluded, employers are required to withhold personal income tax from wages paid to employees. Employers are required to make periodic tax deposits of amounts withheld based on their federal deposit schedule, which can range from the next banking day after payment to quarterly, depending on the amount of withholding. When employers fail to withhold or underwithhold from wages paid to their employees, they become liable and may be assessed for the amounts that should have been withheld.

Employers are required to file a *Quarterly Wage and Withholding Report* that details, by employee, the personal income tax withheld and the employee's wages subject to withholding.

Employers are also required to file an *Annual Reconciliation Statement* that is used to reconcile total payroll taxes due to total payroll tax deposits. Each year EDD collects more than \$35 billion in payroll taxes, including nearly \$27 billion in personal income tax.

Independent Contractor Reporting Program

EDD administers the Independent Contractor Reporting program that is used to locate parents who are delinquent in their child support obligations. Effective January 1, 2001, any business or government entity that is required to file a federal Form 1099-MISC for services performed by an independent contractor is required to report specific independent contractor information to EDD. For purposes of this program, the business or government payer is referred to as a “service-recipient.” The independent contractor payee is referred to as a “service-provider.” Service-recipients must report to EDD within 20 days of either making payments totaling \$600 or more, or entering into a contract for \$600 or more with a service-provider in any calendar year, whichever is earlier. Each failure to report may result in a \$24 penalty, unless the failure is due to good cause. The penalty increases to \$490 if the failure is the result of a conspiracy between the service-recipient and service-provider not to supply the required report or to supply a false or incomplete report.

Periodically, the Department of Child Support Services (DCSS) and the FTB send a file to EDD containing social security numbers (SSNs) of parents who are delinquent in their child support obligations. The SSNs are matched against the independent contractor information reported to EDD. Matched service-provider information is transmitted to the DCSS and FTB for use in respective child support collection programs. EDD annually receives reports from approximately 500,000 service-recipients on approximately 2.5 million independent contractors.

Nonresident Independent Contractor Withholding Program

The FTB currently administers the withhold-at-source program on payments to nonresidents for services performed by independent contractors, rents, royalties, estate distributions, trust distributions, and partnership distributions and allocations of income. FTB also administers withholding on sales of California real estate by residents and nonresidents.

Withholding is required on payments to nonresident independent contractors when the payer expects total payments for the year to the independent contractor to exceed \$1,500. Independent contractors include individuals who are not employees and any other type of entity including corporations and partnerships with no permanent place of business in California. Withholding is required regardless of whether the payments to the independent contractor are subject to a Form 1099-MISC reporting requirement.

The withholding rate is 7 percent. Reduced rates may be granted to prevent overwithholding, but are rarely requested, except by entertainers. However, full waivers are frequently granted when the payee has a consistent history of filing tax returns with FTB. Withhold agents (i.e., the payers) are required to remit payments monthly if accumulated withholding on all payees exceeds \$2,500. Withhold agents are required to file a *Nonresident Withholding Tax Statement* for each payee and a *Nonresident Withholding Annual Return* that summarizes total withholding for the year.

Although payments to nonresident entertainers are withheld upon because they are independent contractors, most withholding on entertainers is handled in a different manner. FTB usually issues a Notice to Withhold Tax at Source (FTB 594) to the venue hosting specific performances.

For tax year 2003, approximately 300 withhold agents withheld \$8.2 million on 3,000 entertainment independent contractors and 500 withhold agents withheld \$10.6 million on 8,000 other nonresident independent contractors.

Independent Contractor Withholding Policy – Federal

The federal government does not have an existing requirement to withhold on payments to independent contractors. However, most payments to independent contractors are subject to what is known as “backup withholding” at a rate of 28 percent. Backup withholding is required if the payee fails to furnish a taxpayer identification number (TIN) or the payer is notified by the IRS that the TIN is incorrect. Also, payments made to foreign persons for personal services performed in the United States are subject to withholding at a rate of 30 percent.

In the 2003 Annual Report to Congress, the National Taxpayer Advocate (NTA) recommended that Congress implement a withholding mechanism on certain payments to self-employed persons to help address the tax gap problem. While acknowledging that the proposal is controversial, the NTA believes that it represents a good starting point for discussions about the issues and would resolve the ongoing debate about which standards to apply in distinguishing between employees and independent contractors.

The recommended withholding regime would “piggyback” off the existing Form 1099-MISC reporting requirements for nonemployee compensation and fishing boat operators. The NTA recommended a withholding rate of 5 percent on payments to independent contractors not maintaining an inventory or receiving payments for materials and supplies, and a withholding rate of 3.5 percent on payments to contractors that maintain inventories or receive payments for materials and supplies. The Secretary of the Treasury would be authorized to establish “safe harbor” withholding rates for certain industries. The withholding rate was designed to offset federal self-employment tax. Self-employment tax is the self-employed individual’s equivalent of social security and Medicare taxes imposed on employees and employers. The current self-employment tax rate is 15.3 percent, and is imposed on all self-employment income (if total self-employment income exceeds \$400). Therefore, this federal proposal avoids problems with determining a withholding rate (or rates) suitable for income subject to progressive income tax rates.

However, IRS Commissioner, Mark Everson, attending a Senate Finance Committee hearing on the tax gap, held on July 21, 2004, is reported as “not favoring” mandatory withholding on nonwage payments because of the burden it places on businesses. Instead, he said he favors strengthening IRS enforcement to deal with the problem.¹⁰ Mr. Everson indicated that a new research initiative to study taxpayer behavior is under way, the results of which should be available in early 2005. Mr. Everson agreed to report to the Senate Finance Committee by the

¹⁰ Tax Analysts, Tax Notes Today, July 22, 2004. *2004 TNT 141-4*.

end of March 2005 on ways to deal with cash business noncompliance and the size of the tax gap.

Independent Contractor Withholding Policy – Other States

The 50 states and the District of Columbia were surveyed to ascertain their withholding policies, if any, related to payments to independent contractors. Currently, no state requires withholding on payments to *resident* independent contractors. See Appendix C for a brief description of the findings for the states having general authority to withhold, or having nonresident independent contractor programs.

METHODOLOGY

Scope

The purpose of this report is to present the results of a study on implementing an independent contractor withholding program. This study includes a detailed description of procedures and processes involved in nonwage payment withholding, and addresses administrative and policy issues associated with adoption of such a program at the state level.

The framework selected for this study is based on the following high-level assumptions:

- EDD would administer the program in a manner similar to the existing wage withholding program.
- FTB would receive independent contractor withholding data from EDD, process returns, and validate claimed withholding credits in a manner comparable to existing withhold-at-source processes.
- The existing nonresident independent contractor withholding program now administered by FTB would be absorbed into the new program, administered by EDD.¹¹
- A single, most feasible withholding scheme – the base scenario explained below – is used to determine baselines for administration costs, revenues, and present a structure to identify and discuss policy concerns.

Terminology

Throughout this report, an independent contractor may be referred to as a service-provider or payee. These terms are interchangeable. Likewise, businesses that make payments to independent contractors may be referred to as payers, service-recipients, or withhold agents. Please refer to the Glossary for definitions.

Base Scenario

The policy discussions in the sections that follow begin by analyzing a minimalist independent contractor withholding scheme. This “base scenario” was selected because it would be, in comparison to other variations of withholding, relatively easy to analyze and provide a baseline for study and discussion of the policy concerns. Key features of the base scenario include a population of sole proprietor independent contractors, withholding thresholds consistent with current information reporting thresholds, a single withholding rate, and the absence of a waiver system. The simplicity of the base scenario does not, however, necessarily make it the preferred

¹¹ See Current Environment for a description of the existing nonresident independent contractors withholding program.

or optimal policy choice for the implementation of a withholding program. The following paragraphs discuss the basic structure of this scenario. This report includes a discussion of each element in greater detail and explains various policy alternatives.

Population: Under the base scenario, the population subject to withholding is independent contractors who are individuals (i.e., sole proprietors) that receive payments for services that are required to be reported in box 6, medical and health care payments, or box 7, nonemployee compensation, of federal Form 1099-MISC.¹² Service-recipients are only required to report payments made in the course of their trade or business. This definition excludes: (1) payments made for personal purposes, (2) payments for goods,¹³ and (3) payments to service-providers that are not individuals. This is the same population that is currently subject to EDD’s independent contractor reporting program described under Current Environment.

Thresholds: The base scenario uses a *payee* threshold of \$600. This means that withholding begins when payments to an independent contractor equal or exceed \$600. This allows the process to “piggyback” on the EDD independent contractor reporting program and the federal Form 1099-MISC reporting requirements. The base scenario does not include a *payer* threshold. Such a threshold, based on some criteria such as gross receipts or aggregate payments to service-providers, would limit those service-recipients required to withhold to those exceeding the threshold. There is no payer threshold under current Form 1099-MISC reporting requirements.

Rate: The base scenario applies a withholding rate of 2 percent. This rate is 40 percent of the 5 percent base-withholding rate proposed for federal purposes by the National Taxpayer Advocate.

Waiver Process: The base scenario does not include a waiver process. A waiver process provides for a reduced rate of withholding, or exemption from withholding, and is usually manually determined on a taxpayer-by-taxpayer basis.

Alternate Scenario

An alternate scenario is presented for comparative purposes, particularly for estimated administrative costs and revenues. The difference between the base and alternate scenario is the population subject to withholding. Under the alternate scenario, the population is expanded to include all independent contractors that receive payments for services that are required to be reported in box 6, medical and health care payments, or box 7, nonemployee compensation, of federal Form 1099-MISC. Each of the other elements—the 2 percent withholding rate, \$600 payer threshold, and no waiver process—is the same under both the base and alternate scenarios.

¹² See Appendix B.

¹³ However, payment for services required to be reported in box 7 of Form 1099-MISC includes payment for parts or materials used to perform the services if supplying the parts or materials was incidental to providing the service.

BUSINESSES AND WORKERS

Affected Businesses and Workers

Independent contractor withholding would affect a large number of California businesses and workers. FTB records indicate that, in 2001, approximately 530,000 service-recipients reported payments to about 2.9 million service-providers in box 6 or 7 of more than 6.3 million Forms 1099-MISC. Considering only payments made to service-providers that are identifiable as sole proprietorships, in 2001 approximately 470,000 service-recipients reported payments to almost 2.1 million service-providers on more than 3.4 million Forms 1099-MISC.

Under either scenario, the withholding population would include many different types of service-providers such as:

- ✓ Attorneys
- ✓ Medical doctors
- ✓ Accounting and tax practitioners, including bookkeepers
- ✓ Architects
- ✓ Engineers
- ✓ Surveyors
- ✓ Building tradespersons
- ✓ Automotive servicepersons
- ✓ Computer programmers and systems analysts
- ✓ Various professional consultants
- ✓ Commissioned salespersons (e.g., lottery sales agents, real estate sales agents, direct consumer sales agents)
- ✓ Miscellaneous health care providers
- ✓ Entertainers and professional athletes
- ✓ Fishermen
- ✓ Corporate directors
- ✓ Independent contractor recipients of golden parachute payments

Generally, an independent contractor withholding program would affect any business that uses the services of independent contractors. If a business is required to report payments to an independent contractor on federal Form 1099-MISC (in boxes 6 or 7), the business would be required to withhold from those payments. Nonprofit organizations, including trusts of employer pension or profit sharing plans and certain tax-exempt organizations, would be required to withhold from payments to independent contractors. State and local government agencies would be required to withhold as well.

Who Isn't Affected

Businesses and workers that are excluded from federal Form 1099-MISC reporting requirements would also be excluded from withholding under the scenarios presented in this report. Service-providers that would not be subject to independent contractor withholding include, but are not limited to:

- ✓ Corporations (with the exception of corporations providing legal or health care services)
- ✓ Sellers/providers of merchandise, telegrams, telephone, freight, storage, and similar items
- ✓ Employees (subject to wage withholding)
- ✓ Tax-exempt organizations, federal and state government agencies, District of Columbia, U.S. possessions, or foreign governments.
- ✓ Informers (if paid by government or certain tax-exempt organizations)
- ✓ Recipients of scholarships or fellowship grants

OVERVIEW OF PROPOSED INDEPENDENT CONTRACTOR WITHHOLDING PROCESSES

As explained above, for purposes of this study it has been assumed that EDD would administer an independent contractor program in a manner similar to the existing wage withholding program. FTB would receive independent contractor withholding data from EDD, process returns, and validate claimed withholding credits in a manner comparable to existing withhold-at-source processes. This section provides a description of the processes that must be implemented and maintained by EDD and FTB to administer an independent contractor withholding program under both the base and alternate scenarios. Later in this report, the Policy Analysis section discusses additional elements of a withholding program. Some of these options, such as a waiver or self-certification process would require the development and implementation of additional processes.

EDD Processes Under Base Scenario

Taxpayer Outreach and Education

EDD and FTB would conduct a joint outreach and education program designed to inform service-providers and service-recipients of the new law requiring withholding from payments to independent contractors. The information would include details of the reporting requirements, the responsibilities of the parties, and the pertinent timeframes.

The outreach program would also target other stakeholder groups, including tax professional associations, business advocacy groups, chambers of commerce, and governmental agencies at the local, state, and federal level. The program would include mass mailings to businesses and independent contractors known to EDD and FTB, notices in newspapers, trade publications, informational websites, and would include partnership with local government agencies involved in providing information to newly established businesses.

Registration Process

EDD currently registers businesses that pay \$100 or more in wages to employees. Each employer is assigned a unique state employer account number. Registered employers that make payments to independent contractors would report the withholding under their current state employer account number.

Businesses that are not employers, but are required to withhold on payments to independent contractors, would be required to register with EDD to obtain an account number and withholding deposit forms. EDD would send a registration package to all such businesses that are identified from a master file developed by EDD and FTB. Businesses that are not identified in the master file would need to contact EDD to register for an account number.

Reporting and Payments

Service-recipients that are also employers would follow their current deposit schedule for reporting independent contractor withholding. Nonemployer service-recipients would be required to withhold on a monthly basis, with the deposit due by the 15th of the month following payment to the service-provider. The existing tax deposit coupon (DE 88) would be modified to include a line for total personal income tax withholding for all independent contractors. Service-recipients would file the following forms after the end of the year:

- *Report of Independent Contractor Payments and Withholdings* (DE 6 IC) listing each independent contractor, social security number (SSN), the amount subject to withholding during the preceding calendar year (i.e., the amount reported on Form 1099-MISC, box 6 or 7), and the amount withheld.
- *Annual Reconciliation Statement* (DE 7) modified to include a line for independent contractor information indicating the amount subject to withholding (the amount reported on Form 1099-MISC, box 6 or 7) and the amount withheld.

The service-recipient's payments and withholding information for each calendar year would be retained in the Tax Accounting System for accounting and enforcement purposes. A file with this data would be sent to FTB on an ongoing flow basis beginning in January of each following year, with the bulk of the data probably being transmitted from February through April. The data file would include the following elements:

- Tax year
- Payer (i.e., service-recipient) name
- Payer address
- Payer telephone number
- Payer FEIN¹⁴ or SSN
- Independent contractor (i.e., service-provider) name
- Independent contractor address
- Independent contractor SSN
- Amount subject to withholding (i.e., the amount reported on Form 1099-MISC box 6 or 7)
- Amount withheld

Front-End Processing (Mail, Cashiering, Imaging, and Data Capture)

Service-recipients that are also employers would mail the payments and reports associated with independent contractor withholding in the same manner as for wage withholding and employment tax payments.

The tax deposit checks would be processed utilizing J&B software. The DE 6 IC would be processed through iCapture software via paper and Internet channels. Paper filings would be captured through:

¹⁴ FEIN is a commonly used acronym for federal employer identification number.

- Optical Character Recognition (OCR)
- Keyed From Paper (KFP)
- Keyed From Image (KFI)

The *Annual Reconciliation Statement* (DE 7) would be processed via paper and captured in the same manner as the DE 6 IC, as noted above. Data captured would be uploaded via the Goethe Tax Office Import/Export Module:

- DE 88 data goes to TAS and posts to PIT IC Fund
- DE 6 IC data goes to the IC withholding Database (to be sent to FTB)
- DE 7 data goes to TAS to calculate account balances.
- Correspondence and Status/Address changes are imaged and put into infoImage workflows.

All source documents would be imaged and available for internal staff to access and view.

Account Management

The independent contractor withholding program's accounting would occur within EDD's Tax Accounting System, which is the existing system used to account for all California employment taxes. This includes billings, adjustments where independent contractors are reported as employees including reciprocal transfers between the PIT IC fund and the PIT fund, and refunds. The Unassigned Correspondence Group would handle correspondence and the call center would handle inquiries and minor account adjustments. An administrative appeals process would be developed as part of the current administrative appeals process administered by the California Unemployment Insurance Appeals Board.

Enforcement

EDD would administer a compliance, audit, and collections program to ensure that service-recipients comply with the requirements of the independent contractor withholding program. Automated billings would be generated where the withholding is below the established amount required or is not timely. Non-filers would be discovered through EDD's audit program, which would be modified to enforce this program, and assessments including applicable penalties and interest would be issued for deficiencies. FTB would enforce income taxes due from the independent contractors.

Additional EDD Processes Under Alternate Scenario

Reporting and Payments

EDD would send FTB a separate file that would provide information on business entities with withholding credits. In addition to relevant data elements listed above, the file would contain the business entity FEIN or number assigned by the California Secretary of State.

FTB Processes Under Base Scenario

Taxpayer Outreach and Education

As previously described, FTB and EDD would conduct joint outreach and education activities to inform service-providers and service-recipients of the new withholding requirements. Such efforts would include developing informational articles, publications, and websites; mass mailings to identified businesses and independent contractors; publishing news releases; conducting focus groups; and, enhancing Interactive Voice Response (IVR) applications.

Tax Return Reporting

Individual service-providers/taxpayers would claim the amount withheld on a new line on the personal income return (Forms 540, 540NR, and 540X).

Tax Return Processing (Mail, Cashiering, Imaging, and Data Capture)

Service-providers/taxpayers would file income tax returns in the normal manner. The mail would be received and opened at the Central Office facility. Cashier and data capture functions would operate in the normal manner, except the tax return will have one additional line to capture. Paper filings will continue to be captured through desktop PCs using CTT or IPACS based software. ScanOptics image technology would be used to scan returns and checks, and Unisys power encoders to prepare bank deposits. Electronically filed personal income tax returns would continue to be processed in the normal manner.

Withhold Credit Verification

Beginning January 31st of each year, and periodically thereafter, EDD would send FTB a file that would provide information on individual (sole proprietor) independent contractors with withholding credits. FTB would use this file to verify claimed withholding amounts as tax returns for individuals are processed and updated to the individual tax (TI) system. If the taxpayer claims an amount of independent contractor withholding different from the amount available on the file, the return would fall out for on-line review and resolution. If the taxpayer is claiming more withholding than should be allowed, FTB would issue a notice and adjust the taxpayer's expected refund/balance due. Taxpayers who disagree with adjustments would write or call FTB to provide documentation of withholding credits.

Account Management

Similar to wage withholding, EDD would pass individual withholding information to FTB's existing TI system. Account billings, adjustments, and refunds would be handled through FTB's return validation process. FTB's current Withholding Services and Compliance Section would be responsible for resolving correspondence and telephone calls resulting from the notices.

Enforcement

EDD would be responsible for auditing service-recipients. FTB would be responsible for enforcement efforts on independent contractors who falsely certify they are not individuals in order to avoid withholding.¹⁵ In addition, FTB would employ normal enforcement methods to collect delinquent taxes from individuals. The existing nonfiler system would be modified to allow independent contractor withholding credits to be displayed on the system and included in proposed tax computations.

Additional FTB Processes Under Alternate Scenario

Information Return Reporting

If the independent contractor is a pass-through entity, such as a partnership, LLC, “S” corporation, or trust, the independent contractor must flow any withholding in excess of its own tax liability to its partners, members, shareholders, or beneficiaries. After the pass-through entity receives its Form 1099-MISC from the service-recipient, the pass-through entity would file existing Forms 592 and 592-B with FTB to allocate the withholding to its partners, members, shareholders, or beneficiaries.

Information Return Processing

Forms 592 and 592-B information would be entered into FTB’s existing nonresident withholding (NRW) system and the withholding would be allocated to the pass-through entity’s partners, members, shareholders, or beneficiaries. This information would be used to provide the files of available credits to the TI (individuals) and BETS (business entities) systems for withhold credit verification during return processing.

Withhold Credit Verification

On an ongoing flow basis beginning in January of each following year, EDD would send FTB an additional file that would provide information on business entities with withholding credits. FTB would use this file to allocate credits posted on the NRW System to partners, members, shareholders, and beneficiaries of pass-through entities. The NRW System would provide a file of available credits for business entities to the BETS system and a file for individuals to the TI system to verify claimed withholding amounts as tax returns are processed and updated. If the return shows an amount of independent contractor withholding different from the amount available on the file, the return would fall out for on-line review and verification. If the claimed withholding amount is different than is allowed, FTB would issue a notice and adjust the taxpayer’s expected refund/balance due.

¹⁵ Persons who are required to file information returns, such as Form 1099-MISC, with the IRS must receive from the payee a completed federal Form W-9, *Request for Taxpayer Identification Number and Certification*. A payee is required to provide a correct taxpayer identification number (TIN) to the payer for reporting purposes. If the payee fails to provide, or provides an incorrect, TIN, payments to the payee will be subject to federal “back-up withholding” at a rate of 28%. California does not currently follow the federal back-up withholding regime. However, the W-9 would serve as the certification of entity type for state independent contractor withholding. See Appendix G.

Account Management

FTB would be responsible for administering the account functions associated with the allocation of withholding credits that are flowed from pass-through entities to their partners, members, shareholders, and beneficiaries.

For non-individuals, EDD will pass withholding information to FTB's current withhold accounting system. As described above, FTB's NRW system will handle the flow-through of withholding and then pass the withholding information on partners, members, shareholders, or beneficiaries to either the individual tax or business entity tax systems as appropriate.

COST AND REVENUE ESTIMATES

Presented in this section are estimates of direct costs and revenue benefits of independent contractor withholding. Certain caveats should be kept in mind regarding these estimates. First, the estimates presented here, particularly the revenue estimates, are highly sensitive to the assumptions on which they are based. Second, the estimates presented are specific to either the base scenario or to the alternate scenario, as indicated. Estimates for other combinations of policy parameters could be substantially different. Finally, both the cost and revenue estimates contain two components. The first is an estimate for the initial implementation phase of the withholding program, the second for ongoing effects of withholding once fully implemented. The latter effects should be given more weight in determining the overall desirability of adopting an independent contractor withholding program.

Government Costs

For purposes of this study, costs were estimated based on the assumption that the EDD Tax Branch would administer the independent contractor withholding program and FTB would process tax returns claiming withholding, as described earlier. The estimates include EDD's one-time and continuing costs to implement and maintain the program, including technology development and support required for new or enhanced computer systems. The estimates also include FTB's one-time and continuing costs for receiving, processing, and verifying returns claiming withholding, including technology development and support required for new or enhanced computer systems to account for and verify withholding credit information.

Estimates include the costs to EDD and FTB for personal services, benefits, and operating expenses and equipment related to the following program areas:

- Technology development
- Processing withholding deposits and accounting services
- Processing withholding credit information
- Program support
- Enforcement
- Taxpayer assistance and education

The program area costs and the technology costs were estimated for the base scenario, the population of which is limited to independent contractors who are sole proprietors, and the alternate scenario, which expands the population to *all* independent contractors that are subject to Form 1099-MISC reporting. For a more detailed breakdown of estimated one-time and continuing costs, see Appendix D and Appendix E.

Under the base scenario, this proposal would result in one-time EDD and FTB costs of approximately \$18.5 million. Annual operating costs would be approximately \$16 million.

Under the alternate scenario, this proposal would result in one-time EDD and FTB costs of approximately \$21 million. Annual operating costs would be approximately \$22 million. Approximately \$5 million is attributable to personnel and administrative costs resulting from the complexities required to pass through amounts withheld on partnerships and limited liability companies to their respective partners and members.

Private Sector Costs

The private sector would also incur costs to implement and administer independent contractor withholding. Businesses would be required to develop and administer systems for calculating appropriate withholding amounts, remitting these amounts to the government, and notifying service-providers of the amounts withheld. Systems currently used for Form 1099-MISC reporting are not designed to perform all of these tasks. For example, systems currently in use only compile information for Forms 1099-MISC at the end of each year. For a withholding program, remittances to the government would be required at least quarterly, and the withholding itself would be required at the time of each payment. If a withholding program were to include waivers or multiple tax rates, payers' systems would require additional features.

The cost to business of tax compliance is difficult to quantify. The GAO reports one reason for this difficulty is that "business respondents said ... to separate tax compliance costs from other costs of doing business would be burdensome."¹⁶ The IRS Office of Research and IBM Corporation are conducting a joint project to better understand the tax compliance burden of small businesses. Some results of the study were presented on June 2, 2004, at the 2004 IRS Research Conference held in Washington, D.C. Employment tax compliance is considered by small businesses to be the most burdensome aspect of the tax system. The required processes for employment taxes are analogous to the expected processes required in complying with independent contractor withholding. Record keeping activities mentioned by small businesses that may apply to independent contractor withholding include:

- Collecting W-9 information from independent contractors.
- Determining the tax treatment of certain types of payments.
- Entering information into an accounts payable/withholding tax system and checking entries for accuracy.

Most taxpayers reported spending two to five hours per week on employment tax record keeping activities, and from one to ten hours annually on W-2 and Form 1099 generation. Conservatively, this indicates a small business could reasonably be expected to devote 100 hours annually to independent contractor withholding processes, depending on the number of independent contractors hired and frequency of payments.

In a further effort to address the issue of taxpayer burden in specific terms, the assistance of several outside sources was sought. Spidell Publishing, Inc., was one of the private-sector sources contacted and the only source to respond. Spidell, publisher of Spidell's California Taxletter, has been a source of California tax information for tax professionals since 1975.

¹⁶ GAO Testimony: *Issues in Tax Compliance Burden* (1996)(GAO/T-GGD-96-100).

Lynn Freer, President of Spidell Publishing, Inc., provided two estimates of the potential cost to small businesses required to withhold on independent contractors.¹⁷ The first, which assumes compliance is performed in-house, arrives at an estimated annual cost for a small business to comply of \$358. Multiplying that figure by 530,000 – the number of businesses that issued Form 1099-MISC to service-providers in 2001 – results in an estimated total annual cost to businesses (i.e., service-recipients) of approximately \$190 million. The second calculation, which assumes a business uses the services of an accounting or tax firm to meet withholding and reporting requirements, arrives at an estimated annual cost of \$1,117 per service-recipient. Multiplying that figure by 530,000 service-recipients results in estimated total annual cost to businesses of approximately \$592 million.

As projected to 2006, the number of service-recipients that would be required to comply with the withholding requirements is about 600,000. Applying the estimated costs provided by Spidell suggests a substantial cost to businesses ranging from \$215 million to \$670 million.

Ms. Freer summarizes her opposition to independent contractor withholding by stating it “...will be an additional burden to small business and encourage more people to work under the table; thus reducing compliance.”

Estimated Program Revenue

Revenue estimation for independent contractor withholding is unconventional because instituting a withholding program does not change the ultimate tax liability of the affected taxpayers. Most revenue estimates assume a consistent level of compliance with the tax law and estimate the change in the amount of tax due that would result from a proposed policy change. In this case, however, the task is to estimate the effects of changes in tax payment behavior that would occur even though there is no change in tax liability. In particular, two effects from a withholding program are anticipated, a compliance effect and an acceleration effect. The following tables present estimates of these revenue effects for the first five years after implementation.¹⁸ By the third year the compliance effect should be almost fully phased in. It is estimated that the acceleration effect would stabilize at a small but positive level by the fifth year after implementation. As a result, the ongoing total revenue impact would be approximately that of the fifth year shown in the tables below.

Base Scenario – Sole Proprietors Only Revenue Impact (in millions of dollars)

	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

¹⁷ See Appendix H for the complete submission, including the assumptions used in the calculation.

¹⁸ For illustrative purposes, these estimates assume that withholding would begin January 1, 2006.

**Alternate Scenario – All Independent Contractors
Revenue Impact (in millions of dollars)**

	2005-6	2006-7	2007-8	2008-9	2009-10
Compliance Effect	100	250	300	300	350
Acceleration Effect	1,200	-50	-500	-150	50
Total Revenue Impact	1,300	200	-200	150	400

The Compliance Effect

IRS studies have shown that taxpayer compliance is dependent on the government’s ability to verify the amount of income reported by the taxpayer. A mechanism for reporting income to the government is a necessary component of any withholding program. Withholding also facilitates compliance by transferring money directly to the government. This has three effects. First, it insures that taxpayers have sufficient (or at least some) funds to pay their taxes (i.e., it reduces any liquidity constraints on compliance). Second, it requires taxpayers to file a return in order to receive a refund of any excess withholding. In other words, a taxpayer with a \$1,000 liability and no withholding may be tempted to simply avoid filing a return, while the same taxpayer with \$1,500 of withholding will be required to file a return to obtain a refund of the \$500 overpayment. Third, some taxpayers will focus more on the “refund” or “amount you owe” lines of the tax return, as opposed to the total tax liability. These taxpayers may contemplate various noncompliance techniques (understating income, overstating deductions) if the amount due is too high. Withholding will tend to reduce the amount due and may lessen the incentive for noncompliance for some of these taxpayers.

The IRS estimate of 96 percent accuracy in cases of substantial information reporting noted earlier in this report is likely greater than the compliance rate for independent contractors. This is because many types of information reports, such as interest payments reported on Form 1099-INT are generally easily matched to amounts reported on tax returns. This is not the case for gross receipts reported on Form 1099-MISC. As described in Appendix F, FTB matched Form 1099-MISC data to tax return data for taxpayers in FTB’s 2001 PIT (personal income tax) sample. Based on this analysis, FTB estimates the current income reporting compliance rate for independent contractors to be 89 percent.¹⁹ Because payments reported on Form 1099-MISC are a less reliable predictor of taxable income than wages reported on W-2s, it is anticipated that the compliance rate after implementation of withholding will be somewhat less than the 99 percent reported by the IRS for wage withholding.²⁰ Therefore, this revenue estimate assumes that the

¹⁹ This compliance rate includes nonfilers. Appendix I describes in detail how this rate was determined.

²⁰ The IRS studies, based on the TCMP, report a compliance rate of 96 percent for income subject to substantial reporting (such as amounts reported on Forms 1099-MISC, -INT, -DIV). The IRS studies indicate that the compliance rate rises to 99 percent with substantial reporting *and* withholding. Based on discussions with IRS report authors, FTB determined that any revenue estimate incorporating these compliance rates should also include an adjustment for changes in compliance by issuers of Forms 1099. Applying these rates, as adjusted, to the alternate scenario, the revenue impact, in millions of dollars, of a withholding program is estimated to be as follows:

	2005-6	2006-7	2007-8
Compliance Effect	50	200	300
Acceleration Effect	1,300	-100	-550
Total Revenue Impact	1,350	100	-250

implementation of withholding on independent contractors will increase the compliance rate on this income by 6 percent.²¹ The magnitude of the revenue estimate is sensitive to this assumption.

Two additional considerations arise from limiting an independent contractor withholding program to individuals, as in the base scenario. The first is that some payees may alter their form of business (by forming LLCs, partnerships, or corporations) in order to avoid withholding. On the other hand, some payers may erroneously withhold on payments to all independent contractors, including those not subject to withholding. The revenue estimate is sensitive to assumptions about the extent of these two phenomena.²²

The Acceleration Effect

In addition to the compliance effect, there would be an acceleration effect on revenues. Revenue acceleration is simply a timing difference – meaning tax payments are received earlier than they otherwise would have been and any payments in excess of tax liabilities must be refunded. For example, for taxpayers that make insufficient estimated tax payments, withholding would accelerate tax payments to the time the withholding is remitted rather than the time the tax return is filed.

Taxpayers who make adequate estimated tax payments, but fail to reduce these payments at the onset of withholding would have excess prepayments. The excess prepayments would offset future liabilities or be refunded, but the time lag between prepayments and the future payment activity represents an acceleration of revenue. This effect would be reduced when taxpayers reduce their estimated payments. Taxpayers whose withholding is greater than their tax liability would still be overwithheld even if they eliminate all other tax prepayments. To the extent that these taxpayers are not able to make adjustments to their withholding (i.e., via a waiver process discussed later in this report), these taxpayers would continue to be overpaid through withholding and then would receive a refund when they file their return. The revenue estimates above are sensitive to assumptions about the extent to which taxpayers can offset withholding by reducing estimated tax payments or other types of withholding, and to assumptions about how quickly taxpayers implement these offsetting mechanisms.²³

²¹ This behavioral change is assumed to phase in over two years.

²² In this estimate, it is assumed that, when fully phased in, the net effect of these considerations will be to reduce the amount of withholding by 25 percent. A commensurate reduction in the administrative burden imposed by the withholding requirements is not anticipated. This is because service-providers with large gross receipts have greater incentive to change business forms in order to avoid withholding and to inform their service-recipients that they are exempt from withholding. If a few large service-providers restructure to avoid withholding, the revenue impact will be much greater than the change in the number of taxpayers being withheld upon.

²³ The estimates assume that taxpayers who are underwithheld upon will offset 90 percent of their withholding by reducing other prepayments; taxpayers that are overwithheld on will offset 70 percent. It is also assumed that these adjustments take place over a three-year period.

POLICY ANALYSIS

There are a number of different elements that must be considered in designing and implementing an independent contractor withholding program. Each such element presents a question of policy. This section, and those that follow, describes some of the tradeoffs involved for these elements.

Population

Solely for the purpose of comparison, the base scenario involves withholding only for payments to independent contractors who are individuals (i.e., sole proprietors). However, a more likely scenario would also include withholding on payments to other business entities.

There would be certain advantages to extending withholding to *all* independent contractors subject to Form 1099-MISC reporting:

- Additional revenue generation.
- Enhancement of horizontal equity, i.e., independent contractors that are providing similar services should receive similar tax treatment regardless of their organizational form.

On the other hand, as noted in Cost and Revenue Estimates, extending withholding beyond sole proprietor service-providers would generate additional administrative costs for both the government and the private sector. As program administrator, EDD would need to procure or develop new systems to process, capture, and account for withholding associated with payments to non-individual business entities. EDD's current systems are designed solely to process and capture information reporting and wage withholding associated with payments to individual employees. FTB would also encounter limitations in current systems. In addition, costs would increase due to increased volumes throughout the entire process of remitting, reporting, and verifying claimed withholding.

For example, when payments to pass-through entities²⁴ are subject to withholding, the entities must flow any withholding in excess of their own tax liability to their partners, members, shareholders, or beneficiaries. Systems would have to be enhanced or developed in order to handle the allocation of withholding credits to the ultimate taxpayer.

Special rules for "S" corporations create an additional policy dilemma. Because "S" corporations are taxed at both the entity and owner levels, it would need to be determined at which level withholding on payments to the "S" corporation would be applied. Conceptually, it may make sense to institute a higher withholding rate on "S" corporations in order to cover both

²⁴ Pass-through entities include partnerships, limited liability companies (LLCs), "S" corporations, and trusts.

levels of tax.²⁵ Administratively, however, it would be much simpler to apply the withholding only against the tax due at the entity level.

Withholding requirements could also be extended to include *all* service providers, which would include payments to corporations that are currently excluded from Form 1099-MISC reporting. Because of the current absence of any reporting requirements, there is no data from which to reliably estimate the costs and revenue impact of withholding on these other service-providers.

Payee Thresholds

A payee threshold represents the amount that must be made by a business payer to an independent contractor (i.e., the payee) before withholding would be required. In our base scenario, withholding is not required until the payer's total payments for a tax year to a payee reach \$600.

Increasing this threshold would reduce administration and processing costs both for payers and for the government. However, it would require service-recipients to track two thresholds, one for reporting purposes, and another for withholding purposes. Compared to the base scenario, it is estimated that raising the payee threshold to \$1,500 per year would exclude 36 percent of payees from withholding, but would reduce revenues by only 2 percent. Raising the threshold to \$5,000 per year would exclude 66 percent of payees, but reduce revenues by approximately 7 percent.

Under the alternate scenario, raising the threshold to \$1,500 per year would exclude only 2 percent of payees, while reducing revenues by approximately 1 percent. Raising the threshold to \$5,000 per year would exclude 68 percent of payees, but reduce revenues by only about 4 percent.

Raising the payee threshold would reduce those costs that are affected by processing volumes, but would not reduce fixed costs incurred by the government in establishing and running administrative systems. However, as noted above, using different thresholds for withholding and information reporting purposes would likely generate confusion for payers. This confusion would likely lead to errors, which would result in increased costs. The net effect of raising payee thresholds is, therefore, unknown.

Payer Thresholds

The base scenario presented above contemplates withholding by all payers making payments to independent contractors where those payments are subject to reporting. Another policy option would be to provide an exclusion from withholding for payers whose total payments (or some other criteria) are below a specified threshold. This could result in a reduction in processing costs for the excluded payers and for the government. Compared to the base scenario, for example, it is estimated that establishing a payer threshold for aggregate payments to independent contractors of \$10,000 per year would reduce the number of payers required to

²⁵ This treatment would be similar to current treatment of "S" corporation tax credits that may be claimed 1/3 at the entity level and passed through to owners at 100 percent.

withhold by 42 percent, and a \$50,000 threshold would reduce the number by 76 percent. Under the alternate scenario, a threshold of \$10,000 per year would exclude 38 percent of payers required to withhold, and a \$50,000 threshold would reduce the number by 71 percent.

Establishing a payer threshold would result in a reduction of the revenue gains from withholding. Compared to the base scenario, it is estimated that a payer threshold of \$10,000 per year would reduce revenue gains by about 2 percent, and a threshold of \$50,000 would reduce gains by about 10 percent. Under the alternate scenario, a \$10,000 threshold would reduce revenue gains by less than 1 percent and a \$50,000 threshold would reduce gains by about 3 percent.

Various issues arise in defining a payer threshold. If the goal is to minimize burden imposed on businesses that do not spend very much on independent contractors, the threshold should be based on a payer's aggregate payments to independent contractors for each tax year. If the threshold is based on the current year's payments, it may be difficult to predict whether the threshold will be met and, therefore, the payer may not know whether or not to withhold on payments made early in the year. As a result, some payers may unnecessarily withhold or fail to withhold when they should, thereby defeating the purpose of the threshold.

In the alternative, the threshold could be based on the payer's payments to independent contractors for the previous year. This method would allow relative ease of determination of which payers must withhold; but it may not be fair to all payers. For example, some payers who exceed the threshold in the current year may be excluded from withholding, while other payers who do not exceed the threshold in the current year may be denied exclusion, resulting in higher administrative costs for the payer that must withhold. A response to this problem could be to exempt from withholding the first \$10,000 (or some other amount) paid by the payer each year. This would have the affect of reducing the revenue gain from withholding. This method could also create inequities among payees working for the same payer, since payments made early in the year would not be withheld upon, while payments made later, and after the payer threshold is exceeded, would be subject to withholding.

Another alternative would be to establish a threshold based on some criterion other than payments. For example, payers could be exempted from withholding if their gross receipts were below a specified amount. This would also grant exclusion to some payers with large payments to independent contractors, while denying exclusion to some payers with small payments to independent contractors.

For each of the alternatives suggested above, it is likely that there would be confusion by payers over whether and when they are required to withhold. This confusion would result in more contacts with state agencies to explain and enforce the requirements, increasing the cost to government. The complexity of applying threshold levels may also result in an increase in the number of small business owners seeking assistance from legal and accounting professionals, increasing their costs and administrative burden. Furthermore, a payer threshold would also create inequities in the administrative burden faced by otherwise similar payers, depending on who exceeds the threshold for any given year.

Finally, a payer threshold would create uncertainty for payees as to which of their contracts are subject to withholding. This may cause taxpayers to miscalculate their estimated tax payments, which, in turn, would exacerbate overwithholding or result in penalties for underpayment of estimated taxes.

Rates and Overwithholding

One important element in the design of a withholding program is the selection of the withholding rate. To be fair both to the government and to the taxpayer, the amount of withholding should be equal to the tax ultimately due on the payment generating the withholding.²⁶ If withholding rates are too low, the government may not receive all of the revenue to which it is entitled, or may not receive that revenue in a timely fashion. If withholding rates are too high, the government will collect more money than is due; and will eventually refund the overpayments to the taxpayer. From a policy standpoint, overwithholding is undesirable because it amounts to an interest-free loan from taxpayers to the government. The financial hardship imposed on a taxpayer by this loan may be particularly harsh for low income taxpayers.

For the entire population in the base scenario, it is estimated that the tax rate at which the aggregate amount withheld equals the aggregate tax due to be 2.4 percent. It is impossible, however, to choose a single withholding rate that will result in the correct amount of withholding for all taxpayers. This is because the amount of tax due on any particular contractor payment varies with the circumstances of the taxpayer.

One factor that plays an important role in determining the relationship between Form 1099 receipts and tax due is the taxpayer's other sources of income. For example, if an independent contractor has only \$30,000 of income from a consulting business and is filing a joint return including two dependent children, he will not have a California income tax liability.²⁷ However, if the independent contractor's spouse has wage income of \$500,000 in addition to his business income, their total California income will be \$530,000. In this case, the marginal tax rate on the \$30,000 of consulting income will likely be 9.3%.

Another important factor in determining the tax due is the cost structure of the taxpayer's business. Consider two independent contractors each working on a \$30,000 contract. The first contractor may be providing only labor services and, thus, generating \$30,000 in taxable income. The second contractor may have \$25,000 of deductible expenses (for materials, labor, or subcontracted activities). This second contractor will have only \$5,000 in taxable income. Therefore, the second contractor will owe less tax than the first contractor even though the size of their initial contracts is the same.

Taxpayers who owe no tax on their Form 1099-MISC income will be overwithheld at any withholding rate, while taxpayers that owe tax will be underwithheld at any rate less than their marginal tax rate. Because taxpayers have different marginal tax rates, there will be a tradeoff in which raising the withholding rate will reduce the amount of underwithholding and increase the

²⁶ Note that as long as all taxpayers are subject to the same withholding rate, a simple change in the withholding rate should not affect the administrative costs of the withholding program.

²⁷ For these taxpayers, their personal exemption and dependent credits will be greater than the tax on their income.

amount of overwithholding, while lowering the withholding rate will have the opposite two effects.

This table presents estimates of the percentage of payees that will be overwithheld and the aggregate amount of overwithholding.

Withholding Rate /a	Percentage of Taxpayers with Overwithholding (Number of taxpayers with overwithholding divided by total number of taxpayers with withholding)	Percentage of Overwithholding (Amount of gross overwithholding as a percentage of total withholding)
2.40%	72.7%	45.5%
2.25%	71.5%	44.4%
2.00%	69.2%	42.6%
1.75%	66.5%	40.5%
1.50%	63.8%	38.0%
1.25%	60.0%	35.2%
1.00%	55.8%	32.0%
0.75%	49.4%	28.5%
0.50%	43.9%	24.1%

/a The 2.4% withholding rate would yield approximately zero net overwithholding.

The withholding rate of 2.4 percent, at which aggregate withholding equals aggregate tax due, results in 73 percent of the independent contractors being overwithheld by approximately 46 percent. At a withholding rate of 1 percent, 56 percent of the independent contractors would be overwithheld by 32 percent. Looking only at sole proprietors, 25 percent of the Schedule Cs filed with California resident income tax returns reflect a business loss.²⁸ Additionally, an unidentified number of California resident income tax returns contain Schedule Cs with net business income, but do not reflect an income tax liability due to other losses, personal deductions, and exemptions.

The fundamental problem is that business gross receipts are not a good indicator of California state taxable income. A waiver process that would allow for reduced or no withholding would alleviate this problem. However, as discussed below, a waiver process is generally manual and resource intensive.

Waivers

In a perfect world, the amount of money withheld on each taxpayer would exactly equal the amount of tax owed by that taxpayer.²⁹ As noted in the previous section, this equality cannot be achieved if the same withholding rate is applied to all independent contractors. It is possible to

²⁸ Source: 2002 FTB Annual Report, Table 4A

²⁹ There is evidence that in the real world some taxpayers like to be overwithheld upon as a savings tool. Adding flexibility to the withholding regime will bring more taxpayers closer to their preferred amount of overwithholding even for those whose target amount is greater than zero.

design a withholding system that would allow for different withholding rates for different taxpayers. A more flexible system could dramatically reduce levels of both overwithholding and underwithholding. On the other hand, adding flexibility would increase administrative costs, invite noncompliance, reduce revenue acceleration, and raise taxpayer privacy issues.

Adjustability is already a feature of several current withholding programs. For example, wage earners are allowed to adjust their withholding on wages by completing Form W-4.³⁰ On this form, employees adjust their withholding by changing the number of allowances they claim.³¹ Employees can also use this form to request additional withholding. The combination of these two features enables sophisticated taxpayers to specify the exact amount of withholding they desire.

If variable withholding rates were allowed, the default withholding rate could be set substantially higher than the 2 percent rate chosen for the base and alternate scenarios. Setting the default rate higher would reduce the incidence of underwithholding, while the option for taxpayers to apply for a lower withholding rate would reduce the incidence of overwithholding.

The primary revenue impact of variable withholding rates would be reduced revenue attributable to acceleration. This is a natural consequence of reductions in overwithholding. A second possible revenue effect from adding flexibility is that raising the default withholding rate may increase compliance. For example, a higher withholding rate would raise more revenue from taxpayers who, despite withholding, choose not to file returns. On the other hand, a more flexible system may reduce compliance by allowing taxpayers to reduce their withholding amounts inappropriately.

The most important decision that must be made in designing a system to allow variable withholding rates is whether taxpayers will be allowed to self-certify that they qualify for a reduced withholding rate, or whether the government must preapprove the reduction (i.e., grant a request for waiver).

Self-certification would be simpler and less costly than a waiver system. Self-certification would require the independent contractor to provide their service-recipients with a statement that they qualify for reduced withholding and, if necessary, the level of withholding they wish to have. Service-recipients would incur costs collecting this information and adjusting withholding amounts accordingly. In addition to those costs, a waiver would require increased record keeping by the independent contractor and the service-recipient to document the validity of the waiver. A waiver system would also require the government to evaluate and process waiver requests. Depending on the criteria set for obtaining a waiver, this could be a costly and complex process. Furthermore, delays arising from the time taken to apply for and receive a waiver from the government could have adverse impacts on the businesses involved.

³⁰ IRS Form W-4, *Employee's Withholding Allowance Certificate*, or comparable California form.

³¹ Employers are required to submit to the IRS copies of any Form W-4's obtained from their employees that claim: (1) more than 10 withholding allowances, or (2) exemption from withholding, when the usual weekly wages will exceed \$200 per week.

The disadvantage of self-certification is the potential for fraud. Dishonest independent contractors may attempt to falsify the certification to avoid withholding. While penalties for fraud may mitigate this problem, application of such penalties would require complex, costly, and potentially intrusive government enforcement activities.

Another issue in designing a more flexible withholding system is the choice of criteria that will be used for allowing a reduced withholding rate. Some policy options would be easier to administer than others, but the more complex options would likely do a better job of matching withholding rates to tax liabilities.

One potential approach to increasing the flexibility of the withholding system would be to establish different withholding rates for different industries, but require all independent contractors within an industry be subject to the same withholding rate. This approach would be advised only if an independent contractor's industry were a good predictor of the tax due on its contracts. FTB data indicate that this is likely not the case.

A more sophisticated, but more intrusive, policy option would be to base withholding rates on the independent contractor's estimated taxable income. This approach would come much closer to matching withholding to tax due, but would almost certainly require independent contractors to reveal sensitive proprietary business information to their customers.

Another question is whether special criteria should be developed for nonresident independent contractors. California currently allows nonresident independent contractors to self-certify the portion of payments received relating to services performed inside California. Withholding is only required on that portion. This process limits withholding to the portion of the payment that is subject to California tax. If this provision were eliminated, there could be constitutional issues arising from a concern that withholding would be required on income that is not sourced in California.

The most flexible withholding system would allow independent contractors to specify any amount that they want withheld (such as is currently the case for wage withholding). The danger in this approach is that independent contractors will simply choose zero withholding, and eliminate all of the benefits of withholding.

One approach that may enable substantial flexibility while retaining a reasonable level of compliance would be a system of pre-certification of independent contractors by the state. For this approach, the default withholding rate would be set high. The government would maintain a list of "taxpayers in good standing." Independent contractors could apply to the government for a certificate of good standing. Independent contractors with a valid certificate would then be allowed to select their level of withholding. This approach would enable the government to issue certificates only to those independent contractors who are likely to be compliant taxpayers. From the independent contractors perspective, privacy concerns would be eliminated because service-recipients would not know whether the independent contractor provided a certificate for reduced withholding based on questionable business practices or simply because the independent contractor prefers making estimated payments to withholding.

Penalty For Failure To Withhold

Tax administrators use penalties to encourage voluntary compliance by helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not. Penalties also serve to deter noncompliance by imposing costs on it and establish fairness in the tax system by justly penalizing noncompliant taxpayers.

IRS policy is to administer a penalty system that is designed to:

- Ensure consistency
- Ensure accuracy of results in light of the facts and law
- Provide methods for taxpayers to have their interests heard and considered
- Require impartiality and commitment to achieve the correct decisions
- Allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate
- Ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases

These values are reflected in FTB's Principles of Tax Administration statement and administration of the following existing penalties.

Existing Penalties For Failure To Withhold

Under the Nonresident Independent Contractor Withholding program administered by FTB, if service-recipients fail to withhold, they are subject to a penalty equal to the amount of net tax due from the independent contractor, but not in excess of the amount required to be withheld.

Under the Employee Wage Withholding program administered by EDD, the employer is generally liable for the tax that should have been withheld and is assessed a 10 percent penalty. The tax assessed is abated if the employee pays the tax with their individual tax return.

Recommended Penalty For Failure To Withhold

A presumably effective, administrable penalty for failure to withhold on payments to independent contractors would be computed based on some percentage of the amount required to be withheld, regardless of whether the independent contractor files a return and pays the tax. This concept would allow assessment of the penalty almost immediately after a failure to withhold is identified. The proposed penalty:

- Would allow for waiver of the penalty for reasonable cause,
- Would not permit waiver or abatement of the penalty if failure to withhold is due to willful neglect.
- Would be a percentage of the amount required to be withheld that is sufficiently high enough to encourage compliance.
- Would provide for a minimum and maximum so that the minimum penalty is significant, but the maximum is not excessive.

INDUSTRY CONCERNS

As business and individual taxpayers strive to comply with federal, state, and local tax requirements, they expend time, incur costs, and experience frustrations. The U.S. Government Accountability Office (GAO) refers to this time, cost, and frustration as taxpayer compliance burden.

In 1998, the IRS contracted with IBM to develop an improved methodology for measuring and modeling taxpayer burden. A published preliminary assessment indicates that the burden of small business taxpayers (defined as partnership and corporation³² filers that have assets below \$10 million) appears to be greater than that of self-employed or wage-earning taxpayers. Record keeping, which includes the maintenance of files and databases containing transactional information, is the most burdensome activity reported by small business taxpayers.

In a *New York Times* article (January 15, 2004) discussing the NTA's proposal (discussed under Current Environment) to impose independent contractor withholding, Ms. Nancy Joerg, an attorney, and a partner in Wessels & Pautsch of St. Charles, Illinois, is quoted as saying, "imposing additional costs onto independent contractors just to discourage the classification of people as independent contractors is misguided." As an alternative, she suggests, "more employer education" and "more enforcement of existing rules."

Russell A. Hollrah of Hahn Kyle & Hollrah LLP, Washington, writing on behalf of the Private Care Association,³³ has urged Treasury not to support the NTA's proposal to impose income tax withholding on payments made to independent contractors. Mr. Hollrah's letter makes four points:

- The NTA report fails to demonstrate that its withholding proposal would reduce the tax gap. The data the NTA offers, moreover, suggests that a proposal for reducing the tax gap should focus instead on taxpayers other than recipients of Forms 1099-MISC.
- The NTA's withholding proposal would not address the alleged competitive inequities. Mr. Hollrah makes the point that the payee rather than the payer "funds" the withholding through reduced compensation (probably including that "cost" in the billing rate), and the payer does not necessarily enjoy a cost benefit when using an independent contractor rather than an employee.
- The NTA's characterization of independent contractors as an oppressed class of worker unable to financially afford to comply is not accurate. Mr. Hollrah makes the point that economic data indicates that independent contractors are financially able to meet their tax obligations without being withheld upon.
- Imposing withholding would not improve the general inequities facing compliant taxpayers. Mr. Hollrah writes, "There is little equity in imposing a harsh and disruptive

³² Partnership filers are those entities that file IRS Form 1065, *U.S. Return of Partnership Income*. Corporation filers are those entities that file IRS Form 1120, *U.S. Corporation Income Tax Return*.

³³ The Private Care Association is a national association representing nurse registries, also known as home-care referral agencies.

requirement on a largely compliant sector for the sole purpose of increasing the compliance of a few—and especially when the new requirement is unlikely to reach the few who are responsible for the noncompliance.”

Mr. Hollrah also notes that in seeking a waiver from the standard withholding rate, the proposal would require the payee to disclose their gross-profit percentage to their clients. In many cases this is sensitive, and in some cases proprietary, information that the independent contractor would prefer not disclosing to a client.

Balance Consulting, Incorporated, publishes the *Balance Information Reporting Bulletin*. In Volume 12, Number 11, there is a discussion of the NTA’s withholding proposal. The article describes some of the payer compliance burden issues.

- Adding payroll type processing to cash disbursement systems
- Implementing multi-jurisdictional withholding
- Capturing additional data to identify the jurisdiction where tax is due
- Resolution of jurisdictional (nexus) disputes over tax
- Handling remittance of withheld amounts
- Defining which payments are subject to withholding
- Providing for alternative withholding rates and a waiver process
- Payees would need systems to track amounts withheld from their payments

Mr. Dean A. Heyl, Manager of Government Relations of the Direct Selling Association,³⁴ has furnished the FTB with information indicating the Association’s opposition to independent contractor withholding. Mr. Heyl’s correspondence cites the following issues:

- The estimated compliance rate of direct sellers is approximately 95%, in part due to the special reporting requirements instituted in 1982. This direct seller requirement applies to payments over \$600, and purchases greater than \$5,000.
- The proposed withholding would likely result in overwithholding that tends to discourage small-scale entrepreneurship.
- The median annual gross income from direct selling is \$2,420, and the turnover rate of salespeople is more than 100% per year. The administrative costs to the state and the taxpayer compliance burden can hardly be justified for the small amount of additional tax revenue collected through withholding.
- The multilevel form of compensation used to pay direct sellers makes it extremely complicated to determine a withholding base.

Mr. Heyl also notes that Governor Arnold Schwarzenegger has stated, “I want to slash the cost of doing business in California...I want business groups to trumpet the fact that California is once again one of the best places in the country to do business.” *Wall Street Journal*, September 24, 2003.

³⁴ The Direct Selling Association is the national trade association representing companies that sell their products and services by personal presentation and demonstration, usually in the home.

Mr. Heyl goes on to write “Withholding tax on independent contractors runs directly counter to the above statement. California would be the **only** state in the country that would place such an onerous burden on business.”

Crain Communications’ *Investment News*, in its February 16, 2004, issue contained an article discussing the NTA proposal and its potential impact on the approximately 150,000-registered representatives who sell securities as independent brokers affiliated with broker-dealers. That article quoted Dale Brown, chief executive of the Financial Services Institute³⁵ in Atlanta as saying, “But the fact that this is even raised is a concern. It would add substantial cost and burden to independent broker-dealers.” Robert F. Gannon, vice president and director of management services with the Securities Industry Association,³⁶ stated, “This could add significant costs to broker-dealers.” Generally, the securities industry executives contend that a withholding tax would fail to accomplish the NTA’s goal: the collection of missed taxes. They argue that such unpaid taxes are prevalent in industries and jobs that pay cash.

The California Society of Enrolled Agents (CSEA) made a statement concerning this proposal to the FTB on June 10, 2004. Vicki Mulak, Enrolled Agent, speaking on behalf of the CSEA remarked that:

- This proposal is extremely disturbing due to the increased paperwork required,
- The lack of a connection between the rate of withholding and the actual amount of tax due, and
- The dubious prospect of actually reaching the targeted “tax gap” people in California.

The CSEA remarks provide a summary of the issues that are causing widespread opposition to this proposal in the taxpayer community. The underlying concern is that this proposal may result in a system costing compliant taxpayers more tax money to pay for state tax administration, higher compliance costs for compliant taxpayers, and a negligible impact on the tax gap.

³⁵ The Financial Services Institute is a trade group organized to advocate for its members, comprised of independent contractor brokers and financial advisors.

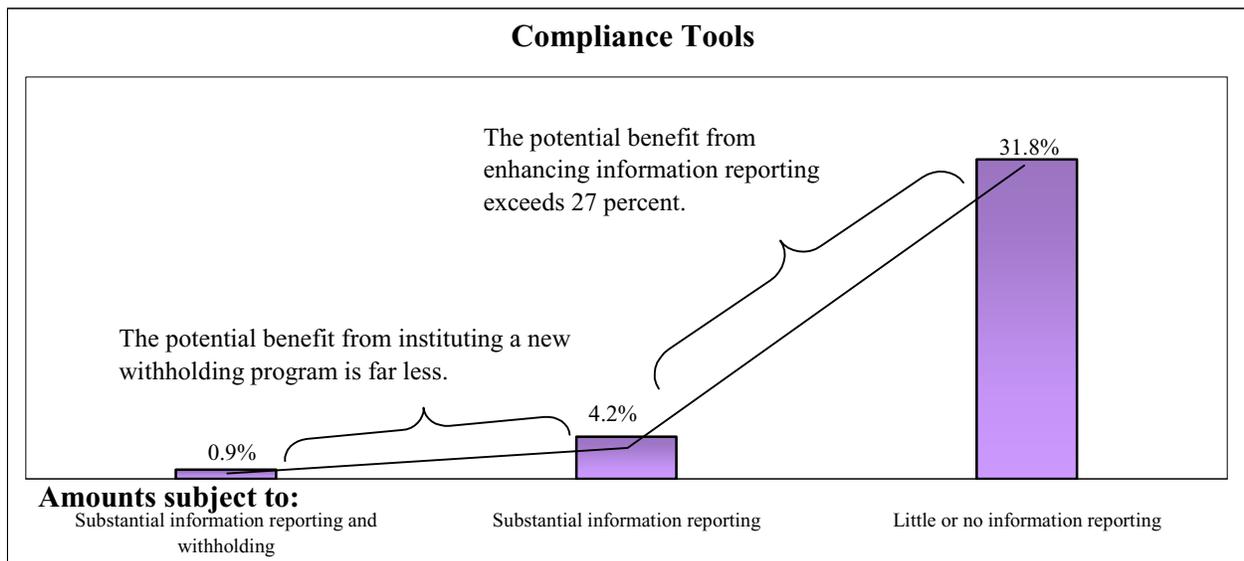
³⁶ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. Member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all domestic and foreign markets and in all phases of corporate and public finance.

ALTERNATIVES TO WITHHOLDING

Withholding on payments is only effective when based on complete, timely, and accurate information. In fact, the IRS studies referred to earlier in this report indicate that substantial third-party information *reporting* of amounts paid, such as Form W-2 and Form 1099, decrease the net misreporting percentage from 32 percent to 4 percent. In comparison, *withholding* on amounts subject to substantial third-party reporting decreases the net misreporting percentage from 4 percent to 1 percent.

The significantly greater impact of reporting compared to withholding leads to the conclusion that expanded reporting could be a more efficient method of closing the tax gap, with potentially lower administrative costs and impact to far fewer service-providers and service-recipients. However, this is not to imply that identifying the specifics of new reporting requirements would be a simple matter when, in fact, the proper identification of new reporting is the greatest barrier to making substantial inroads into the tax gap problem.

The following chart graphically illustrates this significant difference in these two approaches to improving compliance.



Source: IRS (1996).

There are two ways to increase compliance based on information reporting. The first is to enhance compliance with existing reporting requirements, from both a payee and payer perspective. The second, as noted above, is to expand reporting requirements to transactions not currently subject to information reporting (e.g., real estate commissions or payments to general corporations).

There are a variety of methods that may enhance the effectiveness of current information reporting requirements. These methods would require additional study to determine viability,

efficiency, and effectiveness in reducing the tax gap. The following discussion describes some alternatives for improving compliance by enhancing current reporting requirements.

Examine Employer Information Reporting Compliance

A pilot project could be conducted to study the viability of integrating EDD audits of employers and recipients of services provided by independent contractors. The estimated cost for a one-year pilot project to gather information regarding compliance with Form 1099-MISC reporting requirements is approximately \$580,000. Specifically, when EDD auditors conduct employer examinations to determine wage withholding compliance, they could also ascertain whether the employer/service-recipient filed accurate and timely information returns with respect to payments made to properly classified independent contractors. The auditors would review whether Forms 1099-MISC were filed when required, quantify the number of independent contractors involved, the amounts paid to independent contractors, the payment amounts properly reported on Forms 1099-MISC, and the payment amounts not reported. Audit results could be shared with FTB to ensure compliance by service-providers.

PROS:

- The pilot may clarify the percentage of income that is reported by service-providers in instances where Forms 1099-MISC are issued to the percentage of income reported when Forms 1099-MISC are not issued.
- The pilot may identify the level of failure of service-recipients to comply with the Form 1099-MISC reporting requirements.
- The pilot may result in increased compliance (by word of mouth).
- The pilot may allow a determination of whether Form 1099-MISC reporting should be integrated into all employer audits.

CONS:

- EDD's audit program is largely federally funded. If the audit focus were expanded to include an additional state program, the cost of that expansion would have to be borne by the state.
- EDD's audit staffing levels are currently low due to budgetary limitations. Diverting resources to this pilot without additional funding could further reduce audit revenue and compliance.
- Enforcing Form 1099-MISC filing requirements is not directly related to employment tax laws and is not totally consistent with EDD's primary mission of ensuring that workers are afforded the benefits to which they are entitled.
- Some of this data may be available from the IRS.

Study Information Reporting “Stop Filers”

FTB staff is pursuing a study to identify potential information return filer non-compliance by looking at “stop filers” and underreporters. A “stop filer” is a business that previously filed Forms 1099-MISC, but has stopped filing them. The purpose is to determine whether a “stop filer” has dropped out of the reporting system (i.e., failing to comply), or no longer has a filing requirement due to a change in the nature of their business. FTB staff will evaluate the data to determine whether it is sufficient to estimate underreporting by information return filers.

Findings from the study will be used to identify and evaluate further action to improve and enforce information reporting requirements. The target date for completion of the study is June 30, 2005.

PROS:

- The study may identify specific areas of non-compliance with Form 1099-MISC reporting requirements.
- The study may identify specific system enhancements and/or education and outreach solutions that reduce compliance problems.
- The study may result in increased compliance (by word of mouth).

There are no identified downsides to this study.

Other Areas of Possible Study

If the objective of an independent contractor withholding program is scrutinized, more fruitful areas of study may be identified. If the objective is to accelerate revenue, then there may be less costly alternatives that could be investigated. For example, EDD currently collects \$27 billion in income tax withholding. Adjusting the wage withholding tables by less than 5 percent may accelerate \$1+ billion in revenue at a lower cost and spread over a greater number of taxpayers. Also, there is anecdotal evidence that the wage withholding tables seriously under withhold income tax for married taxpayers when both spouses work. Similarly, if the estimated tax payment requirements and penalties do not adequately provide for “pay as you go” treatment for self-employed taxpayers, this issue should be addressed.

Furthermore, the IRS compliance studies cited earlier indicate that the major problem area of underreported income is with cash businesses that are not subject to third-party reporting. A related study³⁷ identifies the five business activities with the lowest reporting rate of income as (1) antique dealers, (2) eating places, (3) grocery stores, (4) used car dealers, and (5) general auto repairs. Focusing compliance efforts on these kinds of business activities may yield higher, long-term returns.

³⁷ GAO Report: *IRS Can Better Pursue Noncompliant Sole Proprietors*, GAO/GGD-94-175.

CONCLUSION

Summary of Findings

California does not currently collect all taxes due under the law, resulting in an estimated annual “tax gap” of \$6.5 billion. The presumed motivation for considering an independent contractor withholding program is the desire to make progress in closing the tax gap. The results of this study indicate that, without regard to the acceleration effect, implementation of such a program (at 2% with no waiver process) could increase independent contractor compliance by about \$300 million by the third year. But, there are policy issues that should be considered. A withholding program would impose substantial costs on California tax administrators, as well as businesses and workers, including those that are already compliant. Furthermore, if California were the only jurisdiction to adopt independent contractor withholding, there would likely be additional costs from a perceived degradation of the California business climate.

Independent contractor withholding would affect a large number of California businesses and workers. FTB records for 2001 indicate approximately 530,000 businesses reported payments to about 2.9 million workers on more than 6.3 million Forms 1099-MISC. For government and for businesses, the costs of a withholding program would include both start-up costs for designing and implementing the processes and systems needed to administer the program and continuing costs for operating these processes and systems. These costs are estimated to be substantial, particularly for the business community. Individuals and entities subject to withholding would incur operational costs to track withholding payments. In addition, for many taxpayers, withholding will exceed their tax liability. These taxpayers will incur the costs of making an interest-free loan to the government.

Revenues raised by an independent contractor program would also have a start-up and a continuing component. When first implemented, many taxpayers will not immediately adjust their other tax prepayments (i.e., estimated tax) to compensate. This will result in a large one-time increase in government revenues. In the years immediately following implementation of withholding, many taxpayers will reduce their other tax prepayments. The combination of decreases in other tax payments and increases in refunds to overwithheld taxpayers would produce a net decrease in state revenues for a year or two after initial implementation. After the first few years, the acceleration effect will become positive again, but will be small relative to the effect from increased compliance levels.

No other jurisdiction currently has a resident independent contractor withholding program. The general business community may view this proposal as an unnecessary additional cost of doing business, unique to California, and detrimental to the state’s business climate.

Another consideration is that there has been opposition to this proposal from the affected business and worker communities, which may foretell future noncompliance. Former Governor Pete Wilson introduced an independent contractor withholding plan in his 1991 budget. It stirred

intense opposition and was apparently dropped when business groups indicated that higher taxes would be preferable to withholding.

Program Design Considerations

There are numerous design issues that must be addressed to implement an independent contractor program, the most critical of which is the specific population of independent contractors to subject to withholding. Withholding only on payments to sole proprietorships would be the simplest to administer, but would generate relatively little revenue. Withholding on payments to all entities subject to Form 1099-MISC reporting would raise more revenue and have a better cost-benefit ratio. However, withholding on payments to pass-through entities would require the design and implementation of complex systems for crediting the appropriate portion withheld amounts to each owner/taxpayer.

Another issue for which there are tradeoffs between conflicting policy goals is the setting of thresholds (for either the payees or payers) below which withholding would not be required. Raising thresholds can remove large numbers of workers or businesses from the withholding program with an insubstantial reduction in estimated revenue. Administering and enforcing effective thresholds may, however, be costly.

Another major design consideration involves the setting of withholding rates. At a rate of 2 percent, almost 70 percent of independent contractors will be overwithheld and more than 40 percent of amounts withheld will be in excess of tax owed. This complication arises because an independent contractor's gross receipts are a poor predictor of taxable income. This problem could be addressed by providing a process (such as a waiver or self-certification) to allow independent contractors to request a reduced withholding rate or exemption from withholding. A fair and effective process would eliminate forced overwithholding. However, adding such flexibility would substantially increase administrative costs, invite abuse through improper requests for exemptions or reduced rates, and dramatically reduce revenue gains from acceleration.

Concluding Remarks

For comparative purposes, this report presents estimates of direct costs and revenue effects for two possible scenarios for an independent contractor withholding program. Particularly under the scenario involving the broader population, revenues raised through increased compliance exceed government costs of implementing the independent contractor withholding program, even though it would be more complex and costly to implement. However, taxpayer burden is estimated to be substantial and these estimates do not include non-quantifiable costs such as the level of financial hardship imposed on taxpayers subject to overwithholding.

Independent contractor withholding would be a more practicable policy for California if the federal government were to adopt it first. On the benefit side, a parallel federal program³⁸ would

³⁸ It is important to note that the independent contractor withholding program proposed by the NTA was designed to increase compliance and collections of self-employment, rather than income, taxes. California has no comparable self-employment tax. Therefore, the federal objective has no relevance for California.

likely increase revenues by raising awareness of withholding requirements and, therefore, compliance levels. Also, information sharing from federal audit activities related to withholding would likely facilitate California enforcement. More importantly, federal withholding would require the private sector to develop systems and processes for administering withholding. The additional cost to enhance these systems to enable state withholding would be substantially less than would establishing and administering stand-alone systems. With lower costs and higher revenues, the cost-benefit ratio for a state withholding program would be much more favorable if the federal government adopted withholding. In addition, the presence of a federal program would dampen complaints that California is creating an unfriendly business climate.

However, as noted earlier, IRS Commissioner Mark Everson recently said he favors strengthening IRS enforcement to deal with the compliance problem over mandatory withholding on nonwage payments because of the burden withholding places on businesses. Mr. Everson indicated that a new research initiative to study taxpayer behavior is under way, the results of which should be available in early 2005, and agreed to report to the Senate Finance Committee by the end of March 2005 on ways to deal with cash business noncompliance and the size of the tax gap. It may be prudent to wait for these results before initiating a new, complex, and controversial program.

APPENDIX A

Legislative Request For Study

Excerpt from:

**SUPPLEMENTAL REPORT OF THE 2004 BUDGET ACT
2004-05 FISCAL YEAR
Containing Statements Of Intent For Requests For Studies Adopted By The Legislature
Compiled by the Legislative Analyst's Office July 2004**

State and Consumer Services

Item 1730-001-0001—Franchise Tax Board

1. ***Independent Contractor Withholding.*** The Franchise Tax Board, in consultation with the Employment Development Department and the Legislative Analyst's Office, shall provide to the Chair of the Joint Legislative Budget Committee and the chairs of the fiscal committees of both houses of the Legislature, a report on withholding on payments to independent contractors including all employees that file a Form 1099. The report shall consist of a detailed description of procedures and processes involved in payment withholding, and address the various administrative and policy issues associated with state adoption of such a program, including the agency that would administer the program. The report shall include, but not be limited to, analysis regarding: (1) withholding rates, (2) threshold levels, (3) overwithholding issues, (4) penalties associated with failure to withhold, (5) waiver processes, (6) types of businesses and workers that would be affected, (7) estimated revenues due to compliance and acceleration, and (8) withholding policies in other states and by the federal government. The report is to be submitted to the Legislature by October 1, 2004, and a copy provided to the Department of Finance.

APPENDIX B

IRS Form 1099-MISC, Miscellaneous Income

If a service-recipient makes certain payments in the course of their trade or business, the service-recipient must generally file IRS Form 1099-MISC for each payee. Payments made for personal purposes or payments for goods³⁹ are not required to be reported. With certain exceptions, service-recipients do not have to report payments to corporate payees.

9595 VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no. \$ _____		1 Rents \$ _____	OMB No. 1545-0115 2004 Form 1099-MISC	Miscellaneous Income
		2 Royalties \$ _____		
		3 Other income \$ _____		
PAYER'S Federal identification number _____	RECIPIENT'S identification number _____	4 Federal income tax withheld \$ _____	5 Fishing boat proceeds \$ _____	6 Medical and health care payments \$ _____
RECIPIENT'S name _____		7 Nonemployee compensation \$ _____	8 Substitute payments in lieu of dividends or interest \$ _____	Copy A For Internal Revenue Service Center File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2004 General Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.) _____		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>	10 Crop insurance proceeds \$ _____	
City, state, and ZIP code _____		11 _____	12 _____	
Account number (optional) _____	2nd TIN not <input type="checkbox"/>	13 Excess golden parachute payments \$ _____	14 Gross proceeds paid to an attorney \$ _____	
15 _____		16 State tax withheld \$ _____	17 State/Payer's state no. _____	18 State income \$ _____

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service
Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

Box 7 – Nonemployee Compensation

Payments to independent contractors are generally reported in box 7 of the 1099-MISC. Box 7 includes payments for nonemployee compensation of \$600 or more. As described in the instructions to Form 1099-MISC, a payer must generally report a payment as nonemployee compensation if the payer:

- Made the payment to someone who is not the payer's employee;
- Made the payment for services in the course of the payer's trade or business (including government agencies and nonprofit organizations);
- Made the payment to an individual, partnership, estate, or, in some cases, a corporation; and
- Made payments to the payee of at least \$600 during the year.

³⁹ However, payment for services required to be reported in box 7 of Form 1099-MISC includes payment for parts or materials used to perform the services if supplying the parts or materials was incidental to providing the service.

Nonemployee compensation includes the following types of payments:

- Fees, commissions, prizes, and awards for services performed as a nonemployee.
- Professional service fees, such as fees to attorneys (including corporations), accountants, architects, contractors, subcontractors, etc.
- Fees paid by one professional to another, such as fee-splitting or referral fees.
- Payments by attorneys to witnesses or experts in legal adjudication.
- Payment for services, including payment for parts or materials used to perform the services if supplying the parts or materials was incidental to providing the service.
- Commissions paid to nonemployee salespersons that are subject to repayment but not repaid during the calendar year.
- Fees of at least \$600 paid to a nonemployee, including an independent contractor, or travel reimbursement for which the nonemployee did not account to the payer.
- Payments to nonemployee entertainers for services.
- Other forms of compensation for services performed in the payer's trade or business by an individual who is not the payer's employee.
- Fish purchases for cash.
- Oil and gas payments for a working interest.
- Federal executive agencies that make payments to vendors for services, including payments to corporations.
- Directors' fees.
- Exchanges of services.
- Taxable fringe benefits for nonemployees.
- Payments to an insurance salesperson who is not a common law or statutory employee.
- Commissions paid to licensed lottery ticket sales agents.
- Payments to section 530 workers.⁴⁰
- Golden parachute payments.

Box 6 – Medical and Health Care Payments

Payments of \$600 or more made to each physician or other supplier or provider of medical or health care services in the course of a payer's trade or business are reported in box 6 of Form 1099-MISC. Payments made by insurers under health, accident, and sickness insurance programs are included.

If payments for services include charges for injections, drugs, dentures, and similar items, the entire payment amount is subject to information reporting. This reporting requirement does not include payments to pharmacies for prescription drugs. The general exemption from reporting payments to corporate service providers does not apply to medical and health care services. However, a payee is not required to report payments to a tax-exempt or government run hospital or extended care facility.

⁴⁰ Section 530 of the Revenue Act of 1978 as extended by section 269(c) of P.L. 97-248, deals with the employment tax status of independent contractors and employees. To qualify for relief under section 530, employers must file Form 1099-MISC. Special rules may apply to certain skilled workers, such as engineers, designers, drafters, computer programmers, and systems analysts.

APPENDIX C

Independent Contractor Withholding In Other States

Arkansas can require, by regulation, that the tax be withheld on payments subject to information returns. Withholding has not been required. Staff indicates the department's focus is on correctly classifying service providers as employees or independent contractors.

Connecticut requires 5 percent withholding when payments to nonresident independent contractors that are professional athletes or entertainers exceed \$1,000.

Iowa requires 5 percent withholding on nonwage payments⁴¹ to nonresidents. Those who prefer to make an estimate payment file a *Nonresident Request for Release from Withholding* form.

Kansas requires withholding of 5 percent on payments to nonresident independent contractors that provide management or other consulting services.

Louisiana provides the Secretary of Revenue with the authority to require withholding on payments of income to taxpayers, but the Secretary does not utilize this authority.

Maryland requires withholding 3 percent of the contract price for real property improvements exceeding \$500,000 made with a nonresident general contractor. This requirement does not extend to owner-occupied residential property.

Minnesota requires 2 percent withholding on payments made to nonresident entertainers. Withholding is also required on payments to nonresidents performing construction work in Minnesota. The Department of Revenue recently published a study of the Minnesota individual income tax gap for the 1999 tax year. The results confirm that underreported income and overreported deductions account for 79 percent of the individual income tax gap. Nonfilers and nonpayers caused the balance of the gap. Ninety percent of taxes owed were voluntarily paid.

West Virginia requires up to 6 percent withholding on payments to nonresident contractors subject to the corporate net income tax to sufficiently cover taxes until certification of taxes paid is received. Failure to withhold subjects the service-recipient to personal liability for up to 6 percent of the contract price if the contractor does not pay the taxes.

Wisconsin requires nonresident athletes and entertainers performing in Wisconsin for fees of \$3,200 or more to post surety bonds or make deposits equivalent to 6 percent of the anticipated fee with the Department of Revenue to ensure payment of Wisconsin taxes. The service-recipient is responsible for ensuring compliance with this requirement and must withhold 6 percent of the payment if the entertainer or athlete does not meet the requirements. Failure to comply will result in the personal liability of the service-recipient.

⁴¹ Entertainer compensation, rental payments for Iowa property, Iowa-source income from partnerships or "S" corporations, and fees paid for services performed in Iowa.

APPENDIX D
Estimated One-Time Costs

	Base Scenario		Alternate Scenario	
	PYs	Cost	PYs	Cost
EDD Program Area/Cost Item				
Tax Program Personal Services & Benefits				
Processing & Accounting	34.5	1,984,000	37.1	2,115,000
Enforcement	4.0	372,000	4.0	372,000
Taxpayer Assistance and Education	25.7	1,368,000	29.2	1,549,000
Core Project Team	7.0	638,000	7.0	639,000
Operating Expenses & Equipment		3,692,000		3,892,000
Mass Mail, Outreach & Forms		762,000		763,000
Tax Branch Subtotal	71.2	\$8,816,000	77.3	\$9,330,000
IT Personal Services & Benefits	37.7	3,767,000	37.7	3,767,000
Operating Expenses & Equipment		4,943,000		4,943,000
IT Subtotal	37.7	\$8,710,000	37.7	\$8,710,000
Total EDD One-Time Costs	108.9	\$17,526,000	115.0	\$18,040,000
FTB Program Area/Cost Item				
Tax Program Personal Services & Benefits				
Processing	1.0	46,000	1.0	46,000
Taxpayer Assistance and Education	0.4	55,000	0.7	93,000
Program Support	0.2	35,000	0.2	35,000
Operating Expenses & Equipment		488,000		1,021,000
Tax Program Subtotal	1.6	\$624,000	1.9	\$1,195,000
IT Personal Services & Benefits	3.5	290,000	20.0	1,648,000
Operating Expenses & Equipment				68,000
IT Subtotal	3.5	\$290,000	20.0	\$1,716,000
Total FTB One-Time Costs	5.1	\$914,000	21.9	\$2,911,000
Total EDD and FTB One-Time Costs	114.0	\$18,440,000	136.9	\$20,951,000

APPENDIX E

Estimated Continuing Costs

	Base Scenario		Alternate Scenario	
	PYs	Cost	PYs	Cost
EDD Program Area/Cost Item				
Tax Program Personal Services & Benefits				
Processing & Accounting	62.7	3,505,000	67.5	3,782,000
Enforcement	85.2	6,666,000	88.2	6,870,000
Taxpayer Assistance and Education	19.3	1,011,000	21.8	1,141,000
Operating Expenses & Equipment		2,155,000		2,263,000
Tax Branch Subtotal	167.2	\$13,337,000	177.5	\$14,056,000
IT Personal Services & Benefits	5.5	346,000	5.2	346,000
Operating Expenses & Equipment		75,000		75,000
IT Subtotal	5.5	\$421,000	5.2	\$421,000
Total EDD Continuing Costs	172.7	\$13,758,000	182.7	\$14,477,000
FTB Program Area/Cost Item				
Tax Program Personal Services & Benefits				
Processing	34.0	1,590,000	110.5	5,129,000
Taxpayer Assistance and Education	0.1	13,000	0.4	55,000
Program Support	3.5	271,000	15.5	822,000
Collections	3.0	145,000	6.0	290,000
Operating Expenses & Equipment		90,000		238,000
Tax Program Subtotal	40.6	\$2,109,000	132.4	\$6,534,000
IT Personal Services & Benefits	2.0	172,000	10.0	808,000
Operating Expenses & Equipment		0		33,000
IT Subtotal	2.0	\$172,000	10.0	\$841,000
Total FTB Continuing Costs	42.6	\$2,281,000	142.4	\$7,375,000
Total EDD and FTB Continuing Costs	215.3	\$16,039,000	325.1	\$21,852,000

APPENDIX F

Population Description For Cost And Revenue Estimation

Independent contractor withholding would affect millions of Californians. FTB records indicate that in 2001, more than 3 million California taxpayers received at least one Form 1099-MISC with payments reported in either box 6 or box 7. This section will describe some characteristics of this population in more detail.

For this analysis, FTB matched Form 1099-MISC records to other taxpayer records found on the FTB's PIT sample.⁴² These records could only be matched for independent contractors that are sole proprietorships. The data presented in the following tables is, therefore, directly applicable only to sole proprietorships. In many cases, the results are likely to be indicative of characteristics of all independent contractors. For example, since sole proprietorships account for approximately 90 percent of the number of unique taxpayers receiving Form 1099-MISC (with entries in box 6 or 7), the distribution of contractors across industries must be almost the same for all contractors as it is for those who are sole proprietorships. On the other hand, since sole proprietorships account for just under half of all gross receipts reported on Form 1099-MISC, income statistics for sole proprietorships may be a less accurate predictor of income statistics for all independent contractors.

Adjusted Gross Income Class

One important factor for determining the appropriate amount of withholding on an independent contractor is the contractor's marginal tax rate. The marginal tax rate is a function of the contractor's taxable income; those with lower taxable income will owe less tax on the same amount of gross receipts than will those with higher taxable income. Table 1 compares the distribution of Form 1099-MISC recipients to the distribution of all California taxpayers by adjusted gross income (AGI) class. Independent contractor incomes span the entire range from less than zero to more than \$5 million. Compared to all California taxpayers, the percentage of independent contractors with AGI between zero and \$50,000 is smaller and the percentage of independent contractors with AGI either less than zero or greater than \$50,000 is larger.

⁴² This is data gathered from a stratified random sample of personal income tax returns filed for each tax year. Sample selection is based on a combination of criteria, including both state and federal adjusted gross income and the relative magnitude of California adjustment items. Information was collected from 80,702 resident returns for the 2001 tax year.

Table 1			
Adjusted Gross Income ¹ (\$)	All California Taxpayers	1099 Recipients	Amount of 1099 Receipts
Less than 0	1.0%	2.1%	1.8%
0 to 20,000	33.1%	23.0%	12.9%
20,000 to 50,000	34.0%	29.9%	19.6%
50,000 to 100,000	20.9%	25.3%	24.3%
100,000 to 500,000	10.4%	18.7%	34.8%
500,000 to 1,000,000	0.4%	0.7%	3.5%
1,000,000 to 5,000,000	0.2%	0.3%	2.4%
over 5,000,000	*	*	0.7%

* less than 0.05 %

¹ The data in this table are for the 2001 tax year.

Expenses

As described elsewhere in this report, the amount of expenses incurred by a service-provider is a critical determinant of the appropriate amount of withholding to be collected on the provider's gross receipts. Based on Schedule C data available in the PIT sample, FTB calculated the ratio of expenses to gross receipts for the independent contractors in the matched sample described above. Table 2 presents the distribution of these expense ratios.

Table 2		
Ratio of Expenses to Receipts	Number of Taxpayers	Amount of 1099 Receipts
Zero	7.0%	3.5%
0 to 25%	14.0%	19.1%
25% to 50%	19.0%	22.2%
50% to 75%	22.8%	26.1%
75% to 100%	20.5%	22.8%
100%	1.2%	0.8%
over 100%	15.5%	5.5%

California independent contractors exhibit a wide range of expense ratios. Seven percent report no expenses to offset their Form 1099 income. It would be appropriate to withhold on these businesses at their marginal tax rate (which could be as high as 9.3 percent). At the other end of the spectrum, our data indicate that 17 percent of contractors are realizing either negative or zero income on their gross receipts and, hence, should not be withheld upon at all.

Marginal Tax Rates

For Tables 3 and 4, this analysis is extended by combining the information on AGI and expense ratios to calculate marginal tax rates for each independent contractor in the sample. For Table 3, the marginal tax rate is calculated as a percentage of gross receipts. In Table 4, marginal tax rates are presented as a percent of profits (gross receipts minus expenses). For each taxpayer, the marginal tax rate on profits must be greater than or equal to the marginal tax rate on gross receipts. For taxpayers with large expense ratios, the difference can be substantial. Comparing Tables 3 and 4, the percentage of taxpayers with a marginal tax rate on profits greater than 9 percent (21 percent of taxpayers) is greater than the percentage of taxpayers (19.2 percent) with a marginal tax rate on receipts greater than 4 percent. This confirms the observation made in the main text that gross receipts are a poor predictor of taxable income.

Table 3		
Marginal Tax Rate on Gross Receipts	Number of Taxpayers	Amount of 1099 Receipts
Negative	15.4%	5.5%
zero	29.9%	22.3%
>0, <1	13.2%	19.8%
>=1, <2	8.8%	8.6%
>=2, <3	7.0%	9.2%
>=3, <4	6.6%	8.1%
>=4, <5	4.6%	7.0%
>=5, <6	4.5%	5.3%
>=6, <7	3.6%	4.6%
>=7, <8	2.3%	4.2%
>=8, <9	2.2%	3.3%
>=9, <=9.3	2.0%	2.0%
Total	100.0%	100.0%

Table 4		
Marginal Tax Rate on Profits	Number of Taxpayers	Amount of 1099 Receipts
zero	29.9%	22.2%
>0, <1	2.8%	6.1%
>=1, <2	7.6%	7.9%
>=2, <3	5.7%	4.1%
>=3, <4	2.2%	5.5%
>=4, <5	9.5%	7.0%
>=5, <6	2.1%	5.4%
>=6, <7	9.6%	6.9%
>=7, <8	2.5%	4.8%
>=8, <9	7.3%	7.6%
>=9, <=9.3	21.0%	22.4%
Total	100.0%	100.0%

Industries

Table 5 presents a breakdown of Form 1099-MISC data by industry. Independent contractors are widely dispersed throughout the California economy. The industries with the most independent contractors are professional services and other services. The most Form 1099-MISC receipts are generated by professional services and construction.

Table 5		
Industry	Percent of Taxpayers	Percent of Receipts
Agriculture, mining, and utilities	0.7%	0.9%
Construction	8.8%	11.4%
Manufacturing	1.6%	1.0%
Trade	7.8%	8.3%
Transportation and warehousing	2.9%	3.9%
Information	2.7%	2.3%
Finance and insurance	3.7%	8.2%
Real estate agents	4.6%	9.6%
Other real estate	2.4%	3.6%
Lawyers and accountants	5.2%	4.7%
Professional services	16.4%	18.0%
Administrative, support, waste management, and remediation services	3.8%	1.9%
Educational services	1.5%	0.4%
Health care	6.7%	8.0%
Social assistance services	4.5%	2.4%
Arts, entertainment, and recreation	6.3%	2.6%
Accommodation and food services	0.6%	0.3%
Other services	10.4%	6.1%
Unknown	9.6%	6.3%

APPENDIX G

Taxpayer Identification Numbers For Form 1099-MISC

The IRS allows service-recipients to use either a sole proprietor's FEIN or SSN when reporting payments made to the sole proprietor on Form 1099-MISC. Service-recipients are instructed to use federal Form W-9, *Request for Taxpayer Identification Number and Certification*, to request a service-provider's taxpayer identification number (TIN). A sole proprietor may provide their FEIN or SSN, although the Form W-9 instructions state that IRS prefers the SSN.

Form W-9 (Rev. January 2003) Department of the Treasury Internal Revenue Service	Request for Taxpayer Identification Number and Certification	Give form to the requester. Do not send to the IRS.		
Print or type See Specific Instructions on page 2.	Name			
	Business name, if different from above			
	Check appropriate box: <input type="checkbox"/> Individual/Sole proprietor <input type="checkbox"/> Corporation <input type="checkbox"/> Partnership <input type="checkbox"/> Other ▶ <input type="checkbox"/> Exempt from backup withholding			
	Address (number, street, and apt. or suite no.)	Requester's name and address (optional)		
	City, state, and ZIP code			
List account number(s) here (optional)				
Part I Taxpayer Identification Number (TIN)				
Enter your TIN in the appropriate box. For individuals, this is your social security number (SSN). However, for a resident alien, sole proprietor, or disregarded entity, see the Part I instructions on page 3. For other entities, it is your employer identification number (EIN). If you do not have a number, see How to get a TIN on page 3.				
		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: center; font-size: small;">Social security number</td> </tr> <tr> <td style="text-align: center;"> </td> </tr> </table>	Social security number	
Social security number				
		<p style="text-align: center; font-size: small;">or</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: center; font-size: small;">Employer identification number</td> </tr> <tr> <td style="text-align: center;"> </td> </tr> </table>	Employer identification number	
Employer identification number				

In general, California follows federal law for Form 1099-MISC reporting, and the federal forms (and federal record layout for magnetic media and Internet files) are used for information reporting to FTB. In general, the TIN used for information reporting to IRS is accepted by FTB. However, California state agencies are required to use Std. 204 to request a service-provider's TIN and the service-provider must provide a correct TIN in order to do business with the State of California. Instructions to Std. 204 state that the TIN for individual and sole proprietors is their SSN.

PAYEE DATA RECORD(Required when receiving payment from the State of California in lieu of IRS W-9)
STD. 204 (Rev. 3-2003)

1	INSTRUCTIONS: Complete all information on this form. Sign, date, and return to the State agency (department/office) address shown at the bottom of this page. Prompt return of this fully completed form will prevent delays when processing payments. Information provided in this form will be used by State agencies to prepare Information Returns (1099). See reverse side for more information and Privacy Statement. NOTE: Governmental entities, federal, State, and local (including school districts), <u>are</u> not required to submit this form.							
2	PAYEE'S LEGAL BUSINESS NAME (Type or Print) <hr/> <table border="0" style="width: 100%;"> <tr> <td style="width: 60%;">SOLE PROPRIETOR – ENTER NAME AS SHOWN ON SSN (Last, First, M.I.)</td> <td style="width: 40%;">E-MAIL ADDRESS</td> </tr> <tr> <td>MAILING ADDRESS</td> <td>BUSINESS ADDRESS</td> </tr> <tr> <td>CITY, STATE, ZIP CODE</td> <td>CITY, STATE, ZIP CODE</td> </tr> </table>		SOLE PROPRIETOR – ENTER NAME AS SHOWN ON SSN (Last, First, M.I.)	E-MAIL ADDRESS	MAILING ADDRESS	BUSINESS ADDRESS	CITY, STATE, ZIP CODE	CITY, STATE, ZIP CODE
SOLE PROPRIETOR – ENTER NAME AS SHOWN ON SSN (Last, First, M.I.)	E-MAIL ADDRESS							
MAILING ADDRESS	BUSINESS ADDRESS							
CITY, STATE, ZIP CODE	CITY, STATE, ZIP CODE							
3	ENTER FEDERAL EMPLOYER IDENTIFICATION NUMBER (FEIN): <input type="text"/> - <input type="text"/>	NOTE: Payment will not be processed without an accompanying taxpayer I.D. number.						
PAYEE ENTITY TYPE CHECK ONE BOX ONLY	<input type="checkbox"/> PARTNERSHIP <input type="checkbox"/> ESTATE OR TRUST CORPORATION: <input type="checkbox"/> MEDICAL (e.g., dentistry, psychotherapy, chiropractic, etc.) <input type="checkbox"/> LEGAL (e.g., attorney services) <input type="checkbox"/> EXEMPT (nonprofit) <input type="checkbox"/> ALL OTHERS							
	<input type="checkbox"/> INDIVIDUAL OR SOLE PROPRIETOR ENTER SOCIAL SECURITY NUMBER: <input type="text"/> - <input type="text"/> <input type="text"/> - <input type="text"/> <p style="text-align: center; font-size: small;">(SSN required by authority of California Revenue and Tax Code Section 18646)</p>							
4	PAYEE RESIDENCY STATUS <input type="checkbox"/> California resident - Qualified to do business in CA or maintains a permanent place of business in CA. <input type="checkbox"/> California nonresident (see reverse side) - Payments to nonresidents for services may be subject to State income tax withholding. <ul style="list-style-type: none"> <input type="checkbox"/> No services performed in California. <input type="checkbox"/> Copy of Franchise Tax Board waiver of State withholding attached. 							

For the EDD Independent Contractor Reporting program, service recipients may use a W-9 when requesting the service-provider's SSN. If the service-provider does not provide an SSN, EDD will make a follow-up request. However, if the SSN is not provided, zeros are entered into the system in the SSN field.

An excerpt from questions and answers on the EDD website discusses the TIN requirement for the Independent Contractor Reporting program:

- Q17. My service-providers have federal employer identification numbers (FEINs) and business names. How do I determine if they are sole proprietors? Can I report their FEINs instead of their social security numbers (SSNs)?
- A17. By statute, you are required to obtain the first name, last name, and SSN of any service-providers that are sole proprietors. The federal [Form W-9](#)* was recently revised and now requires sole proprietors to list their first and last names. You may want your service-providers to complete new Forms W-9. If the SSN is still not known after reviewing the W-9, ask the service-provider for the SSN. If the service-provider does not provide it, fill out the SSN box with zeroes (000000000).

*Form W-9 is available in Adobe Portable Document Format (PDF). You need [Adobe Acrobat Reader](#) to view/print this form.

APPENDIX H

Spidell Publishing, Inc.'s Estimates of Private Sector Costs⁴³

Estimated cost to business that
must withhold on independent contractors

Cost to administer if business does the work themselves

Assumptions:

- Business has in-house staff to calculate the withholding, write the check, complete the form, and mail the payment to the FTB.
- In-house staff has an hourly wage of \$15. With additional employer costs (taxes, workers compensation, medical insurance, pension plan) the net cost is \$18 per hour.
- This \$15/hour employee-position will turn over one time per year.
- Business has two monthly independent contractors (such as cleaning service, gardener, computer tech) and 8 other (annual) independent contractor/vendor payments. (tax/accounting professional, attorney, consultants, plumber, electrician, etc.) that will be subject to withholding. I believe this is probably on the very low end but will make a point.

Annual costs of independent contractor withholding:

1.	Time to calculate withholding and log the amount to be paid at a later date	5 min. per payment (32)	\$ 48
2.	Time to compute payment, prepare voucher, and write check for state	30 minutes per month	\$108
3.	Time to compute and balance payments at year end for inclusion into Form 1099	2 hour	\$ 36
4.	Time to prepare state copies of Forms 1099	1 hour +10 min. per 1099 (10)	\$48
5.	Cost of postage/envelopes/forms		\$50
6.	Time to train staff member each year	1 hour	\$ 18
7.	One hour of manager or accountant time for training		<u>\$ 50</u>
	Total annual cost		\$358

⁴³ Printed with permission of Lynn Freer, President, Spidell Publishing, Inc.

Cost if the business uses services of an accounting/tax firm

The estimate is a low-end estimate, assuming about a \$100 per hour billing rate (an average ranging from \$60 to \$175 per hour). I spoke to several tax and accounting professionals and they generally don't want to perform this kind of work. While some may charge less as a "favor" to the clients, of the 15 CPAs and EAs I spoke to, 5 said they would not do it at all (would require the business to do it themselves), 2 said they would discount their fee to help the client, and 8 said they would their regular billing rate.

Item 1 remains the same	\$ 48
Item 2 (\$50/ month)	\$600
Item 3	\$200
Item 4 (\$10 per state 1099)	\$100
Item 5	\$ 1
Item 6 remains the same	\$ 18
Item 7 (\$100/hour to accountant rather than manager)	<u>\$150</u>
Total cost	\$1,117

Loss in reported revenue

Although I cannot predict the amount of unreported revenue that adding this requirement would generate, I can say, however, that small businesses will find ways around this requirement and reduce state tax collected by:

1. Paying independent contractors in cash rather than by check. This will be done by keeping cash out of the bank and using it to pay independent contractors. That way the business person feels that he or she is not cheating the government. He or she is using unreported income to pay nondeductible expenses.
2. Using schemes to avoid the withholding (and possibly reporting requirements) by writing checks to multiple individuals for jobs done. For example, rather than writing the check to Joe for cleaning service, writing one check to Joe, one to his wife, and one to his son (all of whom clean) so that the total is below the requirements of filing 1099s. In this manner the income will not be subject to withholding or reporting.

Bad policy

In conclusion, requiring withholding from independent contractors is a bad decision. It will:

- Create more work and less productivity from business
- Discriminate in favor of corporations by requiring withholding from self-employed business people but not in-state corporations

- Discriminate in favor of big business, which is better able to put an efficient system in place to handle this additional burden. The cost to administer for a small business will be proportionately higher.
- Discourage businesses from coming to California
- Encourage noncompliance.

Alternate solution:

Currently independent contractor information is reported monthly to the EDD. A better way to find and track nonfiling independent contractors would be to actively use the independent contractor information filed on Forms DE 542 in FTB's nonfiling program on a regular basis.

In short, independent contractor withholding will be an additional burden to small business and encourage more people to work under the table; thus reducing compliance.

Sincerely,



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APPENDIX I

FTB Estimate of Compliance Rate

In order to estimate the impact on state revenues of requiring withholding on payments made to independent contractors, it was necessary to develop an estimate of noncompliance for independent contractors. A paper prepared by Alan Plumley of the Internal Revenue Service contained the best estimate of compliance. This report contained a table that compared the relative level of compliance for various types of income. The table showed that income subject to both information reporting and withholding had a very high compliance rate. Income on which there was only information reporting had a slightly lower compliance rate, while income with little or no information reporting requirement had a significantly lower compliance rate.

While these findings could be used to assign a compliance rate to the reporting of independent contractor gross income, they suffer from two potential weaknesses. First, these statistics are based on IRS studies from the late 1980s. Second, and more important, there are no statistics relating specifically to income earned by independent contractors. In the IRS study, the compliance rate for substantial reporting (94 percent) includes interest and dividends reported on Forms 1099-INT and 1099-DIV, respectively, in addition to amounts reported on Form 1099-MISC. Interest and dividends must be reported on specific lines on federal Form 1040.⁴⁴ The amount reported on Form 1099-MISC may be reported in various places on the return, but only rarely on the front of Form 1040. These differences make the income reported on the Form 1099-MISC more difficult to track using simple matching of data files. As such, it is likely that at least some taxpayers would be aware of this greater difficulty, and, therefore, would conclude that they could get away with non-reporting or underreporting of the Form 1099-MISC income. This suggests that the compliance rate for Form 1099-MISC income is likely less than that for all income with information reporting requirements.

FTB staff developed an estimate of Form 1099-MISC reporting compliance based on the population of 2001 Form 1099-MISC returns. Since this report centers on payments for health care and nonemployee compensation reported on Form 1099-MISC, the focus was restricted to those Forms 1099-MISC that had non-zero amounts in boxes 6 and 7. Staff first identified the Forms 1099-MISC in which the individual payee could be matched with a record from FTB's Integrated Nonfiler Compliance reference file⁴⁵. The first attempt, using very strict matching criteria, resulted in 2 million unique Form 1099-MISC payees, accounting for \$47.6 billion in Form 1099-MISC payments. Using less strict matching criteria, staff located payees representing an additional \$24.5 billion in payments. Finally, staff estimated that Form 1099s representing \$2.2 billion in payments were sent to payees who are individuals, but who are not on our database of individual taxpayers. Thus, it is estimated that Forms 1099-MISC issued to individuals accounted for \$74.3 billion in payments. Staff used different

⁴⁴ These amounts are generally itemized on federal Schedule B, *Interest and Ordinary Dividends*, the totals of which are carried to Page 1 of the Form 1040.

⁴⁵ This file contains information on all taxpayers who have filed an individual tax return (i.e., Form 540) since 1999, or has been identified through filing enforcement efforts.

methodologies for estimating compliance rate for the three groups (i.e., those Forms 1099-MISC that were matched using the strict criteria, those matched using the less strict criteria, and those that were not able to be matched at all).

For the first group, staff focused initially on those who filed a timely 2001 tax return.⁴⁶ There were 1.4 million such taxpayers with Form 1099-MISC payments of \$32.8 billion. Form 1099-MISC records for these taxpayers were matched with data from FTB's 2001 PIT sample. This is a stratified random sample of about 100,000 individual returns, with each record assigned a weight such that the sample reflects the population in terms of number of returns, income, and tax liability. From the PIT sample, staff collected data on each taxpayer's wages, business income, Schedule C detail data, Schedule E (rents, royalties, "S" corporations, and partnership) income, and miscellaneous income, as well as the taxpayer's California adjusted gross income, taxable income, tax before credits, and final net tax liability.

Since payments reported on Forms 1099-MISC that reflect an SSN for identification are typically reported on Schedule C, focus was on those returns that had Schedule C income. This subsample represents approximately \$28.8 billion in gross receipts. To test compliance for this group, staff compared the amount of gross receipts reported on the taxpayer's Form(s) 1099-MISC with the gross receipts reported on the Schedule C.⁴⁷ If the gross receipts reported on the Schedule C was equal to or greater than the amount on the Form 1099-MISC, the taxpayer was considered to be 100 percent compliant. If the gross receipts amount on the Schedule C was less than the gross receipts amount on the Form 1099-MISC, the taxpayer was considered to be compliant up to the amount of gross receipts reported on the Schedule C. For example, if a taxpayer had a Form 1099-MISC showing gross receipts of \$10,000, but his Schedule C only showed gross receipts of \$8,000, the taxpayer would be considered compliant on \$8,000, or 80 percent of total gross receipts. Taxpayers with zero tax liability were also considered to be fully compliant. For this group, it was calculated that out of the \$28.8 billion in Form 1099-MISC gross receipts, and \$27.7 billion reported on tax returns, for a compliance rate of 96 percent.

Records with no Schedule C income were then looked at. These records accounted for \$3.9 billion in Form 1099-MISC gross receipts. For these taxpayers, the amount of Form 1099-MISC gross receipts was first compared with the amount of miscellaneous income. If the amount of miscellaneous income was greater than or equal to the amount of Form 1099-MISC gross receipts, the taxpayer was considered fully compliant. For those where this was not the case, the taxpayer was considered compliant to the extent of miscellaneous income. As with the Schedule C filers, taxpayers with zero tax liability were considered fully compliant. Using this methodology, \$1.2 billion in compliance out of \$3.9 billion in Form 1099-MISC gross receipts was calculated, for a compliance rate of 31 percent.

However, this approach assumes that taxpayers will only report their Form 1099-MISC amounts on Schedule C or as miscellaneous income. To test this assumption, a sample of actual returns representing \$650 million of Form 1099-MISC gross receipts was pulled that had been identified as noncompliant (i.e., not reported). Each of these returns was manually analyzed. Staff found,

⁴⁶ A timely filed 2001 return is a return filed by October 15, 2002.

⁴⁷ For taxpayers reporting miscellaneous income, the Form 1099-MISC gross receipts were compared with the sum of Schedule C gross receipts and other income.

of the \$650 million, it could explain \$480 million as taxpayers reporting the income on other parts of the return (wages, Schedule E, or as miscellaneous income with cost offsets). Thus, 74 percent of the estimated noncompliance for this group was seen to be a function of gross receipts being reported where they were not expected or were not detectable using an automated procedure. As such, staff assumed 74 percent of total noncompliance for those who do not file a Schedule C was misestimated. This raised the compliance rate for these taxpayers to 82 percent.

Combining the compliance and gross receipt amounts from both subgroups, gross receipts of \$32.7 billion and compliance of \$30.9 billion were calculated, for a compliance rate of 94 percent. Of these taxpayers that were matched using the strict criteria, there was a second and third subgroup besides the timely filers. The second subgroup included those who filed late returns. These taxpayers accounted for \$2.1 billion in Form 1099 gross receipts. It was assumed that their compliance rate would be identical to that of the timely filers – 94 percent.

The third subgroup includes those individuals who have not yet filed a return. Most have been or are being pursued by FTB's filing enforcement program. A relatively small portion of the total Form 1099 receipts, \$1.7 billion, was not pursued because the identification number on the Form 1099s was not sufficiently reliable. Staff assumed this group of taxpayers was 80% compliant. The individuals that were pursued by the filing enforcement program represent \$11 billion in gross receipts. The majority of those gross receipts, \$7.2 billion, arose either from erroneous Form 1099s, or belonged to individuals whose net tax liability was zero or too low for the department to pursue. Staff assumed that individuals in this group were 100 percent compliant – that is, that they were reporting 100 percent of the Form 1099 gross receipts that they were required to report. This likely overstates actual compliance because at least some of those individuals had a positive tax liability, but were not pursued simply because it would not be cost-effective for the department. Of the individuals representing the remaining \$3.8 billion in gross receipts, some had been sent filing enforcement letters, some had final assessments issued against them and filing enforcement for various reasons was not pursuing some. Looking at historical departmental data, staff estimated that compliance on this \$3.8 billion would be about 52 percent. Overall, compliance for the third subgroup was estimated to be 83 percent. When the compliance for this third subgroup was combined with the estimated compliance rates for timely filers and late filers, the overall compliance for the first group of taxpayers (those for whom a match was found using a strict matching criteria) is estimated to be 91 percent.

The second group of Form 1099s belonged to taxpayers who were matched using less strict criteria. This group represented \$24.6 billion in gross receipts. It was assumed that this group would have a compliance rate identical to that of the group that was matched with the strict criteria – 91 percent. The group for which no match was found, even using less strict criteria, represented \$2.2 billion in gross receipts. Staff assumed a zero compliance rate for this group.

In sum, the group obtained with strict matching represented \$47.6 billion in Form 1099 gross receipts and had an estimated compliance of 91 percent. The group obtained with less strict matching represented \$24.5 billion in Form 1099 gross receipts and had an assumed compliance of 91 percent. The group for which no matches could be found represented \$2.2 billion in Form 1099 gross receipts and had an assumed compliance of 0 percent. Overall, staff estimated that there is an 89 percent compliance rate on \$74.3 billion.

GLOSSARY

Certification – A document signed under penalty of perjury by independent contractors to indicate they meet a withholding exemption. For example, under the base scenario, the only exemption would be that the independent contractor is not an individual or sole proprietorship.

Employer – A person or legal entity that hires one or more persons to work for a wage or salary.

Independent Contractor – Any person who is not an employee under California law and who renders service, for specified compensation for a specified result, under the control of his principal as to the result of his work only and not as to the manner and means by which such result is accomplished.

Payee – Same as **service-provider**.

Payer – Same as **service-recipient**.

Service-provider – A service-provider is defined as an independent contractor, which means an individual who is not an employee of the service-recipient for California purposes and who receives compensation or executes a contract for services.

Service-recipient – A service-recipient means any business or government entity that, for California purposes, pays compensation to an independent contractor (service-provider) or executes a contract for services to be performed by an independent contractor.

Trade or business, payments made in the course of -- Payments are required to be reported on Form 1099-MISC only when they are made in the course of the payer's trade or business. Personal payments, e.g., for a haircut, are not reportable. A payer is engaged in a trade or business they operate for gain or profit. However, nonprofit organizations are considered to be engaged in a trade or business and are subject to these reporting requirements. Payments by federal, state, or local government agencies are also reportable.

Waiver – A document, issued by FTB or EDD, either fully exempting or reducing the rate of withholding on a particular independent contractor or payment. A waiver would be requested by the independent contractor based on pre-determined criteria.

Withholding at source – Withholding on certain payments made to payees that are not employees of the payer. Currently, any persons making payments to nonresidents in the course of the payer's trade or business are required to withhold at source if the payments are for any of the following:

- Services performed in California by independent contractors.
- Prizes, awards, winnings, etc., earned in California.
- Rent or royalties on California property.

- Distributions of California source income by estates, trusts, or partnerships.

Withholding at source is also required when residents and nonresidents sell California real property.

Withhold Agent – Any service-recipient who is required to withhold on payments made in the course of their trade or business.