Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings

June 14, 2013

Reference Number: 2013-30-058

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

Redaction Legend:
2 = Risk Circumvention of Agency Regulation or Statute
EMPLOYERS DO NOT ALWAYS FOLLOW INTERNAL REVENUE SERVICE WORKER DETERMINATION RULINGS

Highlights

Final Report issued on June 14, 2013

Highlights of Reference Number: 2013-30-058 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

The IRS estimates that employers misclassify millions of workers as independent contractors instead of employees, thus avoiding the payment of employment taxes. This problem adversely affects employees because the employer’s share of taxes is not paid and the employee’s share is not withheld. The Determination of Worker Status Program (referred to as the SS-8 Program) allows either a business or a worker to request a determination letter from the IRS regarding a worker’s Federal employment tax status as an employee or independent contractor.

WHY TIGTA DID THE AUDIT

This audit is part of TIGTA’s Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives. The overall objectives were to evaluate whether the IRS’s Determination of Worker Status Program (the SS-8 Program) is effectively processing worker determination requests and whether the subsequent rulings are being followed.

WHAT TIGTA FOUND

The SS-8 Program has faced a growing inventory of cases, longer processing times, and limited employer adherence to SS-8 Program determination rulings. In response to these issues, the SS-8 Program implemented new prescreening techniques that have the potential to reduce the time required to process cases while improving the quality of the inventory.

TIGTA analyzed 5,325 closed Calendar Year 2009 worker determination rulings in which the individual was ruled an employee. Results showed that not all employers are complying with the determination rulings. However, some of these employers may qualify for relief from employment taxes if their business qualifies under Section 530 of the Revenue Act of 1978. Section 530 provides for relief from employment taxes related to the proper classification of workers if certain requirements are met. The IRS should determine the reasons for employer noncompliance and develop a strategy to increase compliance with the worker determinations.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Small Business/Self-Employed Division: 1) incorporate documentation in the Internal Revenue Manual describing the features of the new prescreening techniques, 2) update performance goals for case processing times, 3) evaluate the new prescreening techniques, including the impact on staffing, and 4) assess SS-8 Program changes needed to increase employer compliance with determination rulings.

The IRS agreed with all four recommendations. It plans to update the Internal Revenue Manual to include the prescreening process and related procedures, including a process to monitor efficiency. The IRS developed a measurement for the new prescreening process and plans to monitor over-age cases weekly. It plans to evaluate the new prescreening techniques during normal headquarter reviews, which are conducted annually. Finally, the IRS plans to form a team to assess potential avenues to improve employer compliance with SS-8 Program determination rulings.
MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings (Audit # 201130037)

This report presents the results of our review to evaluate whether the Determination of Worker Status Program was effectively processing worker determination requests and whether the subsequent rulings were being followed. This review was conducted as part of our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management’s complete response to the draft report is included as Appendix VII.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Augusta R. Cook, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).
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Background

The determination of whether a worker is an employee or an independent contractor has significant tax implications for the worker, the employer, and the Internal Revenue Service (IRS) because employers and workers have different tax obligations depending on employee/contractor status. Determining the correct worker classification affects who is responsible for paying the Social Security tax, Medicare tax, and Federal unemployment taxes, as well as whether or not Federal income tax withholding is needed.

The misclassification of employees as independent contractors is a nationwide problem affecting millions of workers that continues to grow and contribute to the Tax Gap.1 Congress, the IRS, and the Treasury Inspector General for Tax Administration have raised concerns regarding the misclassification of employees as independent contractors.

The IRS’s last comprehensive worker misclassification estimate was for Tax Year 1984. At that time, it found that 15 percent of employers misclassified 3.4 million workers as independent contractors. This resulted in an estimated total tax loss of $1.6 billion in Social Security taxes, Medicare taxes, Federal unemployment taxes, and Federal income taxes (for Tax Year 1984).2 Although the IRS has not updated the information from its Tax Year 1984 report, it has included a worker classification study in its ongoing National Research Program. The study will provide information regarding worker classification. It is designed to identify questionable worker classification issues based upon a review of the taxpayer’s records, as well as the Forms 1099-MISC, Miscellaneous Income, filed by taxpayers who have filed the Form 941, Employer’s QUARTERLY Federal Tax Return. However, the results of this study will not be available before Calendar Year 2015.

By misclassifying employees, employers avoid paying a significant amount of employment taxes

When employers treat their workers as independent contractors, they do not withhold any taxes from their workers’ salaries and are required to annually issue them a Form 1099-MISC. In this

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1 See Appendix VI for a glossary of terms.
2 The study did not include an estimate of the percentage of all independent contractors who were misclassified by their employers (that is, of all independent contractors, the percentage that should have been classified as employees).
Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings

instance, the worker is responsible for paying the entire amount of his or her Social Security and Medicare taxes, as well as any Federal income taxes.

When employers treat their workers as employees, they are required to withhold Federal income taxes from their workers’ salaries and are required to annually issue them a Form W-2, Wage and Tax Statement. Employers are also required to withhold Social Security and Medicare taxes from their employees’ wages, as well as pay the employer’s share of these taxes. Employers are also responsible for paying Federal unemployment taxes for their employees.

The IRS estimates that employers misclassify millions of workers as independent contractors instead of employees. The misclassifications allow employers to avoid paying a significant amount of money in employment taxes, which adversely affects employees and tax administration.

In Calendar Year 2012, employers had to withhold 1.45 percent from their employees’ salaries for Medicare taxes and match it by paying an additional 1.45 percent. For Social Security taxes, employers had to withhold 4.2 percent of their employees’ wages and pay their share, which is an additional 6.2 percent.3 The employer must also pay the Federal unemployment tax, at a rate of 6 percent for the first $7,000 of their employees’ wages, for a total of $420.

As Figure 1 illustrates, on average, an employer can save approximately $3,710 per worker per year in employment taxes on an annual average of $43,007 in income paid per employee4 when the employer misclassifies a worker as an independent contractor.

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4 This is the estimated national average wage index for Calendar Year 2011 that the Social Security Administration uses to compute retirement benefits.
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**Figure 1: Calendar Year 2012 Employment Taxes Employers Pay if the Worker Is Misclassified as an Independent Contractor**

<table>
<thead>
<tr>
<th>Tax</th>
<th>Employer’s Portion of Tax if Worker Is Properly Classified as an Employee</th>
<th>Employer’s Portion of Tax if Worker Is Misclassified as an Independent Contractor</th>
<th>Dollar Advantage per Worker for Employers to Misclassify Employees as Independent Contractors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Security</td>
<td>$2,666</td>
<td>$0</td>
<td>$2,666</td>
</tr>
<tr>
<td>Medicare</td>
<td>$624</td>
<td>$0</td>
<td>$624</td>
</tr>
<tr>
<td>Federal Unemployment</td>
<td>$420</td>
<td>$0</td>
<td>$420</td>
</tr>
<tr>
<td>Total</td>
<td>$3,710</td>
<td>$0</td>
<td>$3,710</td>
</tr>
</tbody>
</table>

Source: Treasury Inspector General for Tax Administration audit analysis based on an average annual income of $43,007.

The Determination of Worker Status Program (hereafter referred to as the SS-8 Program) was established in Calendar Year 1994 to allow either a business or a worker to request a determination letter from the IRS regarding a worker’s Federal employment tax status as an employee or independent contractor. If an employer classifies a worker as an independent contractor and the worker believes the classification is incorrect, the worker can file a Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.

In making a determination, the IRS considers common law rules (factors) on whether the worker is an employee or an independent contractor when a Form SS-8 is processed. These factors include:

1. **Behavioral** – Does the firm control or have the right to control what the worker does and how the worker does his or her job? An employee is generally subject to the business’ instructions about when, where, and how to work.

2. **Financial** – Are the business aspects of the worker’s job controlled by the firm? These include, for example, how the worker is paid, whether expenses are reimbursed, and who provides tools/supplies.

3. **Type of Relationship** – Are there written contracts or employee benefits (pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

If the IRS finds that the worker was misclassified as an independent contractor by his or her employer, it can issue a binding agreement that would allow the worker to stop paying all of the
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employment taxes associated with being an independent contractor. In this instance, the worker would be responsible for paying only the employee’s portion of the employment taxes and the employer would be responsible for the rest.

The IRS sends employers a letter that explains the criteria used to make the determination and the tax ramifications. The letter clarifies that compensation to an individual classified as an employee is subject to Federal income tax withholding, Federal insurance contributions tax, and Federal unemployment tax. The letter also states:

*The SS-8 Program does not calculate your balance due and send you a bill. You are responsible for satisfying the employment tax reporting, filing, and payment obligations that result from this determination, such as filing employment tax returns or adjusting previously filed employment tax returns.*

However, there is relief for employers from paying employment taxes if their business qualifies for relief under Section 530 of the Revenue Act of 1978.\(^5\) Section 530 is a safe harbor provision that prevents the IRS from retroactively reclassifying “independent contractors” as employees and subjecting the employer to Federal employment taxes, penalties, and interest for such misclassification. In order for an employer to qualify for Section 530 relief from employment taxes, certain requirements have to be met:

- **Reporting Consistency** – A business must have filed all required Federal tax returns (including information returns) consistent with its treatment of each worker as not being employees.

- **Substantive Consistency** – A business (and any predecessor business) must have treated the workers, and any similar workers, as independent contractors. If the business treated similar workers as employees, this relief provision is not available.

- **Reasonable Basis** – A business had a reasonable basis for not treating the workers as employees, such as a court case or a ruling issued to the business from the IRS or an audit by the IRS in which the workers were not reclassified.

If all of these requirements are met, Section 530 relief terminates the employer’s, not the worker’s, employment tax liability and any interest or penalties attributable to the liability for employment taxes. In addition, the examination of the worker classification issue will be discontinued without a determination. Even if a worker filed a Form SS-8 and obtained a ruling that he or she was an employee, it is possible that the employer would still not have to pay the employer’s share of the employee’s employment taxes if the employer retroactively qualifies for Section 530 relief.

Section 530 relief terminates the liability of the employer only for the employment taxes, but has no effect on the employee’s status. It does not convert workers from the status of employee to the status of self-employed (independent contractor). The worker is still considered an employee for income tax and qualified benefit plan eligibility purposes. The worker remains liable for the employee share of Social Security and Medicare taxes with respect to all wages received. The hypothetical example below illustrates how Section 530 relief may apply.

**Example:** Worker 1 received a Tax Year 2012 Form 1099-MISC for $24,000 from ABC Company. Worker 1 believes he or she should be classified as an employee of the ABC Company and files a Form SS-8 to receive a determination of his or her worker status. While Worker 1 is waiting on the determination, he or she files a Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, that is used to figure and report his or her share of the uncollected Social Security and Medicare taxes due on his or her compensation. By completing and filing Form 8919, Worker 1’s Social Security and Medicare taxes will be credited to his or her Social Security record.

The IRS determines that the ABC Company meets the requirements to qualify for Section 530 relief, so ABC Company is not liable for any employment taxes for Worker 1. However, Worker 1 is still responsible for his or her portion of the Social Security and Medicare taxes of $1,356 (Social Security tax of $1,008 and Medicare tax of $348), which should be reported on his or her Form 8919. Worker 1’s benefits will not be affected because benefits are based on salary and not employment taxes paid.

This review was performed in the Small Business/Self-Employed Division Headquarters in New Carrollton, Maryland, and the Form SS-8 processing locations in Newport, Vermont, and the Brookhaven Campus in Holtsville, New York, during the period August 2011 through January 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.
Results of Review

New Prescreening Techniques Were Implemented to Improve Processing Efficiency and Inventory Quality

IRS SS-8 Program management implemented a new prescreening process in January 2012 to help process their inventory more efficiently. Unlike the prior process, when cases could stay in inventory for more than a year waiting on information, Forms SS-8 are now reviewed for completeness when the IRS receives them. If additional information is needed or the request does not meet the criteria for a worker determination, the form and a cover letter are sent to the employer/worker stating that the request cannot be processed because of one of the following reasons: 1) the form is incomplete, 2) the form is missing documentation, or 3) the request does not meet the criteria for a worker determination. The employer/worker has 15 calendar days to respond. If no additional information is received, the case is closed out of inventory.

The SS-8 Program received 6,262 worker determination requests in Fiscal Year 2012. Of these, approximately 2,900 were returned to the employer/worker. For about half of those returned, the IRS anticipates it will receive no response. It has been the IRS’s experience that many taxpayers file determination requests just to ask general questions about filing their income taxes (which can be answered by calling the IRS’s Customer Service toll-free telephone number). These types of cases are now being excluded upfront from the SS-8 Program’s inventory.

In addition, the new prescreening process is used to categorize the cases by occupation so that a tax examiner can become familiar with the occupational factors that may affect the determination of whether a worker should be treated as an employee or independent contractor. Besides helping IRS employees process their inventory more efficiently, the new prescreening process has the potential to address the quality of the inventory because incomplete requests are now closed quickly from inventory, which reduces the overall processing times.

As Figure 2 shows, Form SS-8 receipts grew from 5,935 in Fiscal Year 2007 and remained significantly higher until Fiscal Year 2012, when they were 6,262. An IRS official stated that receipts returned to the Fiscal Year 2007 level after the IRS updated IRS.gov, its public website, and clarified the instructions on who should file the Form SS-8. Additionally, SS-8 Program

6 See Appendix V for an example of an SS-8 Program letter sent to taxpayers informing them that a determination cannot be made.
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staff met with the IRS offices that deal directly with the taxpayers on questions concerning employee classification and worker determinations. Program staff provided clarification on who should complete the Form SS-8 and how the Forms should be completed.

Figure 2: Forms SS-8 Received From Fiscal Years 2007 Through 2012

During Fiscal Years 2009 through 2011 when receipts were significantly higher, inventories increased and aged. By the end of Fiscal Year 2012, the SS-8 Program had 12,547 SS-8 cases in its inventory, of which 9,612 (77 percent) were classified as over-age.7 As Figure 3 shows, the average number of days to process a case went from 239 calendar days in Fiscal Year 2009 to 365 calendar days in Fiscal Year 2012.

Figure 3: Form SS-8 Over-Age Inventory and Processing Time Trends for Fiscal Years 2009 Through 2012

Source: SS-8 Program Year-End Reports of Accomplishment by fiscal year.

7 A case is considered over-aged if it has been in inventory more than 180 days.
A Small Business/Self-Employed Division Research Team’s report on Form SS-8 filing trends and SS-8 Program sizing[^8] states that the increase in inventory and longer processing times was attributed to the introduction of Form 8919 in Fiscal Year 2008.

...the SS-8 program saw an 80% increase in receipts.... Until the advent of the new form [8919], the program never had over-age inventory; no cases took more than 180 days to process. Starting in 2008 inventory as a whole and the percent over-age gradually increased....

The IRS created Form 8919 to assist workers who have to file their tax returns before obtaining a determination ruling from the SS-8 Program or before their employer complies with a ruling. Form 8919 advises taxpayers that they must file Form SS-8 if they want the IRS to determine whether they are independent contractors or employees. It is used to calculate and report the worker’s share of the uncollected Social Security and Medicare taxes because he or she was treated as an independent contractor by his or her employer. Because the IRS treats the worker as an employee while the determination ruling is being processed, filing Form 8919 benefits the worker by eliminating the self-employment taxes he or she currently owes as a result of being classified as an independent contractor.

In a prior review,[^9] the Treasury Inspector General for Tax Administration identified 74,068 taxpayers who may have avoided paying $26.2 million in Social Security and Medicare taxes because he or she improperly used the Form 8919. **[2]**[^2] **[2]**[^2] **[2]**[^2]**[^2]**[^2], taxpayers could avoid paying approximately $131.1 million in taxes over five years.

**Plans for Evaluating How Well the Prescreening Techniques Are Working Need to Be Developed and Implemented**

Although the new prescreening process has been in place for more than one year, the IRS has not updated the Internal Revenue Manual with the new procedures, including how the procedures will be monitored. Both IRS guidance and the *Standards for Internal Control in the Federal Government*[^10] state that such documentation assists staff with following required procedures and that ongoing monitoring occurs in the normal course of operations for management comparisons to ensure that controls are followed.

[^8]: IRS, SEA0078, SS-8 Filing Trends and Program Right Sizing (Mar. 2011).
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A key component in an overall framework of best practices emphasizes the need to develop and implement plans for evaluating new processes once implemented.\textsuperscript{11} The purpose of an evaluation is to answer questions about how well (or whether) the process is working and whether further improvements are needed. It typically involves collecting, analyzing, and comparing performance data to a pre-established goal or desired outcome, such as a specified reduction in processing time.

The IRS has not developed plans to evaluate the new process and it has not updated goals for processing cases under the new prescreening process, including the impact on the performance of the SS-8 Program. Such information would give SS-8 Program managers a better understanding of the requisite staffing level for the program and whether additional personnel is warranted. It would also provide needed evidence to address recent stakeholder concerns that staffing shortfalls may be hampering program performance.

For example, concern about the SS-8 Program’s ability to keep pace with the sustained Form SS-8 filings during the Calendar Years 2009 through 2011 filing seasons led the Senate Subcommittee on Financial Services and General Government to report\textsuperscript{12} that it is crucial, given the growing workload, that the IRS maintain sufficient staffing at Form SS-8 processing locations. The subcommittee also indicated in its report that the IRS’s SS-8 Program is critical for ensuring workers are classified correctly and for identifying leads for employment tax examinations, criminal investigations, and combating the underreporting of employment taxes that contribute significantly to the Tax Gap.

Further, the Small Business/Self-Employed Division Research Team report on the Form SS-8 filing trends and SS-8 Program sizing concluded that the new pattern of Forms SS-8 submitted by taxpayers provides a sound basis for predicting future receipts. Although the Research Team’s report was issued before the new prescreening process was implemented, the team concluded that once current accumulated inventory has been cleared and the program returns to normal inventory levels, the SS-8 Program should have in the range of 43 to 54 year-round employees instead of the 29 to 31 employees that were on staff during their study.\textsuperscript{13} The new prescreening process could result in lower staffing levels than the Research Team report suggests, but that will not be known until it is evaluated.

\textsuperscript{12} S. REP. NO. 112-079, at 27 (2012).
\textsuperscript{13} These are direct Full-Time Equivalent employees.
**Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings**

**Recommendations**

The Commissioner, Small Business/Self-Employed Division, should:

**Recommendation 1:** Update the Internal Revenue Manual with the new prescreening process and the related procedures, including how the IRS will monitor the process to ensure that it is operating efficiently.

*Management’s Response:* The IRS agreed with this recommendation. The IRM will be updated with the new prescreening process and the related procedures, including a process to monitor efficiency.

**Recommendation 2:** Measure the contribution the new prescreening process is making towards addressing the backlog of over-age cases.

*Management’s Response:* The IRS agreed with this recommendation. It has developed a measurement for the new prescreening process and will continue to review and monitor the backlog of over-age cases on a weekly basis.

**Recommendation 3:** Develop and implement plans for evaluating the new prescreening process, including its impact on staffing.

*Management’s Response:* The IRS agreed with this recommendation. The IRS responded that procedures are evaluated during normal headquarter reviews, which are conducted annually. The next review is scheduled for May 2013. Additionally, data are analyzed on a continuous basis by headquarters in an effort to identify areas of concern and potential for increased efficiencies.

**Follow-Up Is Needed to Ensure Compliance With Worker Determination Rulings**

Our analysis of all 5,325 closed Calendar Year 2009 SS-8 worker determinations that resulted in the worker being classified as an employee showed that not all employers are complying with the determination rulings. The determinations we analyzed were made in Calendar Year 2009, but we also reviewed information returns issued for Tax Years 2008 through 2010. When the IRS determines that a worker is an employee, the employer is instructed to file corrected employment tax returns and information returns showing that the worker and any other worker performing services under the same circumstances are treated as employees. In addition, if the worker has already filed a Form 1040, *U.S. Individual Income Tax Return*, he or she must file a Form 1040X, *Amended U.S. Individual Income Tax Return*, for the affected tax year(s) to include the additional income as wages and re-compute his or her Federal income.
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Tests of the 5,325 worker determinations included 5,067 employers.\textsuperscript{14} Results showed that:

- 856 (17 percent) of 5,067 employers appeared to comply with the ruling and issued one or more Forms W-2 to their workers during Tax Years 2008 through 2010.

- 940 (19 percent) of 5,067 employers appeared not to have complied with the determinations and issued a Form 1099-MISC instead of a Form W-2 to their workers for Tax Year 2008, 2009, and/or 2010. The IRS stated that 17.25 percent of employers might not be responsible for paying the employment tax associated with these rulings due to relief granted under Section 530 and, therefore, would not need to file Forms W-2. To account for employers that could be granted relief under Section 530, we reduced the 940 employers believed to be noncompliant by the 17.25 percent (162 employers). We estimated that 778 employers did not properly report an estimated $11.2 million in worker income. As a result, approximately $1.2 million in employment taxes may not have been properly reported or paid by these employers. If not pursued, an estimated $6 million in employment taxes may not be properly reported or paid by these employers over the next five years.

- 3,294 (65 percent) of 5,067 employers\textsuperscript{15} did not issue a Form 1099-MISC or a Form W-2 to their workers. Either the taxpayers no longer worked for the employers related to the determinations or the compensation was not reported to the IRS.

The SS-8 Program has little ability to enforce compliance after a determination ruling is made. However, there are opportunities to improve enforcement using the IRS’s audit referral and audit classification process. The IRS relies on audits conducted by the Small Business/Self-Employed Division, the Large Business and International Division, and the Tax Exempt and Government Entities Division to enforce worker determination rulings. The initial step in the process of enforcing the rulings involves the SS-8 Program referring the suspected noncompliant employer to the division having the proper jurisdiction. After identifying which of the three IRS business operating divisions has jurisdiction, the SS-8 Program applies criteria provided by the respective operating division to the underlying facts of the particular ruling in determining if a referral is warranted.

Each of the business units has its own specific criteria. If the referral criteria are met, the ruling and underlying facts of the case are forwarded to the operating division for audit consideration; if not, the case is closed without any further actions. In instances where a referral is made, examiners use their experience and judgment in conjunction with the operating division’s

\textsuperscript{14} Multiple workers could have filed a Form SS-8 for one employer. Percentages do not add to 100 percent due to rounding.

\textsuperscript{15} The three bulleted amounts total 5,090 employers (a difference of 23 employers). An employer could have had more than one determination if multiple workers filed a Form SS-8.
workload priorities and available resources to screen (e.g., classify) the case and decide whether an audit is warranted.

In Fiscal Year 2011, the SS-8 Program closed 8,405 worker determinations and referred 797 (9.5 percent) of them to the operating divisions for audit consideration. The remaining 7,608 (90.5 percent) of the determination ruling cases did not meet the minimum operating division referral criteria according to SS-8 Program management and were closed with no further actions. Figure 4 shows the number of Form SS-8 cases referred to each operating division for audit consideration in Fiscal Year 2011 along with the resulting case resolutions.16 Small Business/Self-Employed Division examiners accepted and worked 538 (6.4 percent) of the 8,405 closed worker determination cases.

**Figure 4: Number of Form SS-8 Cases Referred for Audit in Fiscal Year 2011 and the Resulting Case Resolutions**

<table>
<thead>
<tr>
<th>Business Operating Division</th>
<th>Number of SS-8 Cases Referred for Examination</th>
<th>Number of SS-8 Cases Accepted for Examination</th>
<th>Total Taxes Assessed17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Business/Self-Employed</td>
<td>742</td>
<td>538</td>
<td>$13,463,380</td>
</tr>
<tr>
<td>Large Business and International</td>
<td>7</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Tax Exempt and Government Entities</td>
<td>48</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>797</strong></td>
<td><strong>538</strong></td>
<td><strong>$13,463,380</strong></td>
</tr>
</tbody>
</table>


Since Fiscal Year 2008, the Small Business/Self-Employed Division has refined its referral criteria at least twice and also standardized how its examiners classify SS-8 Program worker determination cases. After the refinements were implemented, the percentage of referrals that resulted in an audit doubled, ranging from approximately 38 percent in Fiscal Year 2008 up to 85 percent in Fiscal Year 2011. The Small Business/Self-Employed Division also provides routine feedback to SS-8 Program managers about each referral, including the reasons for not acting on a referral. Such performance feedback is an important control for improving the

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16 Two of the operating divisions did not take any action on the determination cases referred to them by the SS-8 Program in Fiscal Year 2011.

17 This is the total amount of taxes assessed in Fiscal Year 2011 from the accepted SS-8 Program referrals and includes cases from other fiscal years.
quality of referrals by pinpointing problem areas for possible corrective actions, thereby increasing the number of resulting audits.

The Large Business and International Division and the Tax Exempt and Government Entities Division generally have not assessed or adjusted its referral criteria. In addition, neither operating division has provided feedback to the SS-8 Program on the quality of the referrals received. However, Large Business and International Division officials stated that any feedback not provided on the SS-8 Program examination referrals was an unintentional oversight and that they have an established process to provide such information to the SS-8 Program managers. The Tax Exempt and Government Entities Division recently established new referral criteria procedures for the SS-8 Program and plans to introduce more standardization to its audit classification process for worker determination cases.

Nevertheless, the IRS should determine the reasons for employer noncompliance and develop a strategy to increase compliance with the worker determinations. Following a structured framework, such as the one the Government Accountability Office developed for process improvement projects, IRS personnel should consider and assess alternative approaches to increasing compliance and ensure that taxpayers understand and meet their tax responsibilities.

**Recommendation**

**Recommendation 4:** We recommend that the Commissioner, Small Business/Self-Employed Division, coordinate with the Commissioners of the Large Business and International Division and the Tax Exempt and Government Entities Division to assess SS-8 Program changes needed to increase employer compliance with determination rulings.

**Management’s Response:** The IRS agreed with this recommendation. It agrees that coordination and communication is important for effective administration of the SS-8 Program determination process. The Small Business/Self-Employed Division will form a team with the Tax Exempt and Government Entities Division to address this recommendation by July 31, 2013. A formal proposal to assess potential avenues to improve employer compliance with SS-8 Program determination rulings will be completed by March 31, 2014.
Appendix I

**Detailed Objectives, Scope, and Methodology**

Our overall objectives were to evaluate whether the SS-8 Program is effectively processing worker determination requests and whether the subsequent rulings are being followed. To accomplish our objective, we:

I. Evaluated whether the SS-8 Program was effectively processing worker determination requests and determined the effect of present staffing on the program.
   A. Reviewed SS-8 Program inventory reports and over-age reports to identify trends from Fiscal Years 2009 through 2012.
   B. Reviewed Internal Revenue Manual\(^1\) guidelines and desk procedures to determine how worker determination cases were worked.
   C. Interviewed SS-8 Program managers concerning the worker determination request inventory to determine how they closed cases and what is being done to address staffing.
   D. Reviewed staffing reports to determine whether staffing has increased or decreased over Fiscal Years 2009 through 2011.

II. Determined if the worker determination rulings are being followed by the employers when they receive notification that their worker was an employee.
   A. Reviewed the letters sent to employers and the workers after a determination ruling to ensure that it is clear and understandable so taxpayers know their tax obligations.
   B. Reviewed a judgmental sample\(^2\) of 25 case files to see if any further analysis was required to ensure that workers were sent a letter informing them of the SS-8 Program determination ruling and their tax obligations.
   C. Determined whether employers and their workers complied with the SS-8 Program determination rulings.

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\(^1\) See Appendix VI for a glossary of terms.

\(^2\) A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.
1. Validated the SS-8 Database by taking a judgmental sample of 25 cases matching the case identifier on the SS-8 Database to the case files to ensure that the cases exist and that the data are accurate.

2. Used the SS-8 Database to extract the Social Security Number for the workers and the Employer Identification Number for the employers for cases closed in Calendar Year 2009.

3. Prepared a Strategic Data Services extract to obtain all Forms 1099-MISC, Miscellaneous Income, from the Information Returns Master File that matched the information we provided them in Step II.C.2. Strategic Data Services then provided a database of Forms 1099-MISC with the Social Security Numbers for the workers and the Employer Identification Numbers for the employers along with the income amounts on the forms.

4. Validated the Strategic Data Services extract by taking a judgmental sample of 25 Forms 1099-MISC income amounts and matching the amounts to the Integrated Data Retrieval System.

5. Extracted the same Employer Identification Numbers and Social Security Numbers for the Forms W-2, Wage and Tax Statement, for Tax Years 2008 through 2010 using the Form W-2 file at the Data Center Warehouse.

6. Validated the Form W-2 information obtained from the Data Center Warehouse by selecting a judgmental sample of 25 Forms W-2 income amounts and matching the amounts to the Integrated Data Retrieval System.

7. Matched the Forms 1099-MISC and Forms W-2 using the Employers’ Identification Number and the workers’ Social Security Number information to determine if the employers complied with the SS-8 Program rulings.

8. Totaled the Forms 1099-MISC income fields to determine the unreported income amounts. We also used the Medicare and Social Security tax percentages to determine the unreported employment tax amounts.

D. Reviewed the examination referrals from the SS-8 Program to determine if the examination referrals affected compliance with SS-8 Program determination rulings.

1. Reviewed examination referral reports to obtain how many SS-8 Program worker determination cases were referred to the examination functions.

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3 To assess the reliability of computer-processed data, programmers in the Treasury Inspector General for Tax Administration’s Office of Strategic Data Services validated the data that were extracted, and we verified the appropriate documentation. Judgmental samples were selected and reviewed to ensure that the amounts presented were supported by external sources. As appropriate, data in the selected data records were compared to the physical tax returns to verify that the amounts were supported.
2. Reviewed examination referral reports to obtain how many SS-8 Program worker determination cases were examined, the amount of taxes assessed, the no change rate, and the surveyed rate.

**Internal controls methodology**

Internal controls relate to management’s plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the SS-8 Program’s policies, procedures, and practices for processing determination requests and referring cases that involve noncompliance. We evaluated these controls by interviewing management, reviewing inventory reports, and analyzing data to determine compliance with determination rulings.
Appendix II

**Major Contributors to This Report**

Augusta R. Cook, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Bryce Kisler, Director
Jeff Anderson, Audit Manager
Tina Parmer, Audit Manager
John Chiappino, Lead Auditor
Todd Anderson, Senior Auditor
Kyle Bambrough, Senior Auditor
Earl Burney, Senior Auditor
Marge Filippelli, Senior Auditor
Kim McMenamin, Audit Evaluator
Michele Cove, Assistant Director, Data Extracts Group, Strategic Data Services
James Allen, Information Technology Specialist, Data Services Group, Strategic Data Services
Employers Do Not Always Follow
Internal Revenue Service
Worker Determination Rulings

Appendix III

Report Distribution List

Principal Deputy Commissioner
Office of the Commissioner – Attn: Chief of Staff  C
The Office of Deputy Commissioner for Services and Enforcement  SE
Commissioner, Large Business and International Division  SE:LB
Commissioner, Tax Exempt and Government Entities Division  SE:T
Director, Specialty Programs, Small Business/Self-Employed Division  SE:S:SP
Chief Counsel  CC
National Taxpayer Advocate  TA
Director, Office of Legislative Affairs  CL:LA
Director, Office of Program Evaluation and Risk Analysis  RAS:O
Office of Internal Control  OS:CFO:CPI:C:IC
Audit Liaisons:
  Commissioner, Large and Mid-Size Business Division  SE:LB
  Commissioner, Small Business/Self-Employed Division  SE:S
  Commissioner, Tax Exempt and Government Entities Division  SE:T
Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

**Type and Value of Outcome Measure:**

Increased Revenue – Potential; approximately $6 million in employment taxes may not be properly reported or paid by 778 employers over five years (see page 10).

**Methodology Used to Measure the Reported Benefit:**

We obtained the SS-8 Database and extracted the Social Security Number\(^1\) for the workers and the Employer Identification Number for the employers for all 5,325 closed Calendar Year 2009 SS-8 Program worker determinations that resulted in the worker being classified as an employee. These 5,325 worker determinations included 5,067 employers.\(^2\)

We found that 940 employers did not comply with the IRS’s rulings and did not issue a Form W-2, *Wage and Tax Statement*, to their workers for Tax Years 2008 through 2010 on an estimated $13.5 million in worker income. However, based on information provided by the IRS, 17.25 percent of employers might not be responsible for paying the employment tax associated with these rulings due to relief granted under Section 530 of the Revenue Act of 1978.\(^3\) To account for those employers that could be granted relief under Section 530, we reduced the 940 employers we believed to be noncompliant by the 17.25 percent (162 employers).

We estimate that 778 employers did not properly report an estimated $11.2 million in worker income. As a result, we estimate that approximately $1.2 million in employment taxes may not have been properly reported or paid by these employers. Figure 1 shows the details of these calculations.

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\(^1\) See Appendix VI for a glossary of terms.

\(^2\) An employer could have had more than one determination if multiple workers filed a Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.

Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings

**Figure 1: Calculation of Employment Taxes Not Properly Reported or Paid**

<table>
<thead>
<tr>
<th>Category (2009 Tax Rates)</th>
<th>Amount Not Properly Reported or Paid by Employers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worker Income Not Properly Reported by the 778 Employers</td>
<td>$11,180,112</td>
</tr>
<tr>
<td>Social Security Tax (Employer’s Portion – 6.2 percent)</td>
<td>$693,167</td>
</tr>
<tr>
<td>Medicare (Employer’s Portion – 1.45 percent)</td>
<td>$162,112</td>
</tr>
<tr>
<td>Federal Unemployment Tax (778 Noncompliant Employers X $434)4</td>
<td>$337,652</td>
</tr>
<tr>
<td><strong>Total Employment Tax (Including Federal Unemployment Tax) Not Properly Reported or Paid by 778 Employers</strong></td>
<td><strong>$1,192,931</strong></td>
</tr>
</tbody>
</table>

If IRS management does not take the adequate steps to increase employer compliance with the determination rulings, we believe an estimated $6 million ($1,192,931 x 5 years) in employment taxes may not be properly reported or paid by these employers over the next five years.

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4 The Federal Unemployment Tax calculated in the report text on Page 2 and used in Figure 1 on Page 3 is calculated with the 6 percent rate effective in Calendar Year 2012. In this figure, the Federal Unemployment Tax is calculated with the 6.2 percent rate that was effective in Calendar Year 2009.
SS-8 Program Letter Sent to Taxpayers Informing Them That a Determination Cannot Be Made

Dear Taxpayer:

We have received your submitted Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

We are unable to process your request for a determination since your form is incomplete, missing documentation or does not meet the criteria for a worker determination. We are returning your Form SS-8 to you for the following reason(s):

_____ All questions must be completed. If a question is not applicable, write N/A.

_____ The form does not have your original signature. We are unable to accept this form using a signature stamp, or signed by a Power of Attorney. In addition, photocopies and faxes are not acceptable.

_____ The form does not have the information about the firm completed. The firm’s name, address, telephone number and federal identification number (if available) are needed.

_____ The requested information for Question 1 concerning the dates you provided services to the firm are missing. If the dates are for the current year, please wait until you have received your Form 1099-MISC, Miscellaneous Income, and attach a copy when resubmitting your Form SS-8 request.

_____ The information you have provided requires a copy of a Form 1099-MISC and/or Form W-2, Wage and Tax Statement, to be submitted. Please, do not send originals.
Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings

Source: IRS’s SS-8 Program management.
## Glossary of Terms

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calendar Year</td>
<td>A 12-consecutive-month period ending on December 31.</td>
</tr>
<tr>
<td>Data Center Warehouse</td>
<td>A Treasury Inspector General for Tax Administration Office of Information Technology function that obtains and stores numerous IRS data files and makes them available to auditors and investigators.</td>
</tr>
<tr>
<td>Direct Full-Time Equivalent</td>
<td>A measure of labor hours in which one Full-Time Equivalent is equal to eight hours multiplied by the number of compensable days in a particular fiscal year.</td>
</tr>
<tr>
<td>Employer Identification Number</td>
<td>A unique nine-digit number used to identify a taxpayer’s business account.</td>
</tr>
<tr>
<td>Federal Unemployment Tax</td>
<td>This tax provides for payments of unemployment compensation to workers who have lost their jobs. Most employers pay both Federal and State unemployment tax.</td>
</tr>
<tr>
<td>Fiscal Year</td>
<td>A 12-consecutive-month period ending on the last day of any month. The Federal Government’s fiscal year begins on October 1 and ends on September 30.</td>
</tr>
<tr>
<td>Information Returns Master File</td>
<td>Contains information return data for the current year and prior six tax years.</td>
</tr>
<tr>
<td>Integrated Data Retrieval System</td>
<td>The IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer’s account records.</td>
</tr>
<tr>
<td>Internal Revenue Manual</td>
<td>Contains the policies, procedures, instructions, guidelines, and delegations of authority which direct the operation and administration of the IRS. Topics include tax administration, personnel and office management, and others.</td>
</tr>
<tr>
<td>Medicare Tax</td>
<td>Medicare tax is the amount withheld by your employer from your paycheck that helps cover the cost of running the Medicare program.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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<td>-------------------------------------</td>
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</tr>
<tr>
<td>National Research Program</td>
<td>This program supports measurement of taxpayer compliance with Federal tax laws that require accurate reporting of tax liabilities, timely filing of returns, and timely and complete payment of taxes owed.</td>
</tr>
<tr>
<td>SS-8 Database</td>
<td>A tool used by the SS-8 Program as a tracking system and work area. All aspects of case processing are manipulated and stored in this electronic medium.</td>
</tr>
<tr>
<td>Social Security Number</td>
<td>The identifying number required on tax returns and other documents submitted to the IRS by an individual. A Social Security Number is composed of nine digits separated by two hyphens; for example, 123-45-6789.</td>
</tr>
<tr>
<td>Social Security Tax</td>
<td>A tax imposed by the Federal Government on both employees and employers to fund Social Security, which provides retirement benefits for retirees and other beneficiaries.</td>
</tr>
<tr>
<td>Strategic Data Services</td>
<td>The organization within the Treasury Inspector General for Tax Administration that uses computer code to extract data from IRS systems not readily available to auditors.</td>
</tr>
<tr>
<td>Strategic Data Services Extract</td>
<td>Data received from Strategic Data Services from an IRS system not readily available to auditors on the Data Center Warehouse.</td>
</tr>
<tr>
<td>Tax Gap</td>
<td>The estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.</td>
</tr>
<tr>
<td>Tax Year</td>
<td>The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.</td>
</tr>
</tbody>
</table>
Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings

Appendix VII

Management's Response to the Draft Report

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

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings (Audit # 201130037)

MAY 22, 2013

Thank you for the opportunity to review your draft report titled: “Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings.” We appreciate your acknowledgement of our efforts to improve this program. We agree that revising the Internal Revenue Manual (IRM), measuring the prescreening process, and coordinating with Tax Exempt & Government Entities (TE/GE) will improve the program.

The Large Business and International (LB&I) Employment Tax function was merged with the Small Business/Self Employed (SB/SE) Employment Tax function on October 1, 2012. All SS-8 referrals regarding large cases will now be addressed by SB/SE.

Attached is a detailed response outlining our corrective actions to address your recommendations. If you have any questions, please contact me, or a member of your staff may contact Denice Vaughan, Director, Campus Compliance Services at (404) 338-9116.

Attachment
RECOMMENDATION 1:
Update the Internal Revenue Manual with the new prescreening process and the related procedures, including how the IRS will monitor the process to ensure it is operating efficiently.

CORRECTIVE ACTION:
The IRM will be updated to include the prescreening process, related procedures, and process to monitor efficiency.

IMPLEMENTATION DATE:
January 15, 2014

RESPONSIBLE OFFICIAL(S):
Director, Campus Compliance Services, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:
Measure the contribution the new prescreening process is making towards addressing the backlog of overage cases.

CORRECTIVE ACTION:
We have developed a measurement for the new prescreening process and will continue to review and monitor the backlog of overage cases on a weekly basis.

IMPLEMENTATION DATE:
Completed September 2012 and ongoing

RESPONSIBLE OFFICIAL(S):
Director, Campus Compliance Services, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 3:
Develop and implement plans for evaluating the new prescreening process, including its impact on staffing.
CORRECTIVE ACTION:
Procedures are evaluated during normal headquarter reviews which are conducted annually. The next review is scheduled for May 2013. Additionally, data is analyzed on a continuous basis by headquarters in an effort to identify areas of concern and potential for increased efficiencies.

IMPLEMENTATION DATE:
July 31, 2013

RESPONSIBLE OFFICIAL(S):
Director, Campus Compliance Services, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:
We recommend that the Commissioner, Small Business/Self-Employed Division, coordinate with the Commissioners of the Large Business and International Division and the Tax Exempt and Government Entities Division to assess SS-8 Program changes needed to increase employer compliance with determination rulings.

CORRECTIVE ACTION:
We agree that coordination and communication is important for effective administration of the SS-8 determination process. SB/SE concurs with the recommendation and will form a team with TE/GE to address this recommendation by July 31, 2013. A formal proposal to assess potential avenues to improve employer compliance with SS-8 determination rulings will be completed by March 31, 2014.

IMPLEMENTATION DATE:
July 31, 2013 and March 31, 2014

RESPONSIBLE OFFICIAL(S):
Director, Specialty Programs, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.