

MINNESOTA • REVENUE

Report of Income Tax Withholding from Payments to Individual Construction Contractors – Part II

**This report is made in accordance with the Laws of
Minnesota 2008, Chapter 154, Article 3, Section 9**

Income Tax & Withholding Division
Minnesota Department of Revenue
March 1, 2012

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March 2012

To the members of the Legislature of the state of Minnesota:

The Legislature enacted Minnesota Statutes, Section 290.92, subdivision 31, as a measure to promote compliance with the state's income tax. The law provides for income tax withholding from compensation paid by construction contractors to individual construction contractors (individual proprietors).

The withholding rate is 2 percent of total compensation. This withholding provides additional revenue to the state by ensuring this compensation is properly reported on the tax returns of individual proprietors. At least some of this compensation would otherwise go unreported.

Since the law was enacted, the Department of Revenue has found there are significantly fewer individual contractors subject to 2 percent withholding than first projected. Based on business types that existed when the withholding provision was enacted, we expected more than 20,000 independent contractors would be subject to the requirement. However, returns filed with the department indicate that only 1,866 of these workers had tax withheld from their pay in 2009. Even fewer workers, 1,694, had tax withheld from their pay in 2010.

We believe the primary reason for this discrepancy is that many independent contractors may have changed the form of their business from sole proprietorship to some other form – primarily to limited liability companies – to avoid the state withholding requirement. It is important to note that the vast majority of construction contractors are not breaking the 2 percent withholding law as currently written; it is perfectly legal for individuals to reorganize as a different entity type. However, the state is not seeing the expected revenue increases as a result.

Please contact me if you need additional information about the results contained in this report.

Sincerely,



Myron Frans
Commissioner

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Summary of Findings

For the 2009 tax year, 902 contractors paid \$26,076,320 to 1,866 workers subject to the state's 2 percent individual contractor withholding requirement. The contractors withheld \$521,526.40 of Minnesota state income tax from these payments.

For the 2010 tax year, 810 contractors paid \$22,340,674 to 1,694 workers subject to the state's 2 percent individual contractor withholding requirement. The contractors withheld \$446,813.49 of Minnesota state income tax from these payments.

The Department of Revenue randomly selected 101 taxpayers covered by the 2 percent withholding requirement to determine how many were complying with the law.

Based on our analysis of tax returns and random audits, we don't believe that noncompliance with the 2 percent individual construction contractor withholding law is significant. The taxpayers covered by this statute are among the most likely to avoid reporting and paying income taxes, something the withholding requirement is meant to address. However, they can legally avoid the 2 percent withholding requirement by changing the form of their business for tax purposes and it appears many have done so. As a result, the law has not produced expected revenues.

Estimated Cost of Preparing this Report

Minnesota Statutes, Section 3.197, requires that a report to the Legislature contain the cost of preparing the report. That cost was \$16,506, which includes the costs of auditing, analyzing the data and preparing the report.

Purpose of this Report

This report is a supplement to the “Report of Income Tax Withholding from Payments to Individual Construction Contractors,” submitted to the Legislature on Jan. 31, 2011. At that time we didn’t have data regarding compliance with the law. We’ve now collected that data.

Selection of Random Sample Audits

Department data reflects 47,271 taxpayers reporting North American Industry Classification System (NAICS) code numbers 23 through 238990.¹ We selected every 472nd taxpayer from the list for an audit pool of 101 taxpayers.

We removed 76 taxpayers from this audit pool, though 29 of them were presumed to be fully compliant, for various reasons.² We conducted audits on 18 of the 25 taxpayers that remained in the pool.

¹ The population subject to the 2 percent individual construction contractor withholding requirement as specified under law - Minnesota Statutes Section 290.92, Subdivision 31(a)

² As documented in Appendix 1 of this report:

- We removed 41 taxpayers from the audit pool because of business inactivity during the audit period; 5 because they reported incorrect NAICS code numbers; and 1 that didn’t conduct business in the state during the audit period.
- We removed another 29 taxpayers from the pool, but considered them to be fully compliant with the law. These included: 5 taxpayers that reported no labor expense, 12 that paid wages to employees (but not to independent contractors); 2 that filed withholding tax returns; and 10 that likely weren’t required to withhold tax because gross receipts reported on their business income tax return were less than \$80,000. (The \$80,000 threshold was selected because contractors with annual receipts below that level frequently do the contracted work themselves and don’t subcontract.)

Audit Results

We finished 14 of the 18 audits by the time we prepared this report. Each audit covered the 2009 calendar year (Jan. 1 – Dec. 31).³

Auditors were generally expected to focus on the 2 percent individual construction contractor withholding tax. However, two audits resulted in identification of issues not related to this withholding; we assessed tax in these instances.⁴

Three taxpayers failed to fully comply with the 2 percent withholding requirement but weren't assessed because the amount of tax they failed to withhold was less than \$50. Rather than prepare a tax order for an immaterial amount, the auditors simply educated these taxpayers.

Most audited taxpayers that weren't assessed knew about the 2 percent individual construction contractor withholding tax law. These taxpayers often stated that they didn't subcontract work to an individual unless he or she had formed an LLC or corporation. The reason, they told us, was to avoid administrative burdens related to the withholding; they also wanted to avoid dealing with the Independent Contractor Exemption Certificate program administered by the Minnesota Department of Labor and Industry.

Conclusion

Based on our analysis and audit results, we determined compliance/non-compliance with the 2 percent withholding law for 43 businesses that were active in Minnesota during the audit period. Thirty-seven of these taxpayers, or 86 percent, were fully complying with the law.⁵ Five taxpayers weren't complying with the law, at least in part, and each had underreported tax of \$100 or less. Only one taxpayer was noncompliant on a greater than nominal level.

Based on these findings, there's little evidence to suggest widespread non-compliance with the 2 percent withholding law. However, the tendency of individual construction contractors to change the form of their business – from sole proprietor to LLC or corporate status – has resulted in less revenue than expected when this law was enacted.

³ Appendix 2 contains data on these audits.

⁴ The tax assessed in the course of these audits relates to "Taxpayer G" and "Taxpayer M" in Appendix 2.

⁵ 29 taxpayers presumed compliant through analyzing data and 8 through the audit process. Calculation provided in Appendix 1.

Appendix 1

Random Population & Compliance Rate

<u>Part</u>		
I.	Randomly Selected Population	101
	Not in Operation During Audited Period	-41
	In Operation w/ No Labor Expense	-5
	In Operation w/ Wage Expense Only	-12
	In Operation w/ 2% Withholding Reported	-2
	Improper NAICS Code	-5
	Business not Operating in MN	-1
	In Operation with < \$80,000 Gross Receipts	-10
	Audit Pool:	25
II.	Audits Assigned	18
	Audit Not Yet Completed	-4
	Audited Taxpayers Not Fully Compliant	-6
	Audited Taxpayers in Full Compliance	8
III.	In Operation w/ No Labor Expense	5
	In Operation w/ Wage Expense Only	12
	In Operation w/ 2% Withholding Reported	2
	In Operation with < \$80,000 Gross Receipts	10
	Presumed to be Compliant Without Audit:	29
IV.	Completed Audits	14
	Presumed to be Compliant Without Audit	29
	Total Compliance Determinations Made:	43
V.	Full Compliance Rate (Part II+Part III)/Part IV:	0.86

Appendix 2

2% Individual Construction Contractor Audit Results

	2% Construction Contractor Withholding Tax	Non-2% Construction Contractor Withholding Tax	Penalty	Interest	Total Assessment	Audit Recovery	Hours
Taxpayer A	0.00		0.00	0.00	0.00	0.00	11.50
Taxpayer B	0.00		0.00	0.00	0.00	0.00	9.00
Taxpayer C	0.00		0.00	0.00	0.00	0.00	24.00
Taxpayer D	58.00		100.00	4.19	162.19	162.19	15.25
Taxpayer E	100.00		50.00	7.66	157.66	157.66	18.50
Taxpayer F	0.00		0.00	0.00	0.00	0.00	10.75
Taxpayer G	0.00	37.90	100.00	2.28	140.18	140.18	31.25
Taxpayer H	0.00		0.00	0.00	0.00	0.00	8.75
Taxpayer I	0.00		0.00	0.00	0.00	0.00	7.00
Taxpayer J	0.00		0.00	0.00	0.00	0.00	8.25
Taxpayer K	0.00		0.00	0.00	0.00	0.00	16.25
Taxpayer L	0.00		0.00	0.00	0.00	0.00	31.75
Taxpayer M	0.00	2,759.95	889.50	419.31	4,068.76	0.00	103.50
Taxpayer N	1,110.49		700.00	78.39	1,888.88	1,888.88	30.25
Totals:	1,268.49	2,797.85	1,839.50	511.83	6,417.67	2,348.91	326.00