

Report of Income Tax Withholding from Payments to Individual Construction Contractors

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

Withholding Tax Division
Minnesota Department of Revenue
January 31, 2011

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January 2011

To the members of the legislature of the state of Minnesota:

The Minnesota legislature enacted Minnesota Statutes Section 290.92, subdivision 31 as a measure to promote compliance with Minnesota's individual income tax. The law provides for income tax withholding from compensation paid by construction contractors to individual construction contractors (individual proprietors). Withholding is required at the rate of two percent of total payments. Tax withheld is claimed as a credit on the individual income tax returns of the recipients of the payments. As such, it provides additional revenue to the state to the extent the compensation is not reported on individual income tax returns of individual construction contractors or would not have been reported were it not for the withholding.

The number of individual construction contractors whose compensation was subject to the withholding was far less than initially projected. A significant number, estimated to be in excess of 20,000 individual construction contractors, may have changed business form from sole proprietorship to some other form, principally limited liability companies, in order to circumvent the withholding. Based on business entity types existing when the withholding provision was enacted, the Department of Revenue expected that payments to more than 20,000 payees would be subject to the withholding requirement. Returns filed with the department indicate that less than 2,000 payees have received payments from which tax was withheld.

Please contact me if you need additional information about the results reported herein.

Sincerely,



Daniel A. Salomone
Acting Commissioner

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Summary of Findings

For tax year 2009, 902 payers paid 1,866 individual payees \$26,076,320 subject to the two percent withholding and reported \$521,526.40 Minnesota state income tax withheld.

Estimated Cost of Preparing this Report

Minnesota Statue §3.197 requires that a report to the legislature contain the cost of preparing the report. The cost of preparing the report is estimated at \$6,603.00, including the costs of gathering and analyzing the data and preparing the document.

Purpose of this Report

This report provides information pertaining to income tax withholding from payments to individual construction contractors, including the number and amount of payments received by the Department of Revenue and the types of contractors making payments, in accordance with the Laws of Minnesota 2008, Chapter 154, Article 3, Section 9.

This is expected to be the first of two reports. This report provides data pertaining to the withholding payers and payees – those who have complied with the law. The second report is expected to be made in February, 2012 when sufficient data will have been gathered to evaluate overall compliance with the withholding requirement.

Background

The Department of Revenue (DOR) interprets the legislative intent for this report as a means by which to gauge the compliance impact of income tax withholding from non-wage compensation for personal services performed in construction trades.

Minnesota's Office of the Legislative Auditor (OLA) issued a report in November of 2007 titled *Misclassification of Employees as Independent Contractors*. The OLA estimated that 15% of employers in construction trades misclassified workers. Where workers are misclassified as independent contractors rather than as employees, compensation is reported on Form 1099-MISC. Past studies¹ suggest that payments subject to information reporting but not income tax withholding are far less likely to be reported on the income tax returns of the recipients than

¹ GAO Report to the Committee on Finance, U. S. Senate, July 2007, entitled *Tax Gap, A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*. The misclassification of employees as independent contractors coupled with a lack of third party reporting causes compliance to drop off the map.

"A significant issue is the potential revenue loss to the federal government when employees are misclassified as independent contractors. An IRS survey of 1984 employment tax returns found that nearly 15 percent of employers misclassified employees as independent contractors. When employers classified workers as employees, more than 99 percent of wage and salary income was reported. When workers were misclassified as independent contractors, 77 percent of income was reported when a Form 1099-MISC was filed and only 29 percent was reported when no Form 1099-MISC was filed."

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are wages subject to wage withholding. The 2% independent construction contractor withholding requirement seems intended to increase individual income tax compliance by establishing more uniformity between wages and non-employee compensation in the construction trades.

The number of individual construction contractors whose compensation was subject to the withholding was far less than initially projected. A significant number of individual construction contractors may have changed business form from sole proprietorships to some other form, principally limited liability companies (many of which are single member limited liability companies), in order to circumvent the withholding or for other reasons². Based on business entity types existing when the withholding provision was enacted, the Department of Revenue expected that payments to more than 20,000 payees would be subject to the withholding requirement. The following is based on 2006 federal tax return data³ provided to the Department of Revenue. The counts represent sole proprietorships reporting Minnesota business activity in the construction trades (identified through NAICS codes 23 through 238990) and are stratified by gross receipts:

Gross Receipts \$50,000 and over	12,866
Gross Receipts \$30,000 to \$49,999	5,604
Gross Receipts \$10,000 to \$29,999	10,168

Minnesota Statutes Section 181.723, subs. 5(b) and 5(c), administered by Minnesota's Department of Labor and Industry (DLI), was enacted with the same effective date as the 2% withholding. That law applies to roughly the same population of persons in the construction trades. It requires that individual construction contractors receive an Independent Contractor Exemption Certificate (ICEC) in order to operate as independent contractors. Without an ICEC, the person would be treated as an employee for purposes of compliance with worker compensation laws, regardless of the relationship between the payer and the payee.

The DLI's experiences with the number of applications for ICEC mimics the DOR's experience with the withholding requirement. The DLI anticipated approximately 25,000 applications for the certificate. From October 23, 2008 through December 6, 2010, DLI had issued 1,972 certificates. Those figures, both the anticipated and actual, closely correspond with the DOR's expectations and experience with the 2% withholding. This information, coupled with a spike in registrations of Limited Liability Companies occurring at about the same time, suggests that many individual proprietors formed entities exempt from the ICEC requirement and the 2% withholding.

The two percent contractor withholding became effective for payments made on or after January 1, 2009. Returns reporting the withholding were not due until February 28, 2010. Analysis of the

"Overall, the estimated compliance rate for gross receipts reported on boxes 6 and 7 of Forms 1099-MISC for 2001 is 88 percent."

² During the period October 2008 through March 2009, the number of LLC filings with the Minnesota Secretary of State increased 9,157 from the same period one year earlier.

³ 2006 Information Returns Master File compiled by the Internal Revenue Service and shared with the Department of Revenue as per information exchange agreement.

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effectiveness of the two percent withholding is dependent upon information received from the Internal Revenue Service. Although the Department of Revenue can readily ascertain the number of withholding remitters and the amounts remitted by contractor types, estimating compliance necessitates a match of this information against the population of payers who might be required to collect and remit the withholding and then conduct random sample audits to determine whether those who did not were out of compliance. The population of payers to be considered includes all contractors that file Forms 1099-MISC with the Internal Revenue Service for calendar year 2009. That information should be available to the Department of Revenue by May of 2011 and the data is expected to be in a form suitable for audit selection processes mid-year 2011. Subsequent to compilation of the data, the Department will begin sample audits to evaluate compliance.

Looking Forward

Department of Revenue compliance programs frequently rely upon information submitted to and compiled by the Internal Revenue Service (IRS). Information from Forms 1099-MISC filed with the IRS will be used by the DOR to identify possible noncompliance among payers of compensation to individual construction contractors. The IRS shares its information with the DOR at scheduled intervals. The DOR will receive Form 1099 information for the tax year 2009 during calendar year 2011. The data will be analyzed to identify the population of payers likely to have a 2% withholding requirement. The DOR will then conduct random audits to determine the rate of compliance with the law and report its findings to the legislature in 2012.

If the law has not produced the expected revenues, it seems likely it is principally attributable to the migration away from sole proprietorships among those in the construction trades, although the general downturn in construction during 2009 may be a contributing factor. The legislature could consider expanding the types of businesses subject to the 2% withholding tax to include single member limited liability companies, all limited liability companies, partnerships and/or S corporations in order to achieve higher rates of income tax compliance among workers in the construction trades.

2009 2% Withholding by Construction NAICS Code

NAICS Code	Description	Number of businesses	1099 Compensation*	MN withholding	Number of workers**
236xxx	Construction of Buildings				
236115	New single family	261	\$7,543,569.03	\$145,260.63	546
236116	New multifamily	15	\$662,626.67	\$10,771.14	36
236118	Residential remodelers	83	\$1,300,109.11	\$24,498.02	131
236220	Commercial & industrial bldg.	57	\$2,757,857.86	\$48,058.13	163
	Other construction of buildings	12	\$473,917.66	\$9,366.51	44
	Total construction of buildings	428	\$12,738,080.33	\$237,954.43	920
	Heavy and Civil Engineering				
237xxx	Construction				
237310	Highways, streets, bridges	11	\$212,175.34	\$4,139.04	20
237990	Other heavy & civil eng	17	\$425,349.21	\$8,530.03	29
	Other heavy & civil eng	26	\$712,276.62	\$14,176.48	42
	Total heavy and civil eng. const.	37	\$924,451.96	\$18,315.52	62
238xxx	Specialty Trade Contractors				
238110	Poured concrete found. & structures	15	\$480,711.63	\$9,404.05	37
238140	Masonry	28	\$685,168.17	\$12,904.20	73
238160	Roofing	17	\$365,108.68	\$7,353.07	29
238170	Siding	12	\$574,119.03	\$8,710.74	36
238210	Electrical	17	\$318,734.31	\$5,274.56	23
238220	Plumbing, heating, a/c	28	\$589,055.04	\$10,772.86	41
238310	Drywall, insulation	33	\$605,732.45	\$10,928.96	53
238320	Paint & wall covering	31	\$719,436.17	\$12,917.35	62
238330	Flooring	25	\$2,341,211.49	\$20,350.04	74
238350	Finish carpentry	14	\$291,268.65	\$5,816.40	28
238910	Site preparation	23	\$557,392.55	\$10,479.31	29
238990	All other spec trade cont.	40	\$979,919.80	\$17,470.96	79
	Other specialty trade contractors	61	\$1,669,898.46	\$31,315.82	116
	Total specialty trade contractors	304	\$9,197,836.63	\$146,227.36	601
TOTALS		769	\$22,860,368.92	\$402,497.31	1583

2009 2% Withholding by NAICS Code - other than construction

NAICS Code	Description	Number of businesses	1099 Compensation*	MN withholding*	Number of workers**
442210	Floor covering stores	35	\$2,329,596.41	\$37,422.10	100
444110	Home center store	10	\$843,282.28	\$10,336.07	51
444190	Other building material store	11	\$387,189.21	\$6,915.56	21
53xxxx	Real estate & rental	13	\$137,636.52	\$2,777.49	22
56xxxx	Admin. & support, waste mgmt	13	\$577,341.90	\$10,706.05	42
	All other	51	\$3,060,395.97	\$50,871.82	134
	Total - other than construction trades	133	\$7,335,442.29	\$119,029.09	370
	2009 2% Withholding - All	902	\$30,195,811.21	\$521,526.40	1953

* 1099 Compensation represents the total compensation shown on Forms 1099-MISC issued to individuals who received one or more Forms 1099-MISC reporting compensation subject to income tax withholding. Only compensation for activities described in the specified NAICS codes is subject to withholding. Therefore, the total withholding does not equal 2% of the total compensation paid to recipients of Forms 1099-MISC.

** The total number of workers figure represents the total Forms 1099-MISC subject to withholding issued in each NAICS code category. Some workers received more than one Form 1099-MISC. The total number of individuals who received at least one Form 1099-MISC is 1,866.