

Testimony of  
Rebecca Smith  
National Employment Law Project

Hearing Before the  
United States Congress  
House of Representatives  
Committee on Ways and Means  
Subcommittee on Income Security and Family Support  
Subcommittee on Select Revenue Measures

**Effects of the  
Misclassification of Workers as Independent Contractors**

May 8, 2007

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Chairmen McDermott and Neal and members of the Committee: thank you for this opportunity to testify today on the important subject of independent contractor misclassification and its impacts on workers and their families, law abiding employers, and our economy.

My name is Rebecca Smith, and I coordinate the Justice for Low-wage and Immigrant Worker Project of the National Employment Law Project (NELP), a thirty-five year old national non-profit law and policy organization dedicated to research and advocacy on issues of concern to low wage and jobless workers. We work to promote policies that advance economic opportunity, increase enforcement of baseline workers' rights, and help jobless workers reconnect to the promise of economic progress. NELP has partnered with community and advocacy groups to promote good models for closing independent contractor loopholes and to increase access to the unemployment insurance system. For twenty-five years, I have represented low-wage workers on employment issues, including issues related to the unemployment insurance systems in my home state of Washington and around the country. I worked with over half the states on state level implementation of the SUTA Dumping Prevention Act of 2004, and I have previously provided written testimony to this committee on SUTA dumping implementation and on the FY 2007 US Department of Labor (USDOL) budget for unemployment insurance.<sup>1</sup>

In my testimony today, I will describe misclassification of workers as independent contractors and relate what we know about the extent of misclassification and its impact on the nation's tax gap. Then I will discuss the impacts of misclassification on workers, in the unemployment insurance (UI) system and beyond. I will also touch on the implications of misclassification for the "tax gap" in the UI and other tax systems. Finally, I will propose some key initiatives reducing the incidence of misclassification and increasing the degree of fairness in the unemployment insurance system for workers, taxpaying employers and state trust funds.

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<sup>1</sup> Implementation of the SUTA Dumping Prevention Act of 2004 (June 2005) (with Rick McHugh); U.S. Department of Labor's FY 2007 Budget For Unemployment Insurance (May 2006) (with Andrew Stettner).

## A. Background: Independent Contractor Misclassification

Employers across the United States have found that tax laws and worker protections can be avoided by entering into a “contract” relationship with their workers, even where the worker is providing personal services that are completely integrated into the employer’s business. Generally, employers accomplish this by giving their employees an IRS Form 1099 instead of a Form W-2, or by paying them in cash, off the books. Misclassification may occur at the time of hire, or an employer may convert a worker to “independent contractor” status at a later date in the employment relationship. Employers may require workers to sign a contract stating that they are an independent contractor, or take out their own business licenses or insurance coverage.

By this simple arrangement, employers hope to avoid paying unemployment insurance, workers’ compensation, and social security taxes, and to escape the cost of withholding income taxes, since employers are not obligated to make these payments to, or on behalf of, independent contractors.<sup>2</sup> Misclassifying employers stand to save as much as 30% of their payroll costs if they count workers as independent contractors. Thus, they can undercut law-abiding employers because they don’t account for these normal payroll costs.

Workers who have been misclassified as independent contractors lose out on workplace protections. When they lose jobs, they face potentially insurmountable obstacles in correcting their files and determining eligibility for unemployment insurance. If they are injured on the job, they may be burdened with huge medical bills, and uncompensated for lost wages. They may never receive Social Security benefits and may be on their own for retirement savings and Medicare.

In addition, misclassification of workers as independent contractors contributes significantly to the nation’s tax gap. Total losses, from unpaid federal and state income and payroll taxes show a hefty loss of revenue due to independent contractor misclassification, in the form of unpaid and uncollectible income taxes, payroll taxes, and unemployment insurance and workers’ compensation premiums. The GAO estimated that misclassification of employees as independent contractors reduces federal income tax revenues up to \$4.7 billion.<sup>3</sup> Coopers & Lybrand (now PriceWaterhouse Coopers) estimated in 1994 that proper classification of employees would increase tax receipts by \$34.7 billion over the period 1996-2004.<sup>4</sup>

In systems such as unemployment compensation, nonpayment of taxes can lead to trust fund deficits. When some employers are not paying their fair share, compliant employers must make up the difference.

Genuine independent contractors constitute a small proportion of the American workforce, because by definition, an “independent contractor” is a person who is in business for him- or herself. True

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<sup>2</sup> Workers classified as independent contractors also lack coverage under labor protective laws such as minimum wage, overtime, discrimination, and freedom of association laws. U.S. General Accountability Office, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (July 2006), at 7, 25. Though these are significant issues, my testimony today will focus on work-related benefits and the payroll taxes that fund them.

<sup>3</sup> U.S. General Accounting Office, *Tax Administration Information: Returns Can Be Used to Identify Employers Who Misclassify Employees*, GAOIGGD-89-107 (1989).

<sup>4</sup> Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers, Coopers & Lybrand (1994).

independent contractors have specialized skill, invest capital in their business, and perform a service that is not part of the receiving firm's overall business.<sup>5</sup> Most workers in labor-intensive and low-paying jobs are not operating a business of their own.

Misclassification has significant negative consequences for workers, employers and state and federal tax revenues.

## **B. Misclassification of workers is pervasive.**

Recent studies at both the national and state levels give some indication of the extent of this illegal practice. In 2000 the US Department of Labor commissioned a study of the extent of misclassification in the unemployment insurance system. That study found that up to 30% of firms misclassify their employees as independent contractors.<sup>6</sup> The percentage of employers who had misclassified workers ranged from a low of 9% in New Jersey to a high of 42% in Connecticut.

The states have been leading the way in documenting and recovering taxes unfairly denied the state treasuries due to misclassification. Recent studies document rates of misclassification from 10-20%, with higher rates of misclassification in the construction industry.

The state studies found not only high rates of misclassification, but also that misclassification is a growing problem. For example, the Massachusetts researchers found a misclassification rate of 8.2 % in 1995-1997, but that rate grew to 13.4% in 2001-2003.<sup>7</sup>

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<sup>5</sup> GAO 06-656, at 43. Examples are a plumber called in by an office manager to fix a leaky sink in the corporate bathroom, or a computer technician on a retainer with a shipping and receiving company to trouble-shoot software glitches.

<sup>6</sup> Laliith de Silva et al., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs* iv, prepared for U.S. Department of Labor, Employment and Training Division by Planmatics, Inc. ("Planmatics")(Feb. 2000), available at <http://wdr.doleta.gov/owsdrr/00-5/00-5.pdf>.

<sup>7</sup> Massachusetts, 7.

Table 1 - Recent Studies of Misclassification, Using UI Data

State	Percent of Employers Misclassifying Some of their Workers	Number of Workers Misclassified annually	Years Studied	Source
Illinois	18%	387,000	2001-2003	<a href="#">Kelsay et al. (2006)<sup>8</sup></a>
Maine	11%	573,000	1999-2002	<a href="#">(Carre and Wilson, 2006)<sup>9</sup></a>
Massachusetts	13%	126,000 – 248,000	2001-2003	<a href="#">(Carre and McCormack, 2004)<sup>10</sup></a>
New York	10%	705,000	2002-2005	<a href="#">(Donahue, et al., 2007)<sup>11</sup></a>
Average	13%			

Second, while misclassification rates are especially high in construction, (where as many as 4 in 10 construction workers were found to be misclassified),<sup>12</sup> this practice has expanded to nearly all major industries, including delivery services like FedEx, which has been found to be misclassifying its employees in New Hampshire and California, to building maintenance and janitorial services companies like Coverall, found in Massachusetts to have misclassified employees, to agriculture<sup>13</sup>, home health care,<sup>14</sup> child care<sup>15</sup> and other industries. The Massachusetts study provides a helpful table documenting the scope of misclassification across industries.

<sup>8</sup>Michael Kelsay, James Sturgeon, Kelly Pinkham, “The Economic Costs of Employee Misclassification in the State of Illinois,” 4-5, (Dept of Economics, University of Missouri-Kansas City: December 2006)(“Illinois”), available at [http://www.lecetchicagoarea.org/pdfs/Illinois\\_Misclassification\\_Study.pdf](http://www.lecetchicagoarea.org/pdfs/Illinois_Misclassification_Study.pdf)

<sup>9</sup> Francoise Carre and Randall Wilson, “The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry,” 2 (Construction Policy Research Center, Labor and Worklife Program, Harvard Law School and Harvard School of Public Health: April 2006)(“Maine”), available at [http://www.mccormack.umb.edu/csp/publications/Maine\\_misclassification.pdf](http://www.mccormack.umb.edu/csp/publications/Maine_misclassification.pdf).

<sup>10</sup> Francoise Carre, J.W. McCormack, “The Social and Economic Cost of Employee Misclassification in Construction,” 2 (Labor and Worklife Program, Harvard Law School and Harvard School of Public Health: December 2004)(“Massachusetts”), available at <http://www.mccormack.umb.edu/csp/publications/misclassification.pdf>

<sup>11</sup> Linda H. Donahue, James Ryan Lamare and Fred B. Kotler, “The Cost of Worker Misclassification in New York State,” (Cornell University: 2007)(New York”), available at <http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1009&context=reports>

<sup>12</sup> See Fiscal Policy Institute, “New York State Workers Compensation: How Big is the Shortfall?” (January 2007); Illinois; Peter Fisher et al, “Nonstandard Jobs, Substandard Benefits”, Iowa Policy Project (July 2005); Massachusetts; State of New Jersey, Commission of Investigation, “Contract Labor: The Making of an Underground Economy” (September 1997).

<sup>13</sup> See, *Secretary of Labor v. Lauritzen*, 835 F.2d 1529 (7th Cir. 1988).

<sup>14</sup> See, *Bonnette v. Cal. Health & Welfare Agency*, 704 F.2d 1465 (9th Cir. 1983).

<sup>15</sup> See, IL Executive Order conferring bargaining status on child day care workers otherwise labeled independent contractors, available at <http://www.gov.il.gov/gov/execorder.dfm?eorder=34>.

**Massachusetts Prevalence of Misclassification by Industry 2001-2003.**

	<b>Moderate estimate (All Audits<sup>16</sup>)</b>
Transportation/utilities	28.70%
Information	28.70%
<b>Construction</b>	<b>23.70%</b>
Professional/business services	22.20%
Other services, private	20.00%
Education/health services	18.70%
Natural resources	17.60%
Financial activities	15.70%
Manufacturing	15.30%
Leisure/hospitality	13.70%
Trade	13.40%

Nonpayment of taxes is likely underrepresented in these studies. This is because studies can not adequately capture the so-called “underground economy,” where workers are paid off the books, sometimes in cash. These workers are *de facto* misclassified independent contractors, because the employers do not withhold and report taxes or comply with other basic workplace rules.

Unreported cash pay is one facet of this growing problem that is particularly difficult for the IRS to catch, since employers have no record of pay. The problem is complicated by company’s failure to report payments they make by means of a 1099 to other companies. For instance, a construction employer can subcontract labor and pay the subcontractor \$600,000 in the course of a year. That number is added into the contractor’s business expenses, but the payments to that subcontractor are not identified in any reporting to the IRS. The subcontractor is then free to pay workers cash and only report \$100,000 of income.

**C. Unemployed workers whose employers have misclassified them lose out on vital safety net benefits.**

As the Committee knows, a critical purpose of the unemployment insurance (UI) safety net is to partially replace lost wages of jobless workers. This income replacement function prevents extreme hardship, maintains essential household spending, and supports work search and a return to work. According to a 2004 report by the Congressional Budget Office, UI benefits during 2001 and early 2002 “played a substantial role in maintaining the family income of recipients who experienced a long-term spell of unemployment.” The CBO report found that job loss reduced

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<sup>16</sup> “All audits,” refers to a combination of both targeted audits and random audits. Targeted audits generally result in a higher rate of misclassification.

family income by 40 percent for those receiving UI benefits, as compared to an average income loss of 60 percent for those not receiving unemployment benefits.<sup>17</sup>

Large numbers of workers who should be classified as employees lose out on these vital safety net benefits when they are separated from their jobs and file for unemployment compensation. Many may simply forego filing for unemployment compensation benefits. These workers may wrongly assume that if their employer has told them they are an “independent contractor,” that the state unemployment agency will not question that determination. Still others, having signed a confusing array of papers claiming they are independent contractors, may fear that they will create problems for themselves if they now claim to be an “employee.” Finally, workers may fear that applying for benefits and challenging their employer means they will not be offered a job by that particular employer again.<sup>18</sup>

### **C. Jobless workers face lengthy court battles to establish UI Claims.**

Some workers have overcome these obstacles and filed their claims for unemployment insurance, only to find themselves embroiled in lengthy legal battles, in which they must disprove their employer’s claim that they are an independent contractor:

Rhina Alvarenga was a janitor employed by Coverall, a national cleaning company. After her initial hire in November 2002, Ms. Alvarenga was presented with a \$10,500 “Franchise” package by her employer. She paid for the package by taking out a loan from the employer. She was directed to sign a contract with the company written in English, a language that she does not fully understand. The contract, including the hours that she would work and amount that she would earn per week, had already been negotiated by the janitorial company and the nursing home where she worked. The method that she used to clean was dictated by the company, and a company employee was her supervisor. Ms. Alvarenga applied for unemployment insurance benefits in November of 2003, after losing her job, but the cleaning company argued that she was a “franchisee” and thus not eligible for unemployment compensation. The Massachusetts Supreme Court eventually found that Ms. Alvarenga was the employee of the cleaning company, in December, 2006.<sup>19</sup>

In New Hampshire, a worker lost his long-term job and applied for unemployment compensation. He was hired to deliver packages for FedEx national package delivery service. The service required him to receive a particular kind of training from a particular company, purchase his own van (of a type specified by the company) from a particular dealer and install the company’s logo on the van. He was required to wear a certain

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<sup>17</sup> Congressional Budget Office, *Family Income of Unemployment Insurance Recipients* (March 2004).

<sup>18</sup> Illinois, 10-11.

<sup>19</sup> *Coverall North America, Inc., v. DUA*, Supreme Judicial Court of Massachusetts. No. SJC-09682 (December 12, 2006). The Massachusetts Court decided Ms. Alvarenga’s case using the “ABC” test, a common test of the employer-employee relationship used in about half of the states. To be exempted from the requirement of contributions to the fund, an employer must establish that an individual providing services is an independent contractor. Under Massachusetts’ law, the employer bears the burden of proving “that the services at issue are performed (a) free from control or direction of the employing enterprise; (b) outside of the usual course of business, or outside of all the places of business, of the enterprise; and (c) as part of an independently established trade, occupation, profession, or business of the worker.” Mass. Gen. Law § 151A, 2.

uniform, and the company specified his work days. He could not use his van for any purpose but to deliver packages for the company. Nonetheless, the company argued that he was an independent contractor and not eligible for unemployment insurance when he was separated from his job. Although he eventually won UI benefits, he was without income from December 2005 through July 2006 while he appealed this denial.<sup>20</sup>

Even where unemployed workers have the understanding, sophistication and wherewithal to challenge an employer's claim that they are independent contractors, they may go many months or years without UI benefits before their case is resolved. Even if they prevail at a lower level of appeal, they face the risk of reversal, and of being obligated to repay UI benefits should they lose the appeal at a higher level. In addition, filing a claim for unemployment compensation does not necessarily trigger an audit of the particular employer. In short, misclassification of workers as independent contractors wreaks havoc on the wage replacement purpose of the unemployment compensation program.

#### **D. Misclassification distorts the playing field for business and undermines UI trust funds.**

Employers who misclassify their workers as independent contractors undercut law-abiding employers who pay their fair share of taxes. In addition, they cheat average taxpayers.

The 2000 study commissioned by the U.S. Department of Labor found nearly \$200 million in lost UI tax revenue per year through the 1990s due to misclassification of workers as independent contractors. Carrying this number forward to 2005, estimated losses would be on the order of \$343 million per year. The more recent state studies found much higher losses:

- In New York, the researchers estimated a loss to the state UI fund of \$176 million annually – 7.4% of total taxes paid in the state.
- In Illinois, the loss was estimated at \$39.2 million, and in Massachusetts, a range of \$12.6 to \$35 million annually was discovered.<sup>21</sup>

Total losses from unpaid federal and state income and payroll taxes show a hefty loss of revenue due to independent contractor misclassification, in the form of unpaid and uncollectible income taxes, payroll taxes, and unemployment insurance and workers' compensation premiums.

- The GAO estimated that misclassification of employees as independent contractors reduces federal income tax revenues up to \$4.7 billion.<sup>22</sup>
- Coopers & Lybrand (now PriceWaterhouse Coopers) estimated in 1994 that proper classification of employees would increase tax receipts by \$34.7 billion over the period 1996-2004.<sup>23</sup>

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<sup>20</sup> NH Employment Security Appeal Tribunal, Decision of Appeal Tribunal, Docket No. 06-0463 6016-06.

<sup>21</sup> New York, 10; Illinois, 18; Massachusetts, 2.

<sup>22</sup> U.S. General Accounting Office, *Tax Administration Information: Returns Can Be Used to Identify Employers Who Misclassify Employees*, GAO\GGD-89-107 (1989).

<sup>23</sup> Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers, Coopers & Lybrand (1994).

- The New York State analysis found that noncompliance with payroll tax laws means as many as twenty per cent of workers' compensation premiums—\$500 million to \$1 billion—go unpaid each year.<sup>24</sup>
- The Massachusetts construction industry found that misclassification of employees resulted in annual losses of up to \$278 million in uncollected taxes and premiums.<sup>25</sup>
- Total tax loss in California due to misclassification is as high as \$7 billion.<sup>26</sup>

In order to achieve its program goals, the UI program must, of course, be adequately financed. Employers who misclassify make other employers foot the bill for the program.<sup>27</sup> Some amount of the loss to funds is recaptured when workers such as those mentioned above apply for UI and an audit is triggered. More of it shifted to other employers, whose taxes may increase because the trust fund is not sufficiently solvent.<sup>28</sup>

## **E. Misclassification is inefficiently addressed by current tax law and practice.**

Both state and federal authorities have responsibility for auditing employers to determine whether they are misclassifying workers as independent contractors. At the federal level, federal law creates a gaping loophole that allows employers both to misclassify workers and to escape any future liability for doing so. This loophole is compounded by a lack of serious, concentrated efforts to detect misclassification by employers and recover unpaid taxes. At the state level, greater attention to use of IRS 1099 data and to auditing employers could improve collections.

### **1. The tax gap and the “Safe Harbor” provision of the tax code.**

In 1978, Congress adopted a “safe harbor” provision (Section 530 of the Revenue Act of 1978), which precludes the IRS from collecting employment taxes against employers who “reasonably” misclassify their workers as independent contractors.<sup>29</sup> In addition, the IRS is prevented from reclassifying these workers prospectively as employees under the safe harbor statute. When adopted by Congress, the safe harbor provision was intended to provide “interim relief for taxpayers who are involved in employment tax status controversies with the Internal Revenue

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<sup>24</sup> *New York State Workers' Compensation: How Big Is the Coverage Shortfall?*, (New York: Fiscal Policy Institute, Jan. 2007).

<sup>25</sup> Massachusetts, 15-17.

<sup>26</sup> Jerome Horton, California State Assembly Member, 51<sup>st</sup> Assembly District, recorded interview within “1099 Misclassification: It's Time to Play by the Rules,” video stream *available at* [http://www.mosaicprint.com/client\\_preview/1099/index.html#](http://www.mosaicprint.com/client_preview/1099/index.html#).

<sup>27</sup> Employers pay two types of UI payroll taxes: the federal tax under FUTA is .8% of the first \$7,000 of a worker's earnings, or \$56 per year. State taxes vary according to the health of the state fund and the individual employer's experience with layoffs, with an average tax rate on total wages of .8% in 2006. U.S. Department of Labor, Employment and Training Administration, *Unemployment Insurance Data Summary*, 2006.4.

<sup>28</sup>In Illinois, while the researchers found that the national recession was the major contributing factor to the state's UI trust fund deficit, misclassification also contributed to negative outcome in fund. Illinois, 12.

<sup>29</sup> The safe harbor provision does not apply to IRS determinations related to income taxes, which are subject to the traditional 20-factor “common law” test used by IRS to distinguish employees from independent contractors.

Service, and who potentially face large assessments, as a result of the Service's proposed reclassification of workers, until the Congress has adequate time to resolve the many complex issues involved in this area."<sup>30</sup> The provision was extended "indefinitely" in 1982, and subsequently amended again in 1996.<sup>31</sup> Significantly, since 1978, the federal law has also prohibited the IRS from issuing any regulations or revenue rulings "clarifying the employment status of individuals for purposes of employment taxes . . . ."<sup>32</sup>

Section 530 of the Internal Revenue Code prohibits the IRS from correcting erroneous classifications of workers as independent contractors for employment tax (but not income tax) purposes, including prospective corrections, as long as the employer has a reasonable basis for its treatment of the workers as independent contractors.<sup>33</sup>

To qualify for the safe harbor provision, the employer must have consistently filed 1099s with the IRS identifying their independent contractors and treated all similar workers the same with regard to their employment status. If these requirements are met, then the employer will have a "reasonable basis for not treating an individual as an employee" if the employer's decision was in "reasonable reliance" on any one of three factors: Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer; a past IRS audit; or, a "long-standing recognized practice of a significant segment of the industry in which such individual was engaged." (Section(a)(2))

According to the 1996 IRS compliance manual, the "safe haven most commonly argued, and the one which causes the most controversy between businesses and the Government, is industry practice."<sup>34</sup> The GAO analysis also found that about 40% of the recommended unpaid taxes and penalties they identified could not be assessed because of the Section 530 restrictions.<sup>35</sup>

Under current law, there are only limited penalties, reporting requirements and complaint procedures that regulate employers who hire independent contractors. These include a minimum \$50 penalty. While there is a procedure for individuals to correct their records with the IRS using form SS-4, that procedure lacks any private right of action or safeguards against retaliation by employers.

## **2. The Department of Labor and State level audits of employers.**

Within the Unemployment Insurance system, the federal Department of Labor does not itself conduct audits of employers. Instead, the Internal Revenue Service audits employers for unreported federal taxes, including the FUTA tax, and USDOL recommends that states audit 2% of employers each year, in order to determine whether or not they are misclassifying workers as

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<sup>30</sup> P.L. 95-600, Revenue Act of 1978, Senate Report No. 95-1263, 95<sup>th</sup> Cong., 2<sup>nd</sup> Session, 92 Stat. 2763 (1978).

<sup>31</sup> P. L. 97-248 [Tax Equity and Fiscal Responsibility Act of 1982], title II, Sec. 269(c)(1), (2), 96 Stat. 552 .

<sup>32</sup> Section 530 of the Revenue Act of 1978, Section(b).

<sup>33</sup> Statement of Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Department of the Treasury, Before the Subcommittee on Taxation and IRS Oversight Committee on Finance, U.S. Senate (June 5, 1997), 4.

<sup>34</sup> Department of Treasury, Internal Revenue Services, *Independent Contractor or Employee? Training Material* (October 30, 1996) I-26.

<sup>35</sup> U.S. General Accounting Office, *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers*, 8 (September 1989).

independent contractors.<sup>36</sup> In 2004, for the eighth year in a row, states audited only 1.7% of their employers, and focused their audits on small employers.<sup>37</sup> In program year 2006, audits also focused on small employers. Forty-four percent of that year's audits resulted in some change in the audited employer's liability or taxes due.<sup>38</sup>

States perform random, non-random and targeted audits. Some states conduct only random audits, which generally will show a lower rate of misclassification.<sup>39</sup> Non-random audits are those that are triggered by the filing of a claim for UI benefits. Targeted audits are those that are focused on particular indicators of non-compliance with the law, such as delinquent filings, high degree of employee turnover, type of industry, or prior reporting history. Not surprisingly, the state studies mentioned above find a much higher degree of misclassification when state conduct targeted audits, giving the states a better return on their enforcement dollar.<sup>40</sup> Nonetheless, USDOL permits states to conduct all of its required investigations by random, rather than targeted, audit.<sup>41</sup>

USDOL requires only 1% of the 2% of audited employers to be large employers of 100 or more employees.<sup>42</sup>

Some states rightly view misclassification as a serious, compelling problem, and have set aside their scarce administrative funding to perform additional audits. For example, New York increased both random and specific audits over the four year period covered in study 2002-2005, but cited limited staff and resources as a reason it could not do more.<sup>43</sup> State administrators with whom we have spoken cite the continued reduction in federal administrative funding as a reason that these efforts fall short. Cash-strapped state administrations are increasingly skimping on their audit functions, with the result that program integrity measures intended to recover unpaid taxes have been hampered.

One tool that has been made available to the states by the IRS and USDOL is a cross-match between IRS 1099 forms filed by employers and state wage reports. The IRS has several data sets showing payments made by companies using 1099 forms, since employers are required to file 1099 reports with the IRS for workers paid \$600 or more. IRS has made this data available to states.<sup>44</sup> Two-thirds of the audits resulted in changes in the employer's reports of taxes. At least

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<sup>36</sup> U.S. Department of Labor, Employment Security Manual, Unemployment Insurance Program, ¶ 3677.

<sup>37</sup> 2004 UI Performs, 38, available at [http://www.workforcesecurity.doleta.gov/unemploy/pdf/ar\\_04.pdf](http://www.workforcesecurity.doleta.gov/unemploy/pdf/ar_04.pdf).

<sup>38</sup> UI Performs, PY 2006, 37-39, available at [http://www.workforcesecurity.doleta.gov/unemploy/pdf/ar\\_05.pdf](http://www.workforcesecurity.doleta.gov/unemploy/pdf/ar_05.pdf).

<sup>39</sup> In Illinois, for example, 98% of audits are random. Illinois, 4.

<sup>40</sup> Maine, 13.

<sup>41</sup> DOL encourages states to select some employers in a more targeted fashion, but requires 10% of audits be random. Employment Security Manual, ¶ 3679.

<sup>42</sup> Employment Security Manual, ¶ 3681.

<sup>43</sup> New York, 15.

<sup>44</sup> U.S. Department of Labor, Office of Inspector General, *Use of Form 1099 Data to Identify Misclassified Workers*, (September 2005). Despite these success rates, as of the time that the Office of Inspector General reviewed this system in 2005, only nine states were using the data. OIG anticipated that an additional sixteen states would make use of the data in the following year. States reported difficulties with their own IT processes, procedural difficulties in communicating with the IRS and meeting its safeguards, as well as "other priorities" as reasons that they were not using the IRS data sets.<sup>44</sup> Because the IRS data sets are so large, states were required to load it on their mainframe computers. They also faced IT challenges in converting the tapes to documents that could be useful to auditors in the field. While OIG was satisfied that ETA, having convened a telephone conference call and presented this issue at its

one state that uses the IRS process to target employers, New Jersey, has an even higher success rate, of 70%.

## **F. Some Key Federal Policy Reforms**

While misclassification presents a multi-faceted problem, there are several initiatives that could close the tax gap and protect America's workers.

### **1. Close the Section 530 "safe harbor" loophole that promote misclassification.**

- *Allow IRS to require that employers correct their books prospectively.*

Although there is a strong case that could be made to repeal the entire safe harbor scheme, the specific language that prevents the IRS from reclassifying workers prospectively as employees is especially ripe for reform.

In its 1989 testimony to Congress, the GAO strongly supported this reform of the federal law. Specifically, the GAO stated "In view of the equity issues and tax revenues involved, Congress may want to consider repealing this restriction against requiring employers to prospectively reclassify employees who have been misclassified as independent contractors."<sup>45</sup> In response to the GAO's recommendation, the IRS wrote "we support your recommendation that Congress reconsider Section 530 of the Revenue Act of 1978. Although we continue to seek improvements in our compliance programs, their effectiveness will be limited by the statutory restrictions of Section 530."<sup>46</sup>

- *Eliminate the "everybody does it" defense.*

Another safe harbor rule that significantly compounds the problem of misclassification is the provision that applies to those employers who relied on "long-standing recognized practice of a significant segment of the industry in which such individual was engaged." (Section (a)(2)(C)). Not surprisingly, the 1996 IRS compliance manual states this provision has created the most controversy with employers.

- *Increase penalties for violations.*

To address the more blatant abuses associated with those employers who pay their workers off the books, new penalties far in excess of the \$50 minimum should be established that apply to employers who fail to file 1099s as recommended by the GAO.<sup>47</sup> Elimination of the minimum \$50 penalty was also recommended by the Advisory Council on Unemployment Compensation in

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National UI Tax Conference, was meeting its obligations, there are many other activities, in provision of IT resources, training, and grants to states to help them prioritize use of this data, that can uncover additional tax cheating. The OIG projected that sixteen more states would use the data in 2006.

<sup>45</sup> *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers*, 10.

<sup>46</sup> *Id.*

<sup>47</sup> Statement of Natwar M. Gandhi, Before the Subcommittee on Taxation and Finance, Committee on Small Business, House of Representatives, "Tax Administration: Issues Involving Worker Classification" (August 2, 1995, at page 7.).

1996.<sup>48</sup> The funding generated by these new penalties could be designated to help fund more targeted enforcement on this issue. As the GAO concluded, increased penalties can help increase the number of 1099s filed by employers. And when the 1099's are on file with the IRS, far more income is reported by misclassified workers.

■ *Increase notification and reporting requirements.*

In addition, as recommended by GAO, businesses should be required to notify their workers in writing of their rights and IRS responsibilities as independent contractors, including their rights to file for a status determination and, if adopted, the new complaint procedures proposed above.

Finally, in order to more accurately discover off the books employment, employers should be required to keep records on and to report to the IRS the amount of payments made to their independent contractors (above the existing \$600 threshold), including corporations and other businesses. For instance, a construction contractor should be required to file an information return on payments to a subcontractor, even if that subcontractor is incorporated. In addition to alerting the IRS about misclassification problems and unreported cash pay, this proposal, which is also supported by the Bush Administration, would raise nearly \$8 billion over 10 years.<sup>49</sup>

By enacting these reforms, Congress would remove a clear incentive in the law that specifically rewards industries and employers that misclassify their workers as independent contractors.

## **2. Enlist Workers' Help in Locating Misclassifying Employers and Collecting Taxes.**

Building on the current Form SS-8 now provided by the IRS to workers wishing to correct misclassification, a series of new procedural protections should apply to workers who seek to have their status determined by the IRS.

■ *Procedural protections for workers.*

The law should expressly authorize workers to request employee status determinations and require an IRS decision on the request while maintaining the worker's confidentiality to the maximum extent possible. In addition, the law should authorize third-parties (including unions and other worker representatives) to initiate a status determination on behalf of an individual or a group of workers, similar to the worker representative complaint procedures available under the OSHA.<sup>50</sup> The federal law should, as well, include an anti-retaliation provision protecting workers who request a status determination, backed by serious penalties imposed on employers who violate the new law.

In order to ensure that workers are treated equally with taxpayers, workers and their representatives should have the right to appeal a negative determination by the IRS, just as

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<sup>48</sup> Advisory Council on Unemployment Compensation, Collected Findings and Recommendations: 1994-1996, Recommendation 1995-15

<sup>49</sup> U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals 63 (Feb. 2007), available at <http://www.treas.gov/offices/tax-policy/library/bluebk07.pdf>.

<sup>50</sup> 29 U.S.C. Section 657(f)(1).

taxpayers can appeal a decision in connection with an IRS examination or audit. Finally, workers should have the right to a court proceeding under standards that specifically define fraud in the context of misclassification and provide significant damages to the worker in those cases where the employer acted illegally.

These changes would bring workers' own resources to identification of employers who are misclassifying. Workers' participation is important, not only because the tax system is not the only entry point to discover misclassification, but because workers' participation can be a valuable tool for tax authorities. First, workers are in the best position to either answer or operate as a check on employer information, as tax authorities apply the IRS 20-factor test, such as questions about the degree of control that the employer exercises over workers, who sets hours of work, whether the employer furnishes tools and materials, whether they work for one employer at a time, or whether the employer can fire them.<sup>51</sup> Second, most of the cross-matching currently used by states relies on a paper trail of 1099 forms and does not capture workers who are paid entirely off the books. Enlisting these workers' help via the SS-8 process, with the proper assurances of protection against retaliation, could go a long way towards shutting down the underground economy.

### **3. Increase Targeted and Coordinated Federal Enforcement.**

Repairing Section 530 is, however, a necessary, but not sufficient, solution to the problem of misclassification. There is more that the federal Department of Labor can do to assist states in identifying payroll tax cheaters and collecting taxes owed at the state and federal level. Two good models exist for increased enforcement activity: USDOL's approach to claimant fraud and its approach to SUTA dumping.

In recent years, the Administration's budget proposals and practices have included a number of elements to track down and recover overpayments from workers. These include increased penalties for claimant fraud overpayments and allowing state to use 5% paid benefits recovered for additional program integrity efforts, earmarking for claimant fraud detection efforts, and special grants to the states to enable them to beef up their claimant fraud efforts. USDOL publishes yearly an estimate of the amount of UI benefits overpaid, carrying forward its sampling and applying it to the total workforce.<sup>52</sup>

Both Congress and USDOL should be commended for their approach to SUTA dumping in 2004, for bringing resources to detection of this particular employer fraud scheme.<sup>53</sup> Members of this Committee may recall GAO testimony identifying national accounting firms that at the time were advising their clients that they should engage in SUTA dumping, one suggesting that the employer

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<sup>51</sup> The test is reprinted in GAO, *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers*, GAO GGD-89-107 (1989), available at <http://archive.gao.gov/d26t7/139838.pdf>

<sup>52</sup> See, e.g., U.S. Department of Labor's FY 2007 Budget For Unemployment Insurance (May 2006) (with Andrew Stettner); NELP, *The Whole Truth: Employer Fraud and Error in the UI System* (2003) .

<sup>53</sup> SUTA dumping entails the transfer of employees from a company's direct payroll into the account of a new or existing shell corporation or to a corporation with a lower tax rate, which lists itself as the nominal "employer" of workers, and thus lowers the initial employers' tax rates. Work remains to be done on the use of Professional Employee Organizations (PEOs) in SUTA dumping.

“move your employees on paper into another type of organization to obtain more favorable rates.”<sup>54</sup> After the SUTA dumping bill was passed, USDOL worked with the states to develop a SUTA dumping detection tool, and has commissioned a report to evaluate the states’ success in this area.

USDOL and IRS should prioritize misclassification in their enforcement efforts, as follows:

- *Target audits in problem industries.*

USDOL should mandate that states investigate the extent of misclassification problems within a state, and require that all states perform targeted audits in industries most susceptible to employer misclassification, as well as random audits. This approach was recommended in detailed studies of the UI system as far back as 1995, but has not yet been implemented.<sup>55</sup> The state studies noted above demonstrate its effectiveness.

- *Engage in enforcement across state lines against major violators.*

As GAO identified with respect to SUTA dumping in 2003, and as the cases cited here demonstrate, major firms engage in major misclassification across state lines. Yet USDOL currently only requires that states audit 1% of large employers, out of their 2% total audits. The Department of Labor should engage directly where corporations that are found in one state to be misclassifying are operating with the same policies across state lines.

- *Make special grants and pilots projects to encourage state innovation.*

As it has done with SUTA dumping, USDOL could issue special grants and pilot projects to fund new technology and new statistical models, in order to help states identify employers who are misclassifying workers. The 2000 study conducted by Planmatics and cited here suggested that USDOL investigate new technologies (e.g. intelligent collection systems, pattern recognition) that can be used to track “independent contractors” and their employers.<sup>56</sup> The Planmatics study also recommended that USDOL develop a repository of information on independent contractor issues, best practices, new initiatives, and legislative measures, to be updated, publicized, and its contents made accessible to agencies dealing with independent contractors.<sup>57</sup>

- *Regular reporting of data.*

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<sup>54</sup> GAO, Unemployment Insurance: Survey of State Administrators and Contacts with Companies Promoting Tax Avoidance Policies, Testimony before the Subcommittee on Oversight and Subcommittee of Human Resources, Committee on Ways and Means, U.S. House of Representatives, GAO-03-819T (June 19, 2003).

<sup>55</sup> “From this perspective, profiles of noncompliant firms can improve significantly the collection of UI taxes in two ways. First, UI agencies may be able to detect and collect a large proportion of the taxes that continue to go unreported. Second, employers may be induced to voluntarily report the correct amount of taxable wages to avoid the more certain detection of tax evasion that results from using the profile.” at pages 2-3. Paul L. Burgess, Arthur E. Blakemore, Stuart A. Low, “Improving Employer Compliance with Unemployment Insurance Tax Reporting Requirements,” Advisory Council on Unemployment Compensation Background Papers, Vol. II, July 1995.

<sup>56</sup> Planmatics, 94.

<sup>57</sup> Planmatics, 95.

USDOL should develop models to update the national Planmatics study and provide a yearly estimate of numbers of employers who are misclassifying workers, number of workers affected, industries involved, and the effect on the tax system, in order to support state efforts in this area. IRS should engage in a similar effort with respect to use of the “safe harbor.”

Again, I offer my thanks to the Committee for inviting me to testify on this issue of vital importance to America’s workforce. Myself, as well as other staff at NELP, invite your questions as these policy proposals develop.