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# The Cost of Worker Misclassification

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# Worker Misclassification

- What is it?
- Why is it happening?
- What are the effects?
- What is being done?

# What is Worker Misclassification?

- ▶ When an employer improperly classifies a worker as an independent contractor (IRS 1099) rather than as an employee

## Why Does Misclassification Occur?

- ▶ Employers may not understand the criteria for determining a worker's status
- ▶ Employers may deliberately misclassify because there are financial incentives for doing so

## Employee or Independent Contractor?

- ▶ Key Point: Who controls how the work is done?
  - As a rule, employees do not direct and control the means, methods and outcome of their work
  - Independent contractors are self-employed, assuming the profit & risk of providing services that are outside those customarily offered by the employer. They are not typically dependant on one employer for their livelihood and they retain control over how they accomplish the task they've been hired to do.

# Why Do Employers Misclassify Workers?

- Intentional Misclassification

- Strategy to cut labor costs, avoid citizenship verification issues, & avoid tax responsibilities
- Unscrupulous employers receive an unfair competitive advantage

- Mistaken Classification

- Otherwise responsible employers err: standards aren't clear
- Puts employers at risk - penalties and back taxes

## What is the Impact?

- On workers
- On the business community
- On government and taxpayers

# Impact on Workers

- ▶ Denied **Entitled** Coverage:
  - Fair labor standards: wage and hour laws (overtime)
  - Protection from workplace discrimination
  - Workers' compensation
  - Right to organize: National Labor Relations Act
  - OSHA
  - Family and medical leave
  - Unemployment insurance
  - Disability
  - Pension security
  - Taxes: withholding

## Impact on Workers cont'd

- ▶ Workers who are paid “off-the-books” are not reported at all for tax or other purposes.
- ▶ As part of the underground economy, some of these workers are “transported across state borders, entirely beholden to and dependent upon their employer for food, transportation, and lodging...”\* having little recourse should they complain about excessive hours, no benefits, or unsafe conditions.

\* Report of the NYS Joint Enforcement Task Force, Feb.1 2008

## Impact on Workers cont'd

- ▶ As Independent Contractors, they're on their own
  - Health care
  - Retirement
  - Withholding (Social Security, Medicare, taxes)
  - Insurance
  - Vacation and other leave benefits
  - Workers' Compensation
    - If injured: prove the misclassification

# Impact on Business

- ▶ Misclassification destabilizes the business climate and labor markets
- ▶ Law-abiding employers bear unfair burden:
  - Competitive disadvantage
  - Incur administrative costs and higher payments into funds
- ▶ Industries often affected:
  - Construction
  - Transportation and delivery services
  - High-tech, technology services
  - Financial services
  - Creative (manufacturing and design)
  - Entertainment

# Impact on Government & Taxpayers

## ▶ Enormous revenue losses

- Unemployment insurance
- Workers' compensation
- Taxation and finance – federal & state income taxes
  - *We're seeing only the "tip of the iceberg" – states generally audit less than 2% of employers each year; those audits show an increase in the # of MC ees, 2000-2007, from 106,239 to 151,039. (GAO report, p 13)*

## Impact on Government & Taxpayers cont'd

- ▶ Estimates of Tax Revenue Lost:
  - GAO (2006) → \$2.72 billion annually in fed income taxes
  - Coopers & Lybrand (now PriceWaterhouse Coopers) (1994) → \$34.7 billion for 1996-2004
  - Massachusetts construction industry (2004) → \$278 million in uncollected taxes & premiums
  - California Assembly member estimated state tax loss of \$7 billion
  - Illinois estimates it lost \$124.7 million in income taxes for 2001-05 with almost \$9 million of that in construction

## Impact on Government: Revenue Losses

Our 2007 study suggested that for the period 2002-2005:

Almost 705,000 NYS workers (over 10% of the workforce) were misclassified

- ▶ 45,500 or almost 15% of New York's construction workforce [statewide] misclassified
- ▶ Average unemployment insurance taxable wages underreported for the audited industries: \$4.3 billion each year
- ▶ Unemployment insurance tax underreported: \$175 million +

## Impact on Government cont'd

- Fiscal Policy Institute:  
NYC construction industry losses in payroll taxes and social insurance premiums due to misclassification: \$170 million annually  
All “underground” activity: Annual loss of \$272 million
- ▶ Federal [IRS] estimate:  
\$2.72 billion [2006 dollars] in lost revenue

# Impact on Government and Taxpayers

## ▶ Broad social costs

- Fewer resources available for:
  - State government
  - Communities: county, municipal levels
  - School districts
  - Hospitals
  - Law enforcement
  - Health care and welfare costs

# Impact in Construction

- ▶ Maine – Harvard study estimated that 14% of construction firms misclassified some employees each year; when the state subsequently targeted construction firms for UI audits, they found up to 45% had misclassified employees
- ▶ Massachusetts – Similar Harvard study suggested 14% construction workers were misclassified
- ▶ Illinois – DoL imposed a \$328,500 civil penalty against contractor that consistently misclassified (\$1500/day, 218 days + penalty) (BNA, 12/10/09)

# Impact in Construction cont'd

- ▶ National Conference of Insurance Legislators (NCOIL) has drafted model legislation to control misclassification in construction, hoping state legislatures will consider it for adoption in 2010
- ▶ Some Contractors: Perceive that policymakers “have declared war on independent contracting.” That gov’t is “forcing companies to turn independent contractors into employees,” denying both the worker and the employer the flexibility they need.
  - 12/8/08 by executive director of Coalition for Independent Contractor Freedom

## Impact in Construction cont'd

- ▶ In fact, actual independent contracting is not threatened; it is the misclassification of employees as independent contractors that is being identified and addressed with research studies, Executive Orders, and laws.

# Executive Orders

## ▶ New York State

- Governor Spitzer's Executive Order [9/07] established the *Joint Enforcement Task Force on Employee Misclassification*:
  - NYS Department of Labor
    - Unemployment Insurance Division
    - Division of Labor Standards
    - Office of Special Investigations
    - Division of Safety & Health
    - Bureau of Public Work
  - Workers' Compensation Board
  - Workers' Compensation Board Fraud Inspector General
  - Department of Taxation & Finance
  - Attorney General's Office
  - The Comptroller of the City of New York

# NYS Joint Enforcement Task Force

The Task Force is charged with:

- Coordinating investigations: joint enforcement “sweeps”
- Facilitating the filing of complaints and identification of violators
- Interagency cooperation / information-sharing
- Proposing administrative, legislative, regulatory solutions
- Working with labor, business & community to educate and prevent

# NYS Joint Task Force

- ▶ Within their first 4 months, the Task Force:
  - Established an Oversight Committee to address enforcement, coordinate compliance, develop strategies
  - Established a fraud hotline, website, and email, receiving 570 calls → 200 UI audits
  - Conducted 15 sweeps; 117 employers identified
  - Completed investigation revealing 2078 misclassified employees, \$19.4 million in unreported wages, \$856,000 in UI taxes alone
  - Initiated 17 Labor Standards investigations finding \$3 million in underpaid wages due 646 workers & \$5000 assessed for child labor violations

# NYS Joint Task Force

## July 2009 Update

- ▶ Identification of 12,300 instances of Employee Misclassification
  - 46 joint enforcement sweeps (20 NYC; 26 Upstate)
    - 291 businesses investigated; Construction industry targeted but also restaurants, hotels, factories, and retail
  - 4 Main St. sweeps:
    - Teams of investigators go door-to-door in retail strips; 304 businesses visited; 67% required enforcement action – 34 not registered for UI, 23 carried no WC, 148 being audited re: UI (of 54 audits so far, 38 of them had misclassified workers, totaling 221 workers, \$3,747,832 unreported wages & \$80,443 owed in unemployment taxes).

# Results of Task Force Efforts to-date

- Unemployment Insurance:
  - 163 businesses audited → 7789 misclassified workers, \$86 million in unreported remuneration, \$2.5 million assessed in additional unemployment taxes and \$1 million+ in UI fraud penalties
- Unpaid Wages:
  - \$2.2 million+ in unpaid wages & violations of recordkeeping & child labor
- Workers' Compensation:
  - 27 stop work orders issued; \$1,109,250 in fines & penalties

## Results of Task Force cont'd

- ▶ Criminal referrals, where fraud was evident, to NYS Attorney General's office and to DA's statewide
- ▶ Referrals to NYS Dept of Taxation & Finance and to US IRS
- ▶ Data-sharing with other state agencies instituted
- ▶ Coordinated enforcement: tips, information-sharing among partners, and hotline calls were responsible for 1118 misclassification investigations

## Other Executive Orders

- ▶ Massachusetts – Governor signed an E. O. in March 2008 creating a task force chaired by the Director of the DoL with reps from 8 other state agencies
- ▶ Michigan – Governor signed an E.O. in February 2008 creating a task force within the DoL and Economic Growth with reps from other agencies.
- ▶ New Jersey – Governor signed an E.O. in January 2008 to establish a commission charged with solving misclassification in the construction industry in line with the 2007 Construction Industry Independent Contractor Act.
- ▶ Iowa – Governor's E.O. created Independent Contractor Reform Task Force.
- ▶ Maine – Governor formed Joint Enforcement Task Force in January 2009

## Other Misclassification Activity

### **Maryland**

[05/12/09] Gov. signed into law a crackdown on the misclassification of employees as independent contractors. The Workplace Fraud Act will save taxpayers nearly \$100 million a year in taxes that now go unpaid because workers are misclassified or simply paid "off the books."

E. O. created Joint Enforcement Task Force on Workplace Fraud within Dept of Labor, Licensing & Regulation. Recent audits showed that approx. 20% of MD employers misclassify.

DLLR investigators are empowered to stage unannounced raids on Maryland workplaces to check for misclassification and will have subpoena power.

DLLR may also award misclassified workers damages. Workers who do not receive damage awards for the agency can sue their employers in civil court.

The law presumes employment; penalties include stop-work orders, loss of licensure, debarment, fines.

## Other Misclassification Activity

- ▶ Delaware – The Workplace Fraud Act, which targets construction, defines an IC as a worker who is not under the control or direction of employer, who is usually engaged in an independent business, and whose services are outside those customarily offered by the employer. Workers are presumed employees unless the aforementioned are proven. Penalties include fines, debarment, stop-work orders. Employers must notify workers at time of hire if they are being classified as ICs.

## Other Misclassification Activity

- ▶ New Jersey – Construction Industry Independent Contractor Act of 2007 states “The Legislature finds that employers in the construction industry who improperly classify employees as independent contractors deprive these workers of proper Social Security benefits and other benefits, while reducing the employers’ State and federal tax withholdings and related obligations. Moreover, this practice puts businesses that bear higher costs for complying with the law at a competitive disadvantage.”

## New Jersey CIIICA cont'd

- ▶ Who is an employee?
  - “For purposes of the New Jersey Prevailing Wage Act, unemployment compensation law and other laws, “services performed in the making of improvements to real property by an individual for remuneration paid by an employer shall be deemed to be employment unless...”
    - 1)the individual is free from control or direction
    - 2) service is outside usual course of business, and
    - 3) the individual is usually occupied in an independent business.

## New Jersey CIIICA cont'd

- ▶ Penalties for violators
  - Fines or imprisonment (substantial if willful)
  - Suspension of contractor's registration; stop-work order for 2<sup>nd</sup> violation
  - Willful misclassification results in debarment for a period of 3 years
  - Improperly classified employee may bring civil action against employer

## Other Misclassification Activity

### Colorado

MISCLASSIFICATION OF EMPLOYEES AS INDEPENDENT CONTRACTORS VIOLATES THE "COLORADO EMPLOYMENT SECURITY ACT" (2009).

Upon a finding that the employer, with willful disregard of the law, misclassified employees, the Director may:

- (A) Impose a fine of up to \$5000 per misclassified employee for the first willful misclassification, and for a second or subsequent willful misclassification, a fine of up to \$25,000 per misclassified employee; and
- (B) Upon a second or subsequent willful misclassification, prohibit the employer from contracting with, or receiving any funds for the performance of contracts from, the state for up to two years after the date of the Director's order.

## Other Misclassification Activity

### Connecticut

- ▶ (*Effective July 1, 2008*) (a) established a joint enforcement commission on employee misclassification, consisting of the Labor Commissioner, the Commissioner of Revenue Services, the chairperson of the Workers' Compensation Commission, the Attorney General and the Chief State's Attorney, or their designees.
- ▶ (b) shall meet not less than four times each year; shall review the problem of employers avoiding their obligations under state and federal labor, employment and tax laws; shall coordinate the civil prosecution of violations; shall report any suspected violation to the Chief State's Attorney or the State's Attorney...
- ▶ (c) On or before February 1, 2010, and annually thereafter, the commission shall report to the Governor and the joint standing committee of the General Assembly having cognizance of matters relating to labor, summarizing the commission's actions for the preceding calendar year and including any recommendations for administrative or legislative action.

## Other Misclassification Activity

### Ohio

- ▶ Attorney General announced (May 2009) that his office would collaborate with the Department of Jobs and Family Services, the Department of Taxation, and the Bureau of Workers' Compensation to smoke out the "underground economy."
- ▶ "The agencies will exchange investigative and audit data that gives information on employee misclassification;" some of the documents involved would include payroll information reported to the Department of Taxation and audits by the Unemployment Compensation Division of the Ohio Department of Job and Family Services, which is required by the U.S. Department of Labor to audit some of the companies that pay unemployment insurance premiums.

# Congressional Efforts

## 111<sup>th</sup> Congress

- ▶ **H.R. 3408** : Taxpayer Responsibility, Accountability, and Consistency Act of 2009. Purpose: To amend the Internal Revenue Code of 1986 to modify the rules relating to the treatment of individuals as independent contractors or employees, and for other purposes.  
Sponsor: **Rep McDermott, Jim** [WA-7] (introduced 7/30/09)
  - ▶ Would significantly increase penalties for misclassification, depending on the nature of the violation. Current fines of \$75,000 would increase to \$500,000; \$100,000 would jump to \$1,000,000; \$150,000 would increase to \$1,500,000.
- ▶ **H.R. 635**: National Commission on State Workers' Compensation Laws Act of 2009. Purpose: To establish the National Commission on State Workers' Compensation Law. Duties would include the study and evaluation of state workers' comp laws in order to determine if they are adequate, if payment of benefits is timely, and to discourage the misclassification of employees as independent contractors as a way to avoid paying w.c. benefits.  
Sponsor: Rep. Baca (introduced 1/22/09)

# Sources [Online]

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> *Building Up New York, Tearing Down Job Quality: Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry [December 2007]*

*A Fiscal Policy Institute Report*

Available at: <http://www.fiscalpolicy.org>

> *Annual Report of the Joint Enforcement Task Force on Employee Misclassification*

to David A. Paterson, Governor of NYS, submitted by M. Patricia Smith, Commissioner, NYS DOL

Available at: <http://www.labor.state.ny.us>

National Employment Law Project:

[http://www.nelp.org/site/issues/category/independent\\_contractor\\_misclassification\\_and\\_subcontracting](http://www.nelp.org/site/issues/category/independent_contractor_misclassification_and_subcontracting)