INTRODUCTION

Wage and hour violations continue to grab the news. A national survey of workers in New York, Los Angeles and Chicago found that 26 percent of workers were paid less than the minimum wage, and an astonishing 75 percent were not paid overtime pay in the previous week.¹ In the last year alone, workers recovered tens of millions of dollars in unpaid wages from their employers in a range of industries. For example, Farmer’s Insurance, Inc. paid over $1.5 million in overtime back wages to its call center workers in Kansas, Oklahoma, Florida, and Michigan²; a Manhattan-based sandwich chain Lenny’s paid $5 million in unpaid wages to its employees³, and Levi-Strauss & Co. paid

over $1 million in overtime pay to its assistant managers in a nationwide class action settlement.4

An expanding trend behind many of the largest wage and hour violations is employers’ decisions to call their employees “independent contractors”. Despite federal and state government crackdowns on this tactic, large employers in many sectors continue to use this scheme, including FedEx Ground5, landscaping companies6 and construction7, building services8, port trucking9, and home health care10, to name a few.

This paper will provide a brief background on the magnitude and import of the problem of independent contractor misclassification and the related practice of paying workers off the books completely, and then describe state and federal efforts to combat the problem, including state and federal studies showing staggering public losses due to the practice.

I. Independent Contractors: Are They Really in Business for Themselves?

Employers legitimately contract every day with other independent businesses, typically to perform specialty jobs that the contractor performs for a variety of customers. These routine practices are not the subject of independent contractor misclassification reforms.

Yet, genuine independent contractors constitute a small proportion of the American workforce, because by definition, an “independent contractor” is in business for him- or herself.11 True independent contractors bring specialized skill, invest capital in their

7 Studies have found that upwards of 30% of construction firms misclassify their employees as independent contractors. Francois Carre, J.W. McCormack, “The Social and Economic Cost of Employee Misclassification in Construction (Labor and Worklife Program, Harvard Law School and Harvard School of Public Health: December 2004), at p. 8.
9 See, e.g, NELP et al, The Big Rig, http://nelp.3cdn.net/000beaf922628dfea1_cum6b0fab.pdf.
10 See, e.g, Lee’s Industries, Inc. and Lee’s Home Health Services, Inc. and Bernice Brown, Case No. 4-CA-36904 (Decision by National Labor Relations Board Division of Judges), 2/25/10.
11 See, Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification, GAO-06-656 (July 2006), at p. 43.
business, and perform a service that is not part of the receiving firm’s overall business. 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 manufacturing company to trouble-shoot software glitches.

But, with increasing frequency, employers misclassify employees as “independent contractors,” either by giving their employees an IRS Form 1099 instead of a Form W-2, or by paying the employee off-the-books and providing no tax forms or tax reporting and withholding. Many of these employers require workers to sign a contract stating that they are an independent contractor as a condition of getting a job, and while the contracts themselves are not legally-binding, they create confusion and deter enforcement of basic pay rights. Here are some reasons why this independent contractor misclassification is on the rise:

- Firms argue they are off-the-hook for any rule protecting an “employee,” including the most basic rights to minimum wage and overtime premium pay, health and safety protections, job-protected family and medical leave, anti-discrimination laws, and the right to bargain collectively and join a union. Workers also lose out on safety-net benefits like unemployment insurance, workers compensation, and Social Security and Medicare.
- Misclassifying employers stand to save upwards of 30% of their payroll costs, including employer-side FICA and FUTA tax obligations, workers compensation and state taxes paid for “employees.”
- Businesses that 1099 and pay off-the-books can underbid competitors in labor-intensive sectors like construction, port trucking, and building services, and this creates an unfair marketplace.

The United States Government Accountability Office (GAO) concluded in its July 2006 report, “employers have economic incentives to misclassify employees as independent contractors because employers are not obligated to make certain financial expenditures for independent contractors that they make for employees, such as paying certain taxes (Social Security, Medicare, and unemployment taxes), providing workers’ compensation insurance, paying minimum wage and overtime wages, or including independent contractors in employee benefit plans.”

Most workers in labor-intensive and low-paying jobs are not operating a business of their own. As the U.S. Department of Labor’s Commission on the Future of Worker-Management Relations (the “Dunlop Commission”) concluded, “[t]he law should confer independent contractor status only on those for whom it is appropriate—entrepreneurs who bear the risk of loss, serve multiple clients, hold themselves out to the public as an independent business, and so forth. The law should not provide incentives for misclassification of employees as independent contractors, which costs federal and state

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12 Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification, GAO-06-656 (July 2006), at p. 25.
treasuries large sums in uncollected social security, unemployment, personal income, and other taxes.”

A. Misclassification in Increasing Sectors.

Calling employees “independent contractors” is a broad problem and affects a wide range of jobs. A 2000 study commissioned by the US Department of Labor found that up to 30% of firms misclassify their employees as independent contractors.

Most government-commissioned studies do not 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. Many of these jobs are filled by immigrant and lower-wage workers. A three-city survey of low-wage workers co-authored by NELP found that one-third of all surveyed workers were paid in cash and 57% did not receive a paystub or other documentation with their wages. Of those paid in cash, 34% suffered minimum wage violations, 89% were not paid overtime for extra hours worked, and 75% were not paid for “off the clock” work.

In my practice, I have met workers who were misclassified. Here are a couple of examples:

- Faty Ansoumana, an immigrant from Senegal, worked as a delivery worker at a Gristede’s grocery store in midtown Manhattan. He worked as many as seven days a week, 10-12 hours a day and his weekly salary averaged only $90. He and his fellow delivery workers, who had similar pay and hours, were all hired through two middlemen labor agents, who in turn stationed the workers at grocery and pharmacy chain stores throughout the City. The workers all reported directly to the stores and provided deliveries pursuant to the stores’ set delivery hours and under the stores’ supervision. Many delivery workers were required to bag groceries and to do other non-delivery work, including stocking shelves. When NELP challenged the abysmally low pay, the stores said the workers were not

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their employees, and the labor brokers said the deliverymen were independent contractors. NELP, our co-counsel, and the NYS Attorney General’s office worked together to recover $6 million for the over 1,000 workers in the lawsuit, but only after overcoming the stores’ claims that they were not responsible.

- Janitors from Central and South America and Korea were recruited by a large building services cleaning company, Coverall, Inc., to clean office buildings in MA and other states. The janitors were “sold” franchise agreements for tens of thousands of dollars, permitting them to clean certain offices assigned by Coverall. The janitors were told where to clean, what materials to use, and were not permitted to set their own prices for the cleaning services. When one janitor quit when she couldn’t make ends meet, she applied for unemployment benefits in MA and was told she was an “independent contractor” and not eligible. She challenged that decision and Massachusetts’ Supreme Judicial Court ruled in her favor. NELP wrote an amicus brief in Coverall and provided assistance.

- Home health care workers in Pennsylvania were hired as employees by a home health care agency to place them in individual homes, where they cared for elderly and disabled people. The employees were not paid overtime or for their time spent traveling from household to household during their workdays, and they brought a lawsuit with SEIU and NELP’s help to claim their unpaid wages. Several months after the lawsuit was filed, the home care agency told each of these employees that they had to sign an agreement calling them “independent contractors” if they wanted to keep their jobs, even though other aspects of their jobs did not change.

Independent contractor misclassification occurs with an alarming frequency in: construction, day labor, janitorial and building services, home health care, child

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19 Lee’s Industries, Inc. and Lee’s Home Health Services, Inc. and Bernice Brown, Case No. 4-CA-36904 (Decision by National Labor Relations Board Division of Judges), 2/25/10.
care, agriculture, poultry and meat processing, high-tech, delivery, trucking, home-based work, and the public sectors.

II. What is The Impact on Workers and Their Families?

Just because an employer calls a worker an “independent contractor” does not make it legally true. But, these labels carry some punch and deter workers from claiming rights under workplace laws that rely on individual complaints for enforcement. Because misclassified independent contractors face substantial barriers to protection under labor and employment rules, workers and their families suffer. The same occupations with high rates of independent contractor misclassification are among the jobs with the highest numbers of workplace violations. The result is our “growth-sector” jobs are not bringing people out of poverty and workers across the socio-economic spectrum are impacted.

24 See, e.g., IL Executive Order conferring bargaining status on child day care workers otherwise called independent contractors: http://www.gov.il.gov./gov/execorder.cfm?eorder=34.
25 Sec’y of Labor v. Lauritzen, 835 F.2d 1529 (7th Cir. 1988).
27 Vizcaino v. Microsoft Corp., 97 F.3d 1187 (9th Cir. 1996).
32 The vast majority of DOL’s Wage & Hour Division’s (WHD) enforcement actions are triggered by worker complaints. See, e.g. U.S. Gov’t. Accountability Office, GAO-08-962T, Better Use of Available Resources and Consistent Reporting Could Improve Compliance 7 (July 15, 2008) (72 percent of WHD’s enforcement actions from 1997-2007 were initiated in response to complaints from workers); David Weil & Amanda Pyles, Why Complain? Complaints, Compliance, and the Problem of Enforcement in the U.S. Workplace, 27 Comp. Lab. L. & Pol’y J. 59, 59-60 (2005) (finding that in 2004, complaint-derived inspections constituted about 78 percent of all inspections undertaken by WHD.)
33 See, National Employment Law Project, Holding the Wage Floor, http://nelp.3cdn.net/95b39fc0a12a8d8a34_iwm6bbv2.pdf
Workers could lose out on: (1) minimum wage and overtime rules; (2) the right to a safe and healthy workplace and workers’ compensation coverage if injured on the job; (3) protections against sex harassment and discrimination; (4) unemployment insurance if they are separated from work and other “safety net” benefits; (5) any paid sick, vacation, health benefits or pensions provided to “employees;” (6) the right to organize a union and to bargain collectively for better working conditions, and (7) Social Security and Medicaid payments credited to employee’s accounts.

III. What is the Impact on Federal and State Government Receipts?

Federal and state governments suffer hefty loss of revenues due to independent contractor misclassification, in the form of unpaid and uncollectible income taxes, payroll taxes, and unemployment insurance and workers’ compensation premiums.

Federal losses.

A 1994 study by Coopers and Lybrand estimated the federal government would lose $3.3 billion in revenues in 1996 due to independent contractor misclassification, and $34.7 billion in the period from 1996 to 2004.34

A 2000 study commissioned by the US DOL found that between 10% and 30% of audited employers misclassified workers.35 Misclassification of this magnitude exacts an enormous toll: researchers found that misclassifying just one percent of workers as independent contractors would cost unemployment insurance (UI) trust funds $198 million annually.

A 2009 report by the Government Accountability Office (GAO) estimated independent contractor misclassification cost federal revenues $2.72 billion in 2006.36 The GAO’s estimate was derived from data reported by the IRS in 1984, finding that 15% of employers misclassified 3.4 million workers at a cost of $1.6 billion (in 1984 dollars).

According to a 2009 report by the Treasury Inspector General for Tax Administration,37 the IRS’s most recent estimates of the cost of misclassification are a $54 billion underreporting of employment tax, and losses of $15 billion in unpaid FICA taxes and UI taxes.38 The $15 billion estimate is based on 1984 data that has not been updated. The

34 Coopers & Lybrand, Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers. Prepared for the Coalition for Fair Worker Classification (1994).
38 Treasury Inspector General for Tax Administration, While Actions Have Been Taken to Address Worker Misclassification, and Agency-Wide Employment Tax Program and Better Data Are Needed (February 4, 2009).
report explained, “Preliminary analysis of Fiscal Year 2006 operational and program data found that underreporting attributable to misclassified workers is likely to be markedly higher than the $1.6 billion estimate from 1984.”

A 2010 study by the Congressional Research Service estimated that a proposed modification to the IRS’s “Safe Harbor” rules, which allow employers significant leeway to treat workers as non-employees for employment tax purposes, would yield $8.71 billion for FY 2012-2021.

State losses.

A growing number of states have been calling attention to independent contractor abuses by creating inter-agency task forces and commissions to study the magnitude of the problem. Along with academic studies and other policy research, the reports document the prevalence of the problem and the attendant losses of millions of dollars to state workers’ compensation, unemployment insurance, and income tax revenues.

A review of the findings from the twenty state studies of independent contractor misclassification demonstrates the staggering scope of misclassification, the difficulties in reaching precise counts of workers affected and funds lost, and the potential for enforcement initiatives to return much-needed funds to state coffers.39

- **States are losing hundreds of millions of dollars.** Audits conducted by California’s Employment Development Department between 2005 and 2007 recovered a total of $111,956,556 in payroll tax assessments, $18,537,894 in labor code citations, and $ 40,348,667 in assessments on employment tax fraud cases.40 Each year, Connecticut’s state income tax receipts were reduced by $65 million; the workers’ compensation system lost $57 million in unpaid premiums; and the unemployment insurance fund lost $17 million.41 In Illinois, a 2006 study

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40 California Employment Development Department, Annual Report: Fraud Deterrence and Detection Activities, report to the California Legislature (June 2008).
41 William T. Alpert, Estimated 1992 Costs in Connecticut of the Misclassification of Employees. Department of Economics, University of Connecticut (1992). The first annual report from the Joint Enforcement Commission on Worker Classification reported that the Labor Department reclassified 7,900 workers as employees, uncovered more than $53 million in wages and additional unemployment tax of $750,000, assessed over $2 million in additional tax, and collected $90,000 in civil penalties against violating employers. State of Connecticut Joint Enforcement Commission on Worker Misclassification, Annual Report, (February 2010).
estimated that independent contractor misclassification resulted in a loss of $39.2 million in unemployment insurance taxes, and between $124.7 million and $207.8 million in state income taxes each year from 2001 to 2005.42 Indiana’s 2010 report found that the state lost $36.7 million in unemployment insurance premiums, $147.5 million in state income taxes, and $24.1 million in workers compensation premiums each year from 2007-2008. From 1999 to 2002, Maine had an annual average loss of $314,000 in unemployment compensation taxes, $6.5 million in workers compensation premiums, between $2.6 million and $4.3 million in state income taxes, and $10.3 million in FICA taxes from construction alone.43 A recent study of the Massachusetts construction industry found that misclassification of employees resulted in annual losses of up to $278 million in uncollected income taxes, unemployment insurance taxes, and worker’s compensation premiums.44 A recent analysis of workers’ compensation and unemployment compensation data in New York state 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.45 A 2009 report by the Ohio Attorney General found that the state lost as much as $100 million in unemployment compensation payments, $510 million in workers compensation premiums, $248 million in state income taxes.46 Pennsylvania’s unemployment trust fund lost over $200 million, and its workers compensation fund lost $81 million in 2008.47

45 New York State Workers' Compensation: How Big Is the Coverage Shortfall?, (New York: Fiscal Policy Institute, Jan. 2007). A 2007 study issued by the Cornell University School of Industrial and Labor Relations estimated annual misclassification rates of about 10.3% in the state’s private sector and approximately 14.9% in the construction industry. Average UI taxable wages underreported due to misclassification each year was $4,238,663, and UI tax underreported was $175,674,161. Linda H. Donahue, James Ryan Lamare, Fred B. Kotler, The Cost of Worker Misclassification in New York State. Cornell University School of Industrial Labor Relations (Feb. 2007).
46 Richard Cordray, Ohio Attorney General, Misclassification of Employees as Independent Contractors (May 11, 2010).
47 Testimony of Patrick T. Beaty, Deputy Secretary for Unemployment Compensation Programs, Pennsylvania Department of Labor and Industry, before the House of
• **Studies most likely underestimate the true scope of misclassification.** Many of the studies are based on unemployment insurance tax audits of employers registered with the state’s UI program. The audits seek to identify employers who misclassify workers, workers who are misclassified, and the resulting shortfall to the UI program. Researchers extrapolate from UI audit data to estimate the incidence of misclassification in the workforce and its impact on other social insurance programs and taxes. UI audits rarely identify employers who fail to report any worker payments to state authorities and workers paid completely off-the-books, where misclassification is generally understood to be even more prevalent.

• **Independent contractor misclassification rates are rising.** In California, for example, the number of unreported employees increased by an impressive 54% from 2005 to 2007. In Illinois, the rate of misclassification by violating employers increased by 21% from 2001 to 2005. A recent report by the Ohio Attorney General reported a 53.5% increase in the number of workers reclassified from 2008 to 2009. A study of misclassification in Massachusetts’s construction industry from 2001 to 2003 noted that both the prevalence of misclassification and the severity of the impact have worsened over the years.

IV. State Activity and Federal Policy Reforms

A. States are taking the lead on reforms.

The problem is so pervasive that states have led the way in reforms:

- Many states create a presumption of employee status so that workers providing labor or services for a fee are presumed to be “employees” covered by labor and employment laws. This is already law in over ten states’ workers’ compensation acts, several states with recently-enacted construction industry-specific laws

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49 Richard Cordray, Ohio Attorney General, Misclassification of Employees as Independent Contractors (May 11, 2010).


51 See definition of “worker” in the WA state workers’ compensation act as an example:
and in Massachusetts’ wage act. The so-called “ABC” test is the strongest, and requires employers to show: (a) an individual is free from control or direction over the performance of the work; (b) the service provided is outside the usual course of the business for which it is performed, and (c) the individual is customarily engaged in an independent business.

Several states (NY, MA, CT, OH, NH, TN, VT, IN, UT, CA and others) have created inter-agency task forces to share data and enforcement resources when targeting independent contractor abuses and conduct periodic audits and sweeps and then report on their efforts. In a twist, Maine’s 2009-created inter-agency task force was abolished by Governor LePage via Executive Order.

Others create “statutory employees” in certain industries (construction, trucking) where independent contractor schemes prevail. Similarly, states have created job-specific protective laws that target persistent abuses to encourage compliance, regardless of the label (independent contractor or employee) attached to the worker, including for messenger delivery and trucking jobs. At least five states have farm labor contracting laws (CA, FL, IA, OR and WA). Six states have laws that regulate day labor (AZ, FL, GA, IL, NM and TX).

At least 10 states (AZ, CA, CO, CT, DE, HI, NH, ND, WI, WA) have a general presumption of employee status in their workers' compensation acts (regardless of what job the injured worker has). An employer may overcome the presumption of employee status by showing an “ABC-Plus” test: (a) the individual is free from control or direction over performance of the work, both under the contract and in fact; (b) the service is outside the usual course of business for which the service is performed, and (c) the individual is customarily engaged in an independently established trade, occupation or business, or (d) the individual is deemed a legitimate sole proprietor or partnership. The law requires cooperation and data-sharing by the state departments of labor, employment security, revenue, and workers’ compensation.

See, e.g., Illinois HB 1795, creates a presumption of employee status in construction across several IL state labor and employment laws. An employer may overcome the presumption of employee status by showing an “ABC-Plus” test: (a) the individual is free from control or direction over performance of the work, both under the contract and in fact; (b) the service is outside the usual course of business for which the service is performed, and (c) the individual is customarily engaged in an independently established trade, occupation or business, or (d) the individual is deemed a legitimate sole proprietor or partnership. The law requires cooperation and data-sharing by the state departments of labor, employment security, revenue, and workers’ compensation.


See, NELP, Subcontracted Workers: The Outsourcing of Rights and Responsibilities (March 2004).
More states are beginning to crack down on the increased use of limited liability corporations (LLC’s) as a new way of evading labor and employment standards.59

B. Federal Initiatives

Payroll Fraud Prevention Act (S. 770):60 The bill was introduced in April 2011 by Sen. Brown, and amends the recordkeeping requirements of the Fair Labor Standards Act to require employers to keep records relating to non-employees who perform services for remuneration. The bill also requires an employer to provide notice in writing of a worker’s classification and to keep accurate classification of the worker as either an employee or non-employee. The bill establishes a presumption that an individual is an employee under the FLSA if the employer violates these recordkeeping and notice requirements, and imposes civil penalties.

The bill also amends the Social Security Act to require state unemployment insurance programs to implement investigative procedures and establish penalties for misclassification, and requires the Department of Labor to measure state performance in this misclassification enforcement when conducting unemployment compensation tax audits.

The bill requires information sharing within the Department of Labor regarding possible misclassification under the FLSA, and authorizes the sharing of such information with the IRS. The bill also requires that targeted audits conducted by the Wage & Hour Division shall include industries with frequent incidence of employee misclassification. The bill was referred to the HELP committee in April 2011.61

59 See, Ohio’s HB 137, with a provision that prohibits an incorporated individual to elect to obtain workers’ compensation coverage.
http://www.lsc.state.oh.us/analyses129/h0137-i-129.pdf; Delaware’s Workplace Fraud Act contains a provision prohibiting an employer or person from knowingly incorporating or forming a corporation or other business entity for the purpose of evading the provisions of the law.
http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HS+1+for+HB+230/$file/legis.html?open; Texas HB 2989 contains a provision making it a violation to form or help to form a business entity in order to facilitate misclassification.
60 Available at http://www.govtrack.us/congress/bill.xpd?bill=s112-770.
S. 770’s precursor, the Employee Misclassification Prevention Act (EMPA), held Senate Committee hearings and was introduced the year earlier, in April 2010.62

These bills would be an important first step to encourage transparency in employment relationships. If workers know about their employment classification and the impacts of that status, they would be better prepared to report any violations, and US DOL would be better equipped to determine whether there is compliance if the employers maintain the basic records of their contractors. These are records employers would likely keep in any event when dealing with outside vendors and contractors, including payments and the labor that was the basis for those payments, including, in some cases, hours worked on the job.

➢ **Taxpayer Responsibility, Accountability and Consistency Act of 2009 (S. 2882)** was introduced by Senator Kerry in 2009.63 This bill would amend the Internal Revenue Code to modify the rules giving employers a “safe harbor” when they misclassify employees as independent contractors, and would permit the IRS to issue guidance on the subject. A provision like this bill is vital to serious reform seeking to combat independent contractor abuses.64

➢ **Department of Labor Employee Misclassification Initiative:** The Department of Labor has initiated a multi-agency initiative to strengthen and coordinate federal and state efforts to identify and deter employee misclassification. The Initiative was launched in 2010, and in the DOL’s 5-Year Strategic Plan, the Department commits to a comprehensive initiative focused on enforcement, working closely with the Treasury Department. The Department plans: targeted Wage & Hour Division investigations in industries with the most substantial misclassification problems, and training for investigators on the detection of misclassified workers; targeted efforts to recoup unpaid payroll taxes due to misclassification, including a pilot program to reward states with the most success at detecting and prosecuting employers that misclassify; coordination with the states on enforcement litigation against multi-state employers that routinely abuse independent contractor status; training for Occupational Safety and Health inspectors on misclassification issues; and legislative changes requiring proper classification, providing

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[http://www.dol.gov/_sec/media/congress/20100617_Harris.htm](http://www.dol.gov/_sec/media/congress/20100617_Harris.htm)


64 A major bar to effective enforcement against independent contractor abuses is the safe harbor provision in the Internal Revenue Code, at Section 530 of the Revenue Act of 1978, 26 U.S.C. § 7436. Currently, employers decide whether their workers are employees or independent contractors with little scrutiny from the IRS and no consequences. Under current law, an employer who is found by the IRS to have misclassified its workers can have all employment tax obligations waived. Section 530 also prevents the IRS from requiring the employer to reclassify the workers as employees in the future. Among other factors, a business can rely on its belief that a significant segment of the industry treated workers as independent contractors, thereby perpetuating industry-wide noncompliance with the law.
penalties for misclassification, and restoring protections for employees who have been improperly classified. In addition, the Obama Administration’s budget for 2011 sought $25 million for the DOL’s Misclassification Initiative to target misclassification with additional enforcement personnel and competitive grants to state unemployment insurance programs to address independent contractor abuse.