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REPORT: INDEPENDENT CONTRACTOR ABUSES COST STATES AND FEDS BILLIONS IN LOST REVENUES

Agencies Move to Stem Employee Misclassification and Recover Unpaid Taxes

New York, NY. Growing numbers of employers are wrongly classifying their employees as "independent contractors" instead of "employees" in order to sidestep workplace laws and save on labor costs, including tax obligations—a practice that is having a profound impact on state and federal revenues at a time when public coffers can least afford it, according to a report from the National Employment Law Project.

A second NELP report surveys how states and the federal government are responding to combat the trend.

"Misclassifying workers as independent contractors is a way for companies to sneak out the back door and shirk their legal responsibilities. Misclassification leaves workers vulnerable to violations of workplace protections, puts law-abiding businesses at a competitive disadvantage, and drains public coffers through uncollected taxes, further devastating communities already hit hard by the economic downturn," said **Christine Owens, executive director of the National Employment Law Project**.

Drawing upon data from state task forces, commissions, and other researchers, NELP reports that as many as 30 percent of employers misclassify employees as independent contractors, with several million workers affected nationwide. The practice cost the federal government $2.72 billion in revenues in 2006, according to the most recent estimate from the Government Accountability Office.

States report that they are losing tens-of-millions to hundreds-of-millions of dollars annually in income tax revenues and workers' compensation and unemployment insurance contributions. **New York**, for example, lost approximately $170 million in unpaid state income taxes in 2010, while **Massachusetts** loses between $91 million and $152 million in income taxes annually as a result of misclassification. **Pennsylvania** lost $200 million in unpaid workers' compensation premiums and $81 million in unpaid unemployment insurance taxes in one year alone.

States that have aggressively targeted independent contractor abuses through multi-agency enforcement have recouped tens of millions of dollars in revenues—a small fraction of the taxes estimated to be lost each year due to misclassification. In 2010, for example, **New York's** Joint Enforcement Task Force recovered over $10.5 million in unemployment insurance taxes, over $2 million in unpaid wages, and over $800,000 in workers' comp fines and penalties—an impressive accomplishment but still well short of what workers and the state and federal government lose each year from misclassification by New York employers. **California's** Employment Enforcement Task Force recovered $17.9 million in payroll tax assessments and $4 million in labor code citations in 2009.

Among NELP's findings on the rise of this abuse:

- Independent contractor misclassification rates are rising, according to the states. In **California,** the number of workers that had not been reported by employers for tax purposes increased by nearly one-third from 2006 to 2008; the rate of misclassification in **Illinois** increased by 21 percent from 2001 to 2005; and **Ohio** reported a 53.5-percent increase in the number of misclassified workers from 2008 to 2009.

- Misclassification occurs across the economy, but rates are disproportionately high in construction, real estate, home care, trucking, janitorial and hi-tech jobs. Studies from **Maine**, **Massachusetts**, **Minnesota,** and **New York** found misclassification rates were up to several points higher in construction as compared with the overall workforce.

- Targeted audits are cost-effective and have the potential to return hundreds of millions of dollars to state coffers. **California** recovered nearly $112 million in payroll taxes, over $18 million in labor code citations, and more than $40 million on employment tax fraud cases from 2005 to 2007. **New York** has assessed over $21.5 million in UI taxes, over $1.85 million in unemployment insurance fraud penalties, and over $2.3 million in workers' comp fines and penalties since 2007. **Washington** reported that it brought in over $7 for every dollar invested in enforcement efforts.

The bright side to the disturbing trend is that states and the federal government have stepped in with innovative reforms to make it harder for employers to game the system, as NELP's 2011 Independent Contractor Reform Update shows. Almost half of the states now have a task force or commission to document the problem and better direct enforcement efforts. Many others have strengthened their labor laws to make it harder for employers to avoid compliance.

Among the initiatives launched in the 2010-11 legislative session and summarized in the NELP report are the following:

- **Virginia**, **New Hampshire**, and **Utah** all set up commissions to study and coordinate state agency efforts to identify and investigate independent contractor abuses.

- Several states proposed laws that would create a presumption of "employee" or "employer" status for those performing or receiving labor or services for a fee, as Massachusetts and other states do. These include **Ohio**, **Virginia**, and **North Carolina.**

- **Pennsylvania**, **Delaware**, and **Maine** passed sector-specific laws targeting industries with rampant independent contractor misclassification, such as construction and delivery.

- A growing number of states are raising the stakes for violators by enabling members of the public to bring suits against lawbreakers and by increasing penalties for misclassification violations. A new **Massachusetts** law provides for a private attorney general action against employers that break the workers' compensation law, while **Massachusetts**, **Kansas,** and **California** have all proposed increasing civil penalties or allowing for the issuance of stop-work orders against lawbreakers.

The federal government is joining the states in tackling independent contractor misclassification. NELP's report summarizes recent federal action, including introduction in Congress of the **Payroll Fraud Prevention Act**, which would amend the recordkeeping requirements of the Fair Labor Standards Act to require employers to keep records relating to non-employees who perform services for remuneration. Another example is the **Taxpayer Responsibility, Accountability and Consistency Act**, which would amend the Internal Revenue Code to tighten up the rules that give employers a “safe harbor” when they misclassify employees as independent contractors. The **U.S. Department of Labor** has initiated a **multi-agency initiative** to strengthen and coordinate federal and state efforts to identify and deter employee misclassification. And the **Internal Revenue Service** recently announced the launch of the **Voluntary Worker Classification Settlement Program**, which will enable employers to resolve past worker misclassification problems by voluntarily reclassifying their workers prospectively and making a minimal payment covering past payroll tax obligations rather than waiting for an IRS audit.

“Rampant independent contractor misclassification drags down working conditions and robs communities of funds to pump back into the economy. Misclassification hits workers in every earnings bracket and especially affects low-wage earners in industries like construction, package and freight delivery, and home care. At a time when many states and the federal government are looking to boost economies and close huge deficits, ending unlawful independent contractor misclassification is the hallmark of good government. Implementing the smart, efficient and reasonable strategies like those described in NELP’s report will help create good jobs and shore up the economy nationally and in the states, by reclaiming revenues unlawfully withheld from the government,” said Catherine Ruckelshaus, NELP’s legal co-director.

NELP’s two reports can be found online at Independent Contractor Costs to States and 2011 Independent Contractor Reform Update.

The National Employment Law Project is a non-partisan, not-for-profit organization that conducts research and advocates on issues affecting low-wage and unemployed workers. For more about NELP, visit www.nelp.org.

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