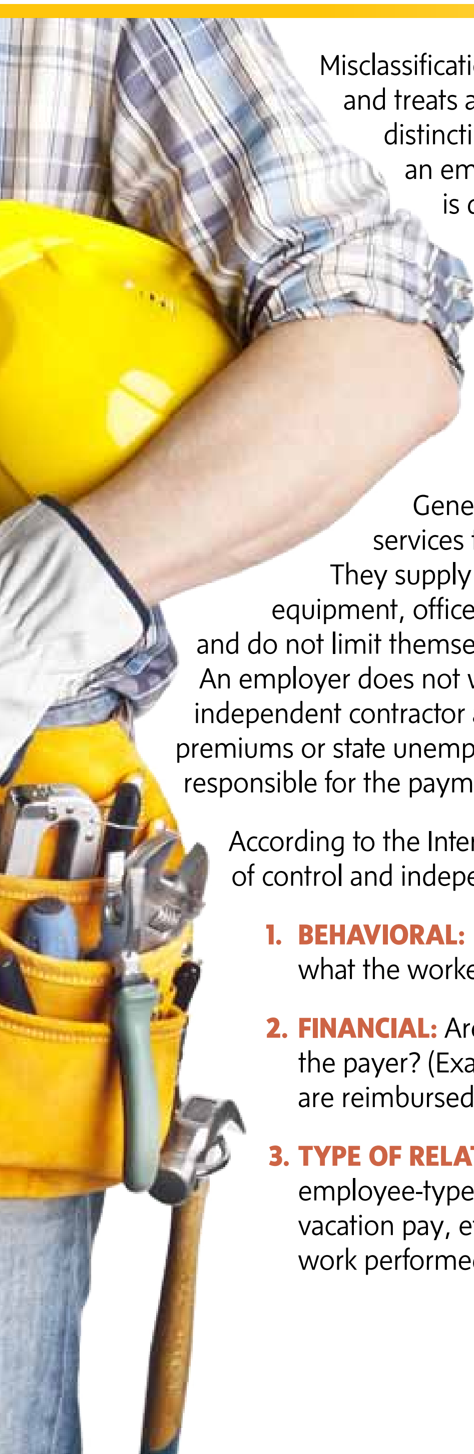
CHEATING THE SYSTEM:

How improperly classifying employees as independent contractors hurts workers, businesses and taxpayers

MARCH 2012

What is misclassification of employees?



Misclassification occurs when an employer improperly classifies and treats an employee as an independent contractor. A key distinction between the classifications is the degree of control an employer exercises over the worker. Employees' work is directed by an employer, who determines what needs to be done and controls how it is to be done. Independent contractors, on the other hand, are not subject to the full-time direction of an employer and are in business for themselves. Independent contractors are hired by an employer to accomplish a task, but the contractors determine how they will do the work.

Generally, independent contractors perform specialized services that are not central to the overall function of a business. They supply their own means of accomplishing their work (tools, equipment, office space, etc.), make themselves available to other clients and do not limit themselves to performing services for a single company. An employer does not withhold state and federal taxes when paying an independent contractor and does not pay workers compensation insurance premiums or state unemployment taxes, as independent contractors are responsible for the payment of any taxes owed.

According to the Internal Revenue Service, factors that determine the degree of control and independence of workers fall into three categories:

1. **BEHAVIORAL:** Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. **FINANCIAL:** Are the business aspects of the worker's job controlled by the payer? (Examples include how a worker is paid, whether expenses are reimbursed, who provides tools/supplies or workspace, etc.)
3. **TYPE OF RELATIONSHIP:** Are there written contracts or employee-type benefits (i.e. pension plans, insurance, vacation pay, etc.)? Will the relationship continue, and is the work performed a key aspect of the business?

A CASE OF MISCLASSIFICATION

In a recent case from Louisville, a driver for a courier service had filed for unemployment insurance benefits and the Kentucky Unemployment Insurance Commission found the employer had not reported wages for the worker because they considered him an independent contractor. The commission determined the worker was actually an employee based on several factors: the courier service provided him with a shirt with the company logo; the company provided him with his designated route (and would add or subtract stops) and reimbursed him for vehicle expenses; and the company would not allow him to advertise as an independent business to offer his services to others. The commission ordered the employer to pay unemployment benefits to the driver.

Why is the misclassification of employees important?

When employers misclassify employees as independent contractors, everyone ends up paying for it.

- **WORKERS ARE HARMED:** When workers are improperly misclassified as independent contractors they lose important protections under laws and programs designed to help employees. These include minimum wage provisions, overtime pay, worker health and safety laws, medical and family leave requirements, workers compensation insurance for injuries suffered on the job and unemployment benefits if they are laid off. Independent contractors have a higher tax burden, as they are required to pay both the employee and employer share of Medicare and Social Security taxes—double what regular employees pay (15.3% for a contractor vs. 7.65% for employees). Improperly classified workers also don't have access to key benefits that employers provide to full-time employees, such as health insurance, retirement plans and paid leave.

- **EMPLOYERS WHO PLAY BY THE RULES ARE HARMED:** Employers who improperly classify employees as independent contractors gain an unfair competitive advantage over companies that follow the law because they do not pay Social Security and unemployment taxes or workers compensation premiums—saving an estimated 30% in payroll costs. This allows them to under-price their law-abiding competition. The failure to pay these premiums and taxes also contributes to the under-funding of these important programs, forcing employers who follow the rules to pay more than their fair share.

- **TAXPAYERS ARE HARMED:** Audits have found that many employers who misclassify employees also under-report or fail to report wages, and workers who are misclassified often fail to pay taxes owed when they are improperly paid as independent contractors. The Government Accountability Office estimates that the federal government loses $3 billion to $4 billion each year in federal income and employment taxes due to misclassification. States are also losing billions of dollars a year in tax and other revenue due to employee misclassification.

How widespread is the problem of employee misclassification?

The U.S. Department of Labor estimates that 10% to 30% of employers misclassify their employees. The table below summarizes the findings of 20 state-level studies that estimate the scope of the problem in terms of the percent of employees misclassified in each state (ranging from 10% to 62% of audited cases) and the loss of state tax revenues and unemployment insurance and workers compensation premiums (totaling more than $800 million per year in Ohio alone).

"We conclude that misclassification is an increasing problem in Kentucky. The effects of increasing misclassification negatively impact workers, employers, small businesses, insurers, taxpayers and tax authorities.... Kentucky will stand to benefit from better documentation of misclassification, from adopting measures that help to improve compliance with state statutes and from targeting employers who intentionally and repeatedly misclassify their employees."

The Economic Costs of Employee Misclassification in the Construction Sector in the Commonwealth of Kentucky, Kelsay and Sturgeon, 2011

Kentucky findings

A September 2011 study of the misclassification of workers in the Kentucky construction industry reached a number of troubling conclusions:

- An estimated 8.01% (11,215) of Kentucky construction employees are misclassified.
- State audits found an average of 26.4% of audited construction employers had misclassified workers as independent contractors for the years 2007-2010.
- The number of misclassified employees found in state audits increased 113% from 2007 to 2010.
- The unemployment insurance system lost an estimated $1.75 million per year as a result of construction worker misclassification.
- The state lost $6.13 million per year in unpaid taxes from misclassified construction workers.
- An average of $3.4 million per year in workers' compensation premiums was lost—shifting the burden to employers who properly classified employees.
- The federal government lost more than $30 million in federal tax payments.

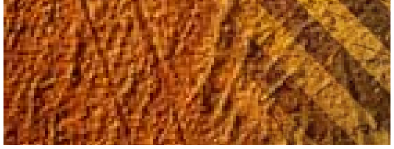
The bottom line: misclassification of construction workers cost Kentucky state government an estimated $11.3 million to $18.4 million per year in lost revenue—and this is just for one sector of Kentucky's $163 billion annual economy.

Annual Losses Due to Independent Contractor Misclassification: Summary of Leading State Studies

*Indicates figures for the construction industry.

STATE	% EMPLOYERS WHO MISCLASSIFY	LOSS TO UNEMPLOYMENT INSURANCE	LOSS TO WORKERS' COMPENSATION	UNPAID STATE INCOME TAXES
CA	29% OF AUDITED EMPLOYERS			$137 MIL (COLLECTED)
CO	33.9%			
CT	42% OF AUDITED EMPLOYERS	$17 MIL	$57 MIL	$65 MIL
IL	19.5% ('05) $8.9 MIL*	$53 MIL ('05) $23.2 MIL*	$97.9 MIL $14.8 MIL*	$124.7 - $207.8 MIL
IN	16.8% 47.5% OF AUDITED EMPLOYERS	$36.7 MIL	$24.1 MIL	$147.5 MIL
ME	11% 14%*	$314,000*	$6.5 MIL*	$26. - 4.3 MIL*
MA	12% 14%*	$35 MIL $3.9 MIL* $2 MIL (COLLECTED)	$91 MIL $7 MIL*	$91 - 152 MIL $6.9 MIL* $1.6 MIL (COLLECTED)
MD	20%	$20 MIL $3.5 MIL* (COLLECTED)		
MI	30%	$17 MIL		$2 - 33 MIL
MN	14% 15%*			
NE	10%			
NJ	38 - 42% OF AUDITED CASES	$15 MIL (UI & DISABILITY)		$5 MIL
NY	10.3% 14.9%*	$175.6 MIL $21.5 MIL (COLLECTED BY JETF) $40 MIL (COLLECTED THROUGH NY DOL UI AUDITS)	$1.1 MIL (INCL. PENALTIES) $2.3 (COLLECTED)	$170 MIL
OH		$12 - $100 MIL	$60 - $510 MIL	$21 - 248 MIL
PA	9%	$200 MIL	$81 MIL	
TN		$8.4 - $15 MIL*	$52 - $91.6 MIL*	
VA	10 - 14%			
WA	62% OF AUDITED CASES	$2.51 MIL (COLLECTED)	$25.4 MIL (COLLECTED)	$29.7 MIL (COLLECTED)
WI	44% OF AUDITED EMPLOYERS			

Source: *Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries, National Employment Law Project, October 2011*



Recent State Actions on Employee Misclassification

Given the growing awareness of the cost of employee misclassification, states have taken a number of recent actions to combat the problem. These actions fall into three basic categories shown on the map below:

1. State initiatives/task forces to identify and resolve employee misclassification *(States shown in red: Massachusetts, New York, Connecticut, California, Utah, Florida)*

2. State studies to assess the magnitude of the problem *(States shown in blue: Virginia, New Hampshire, Utah)*

3. Legislation to rein in the practice, such as creating a presumption of employee status for workers *(States shown in green: California, Connecticut, Kansas, Nevada (vetoed by Governor), Pennsylvania, Delaware, Maine)*

Recommendations

Kentucky should take the following actions to reduce employee misclassification:

- **INTERAGENCY COOPERATION:** Workforce Development, the Labor Cabinet and the Department of Revenue should be required to share information on potential violations, through an interagency task force focused on compliance. Due to the significant lost revenue to the Commonwealth as a result of misclassification, the issue should also be considered by the Governor's Commission on Tax Reform.

- **PRESUMPTION OF EMPLOYEE STATUS:** Legislation should be enacted that creates the presumption of employee status for a worker unless certain factors are met, such as the employer exhibiting no direction or control over the worker, the worker offering similar services to the public, or the worker filing taxes as an independent business.

- **PENALTIES:** Legislation should be enacted to create penalties for repeat or knowing violations by employers improperly misclassifying employees as independent contractors.

RECENT STATE ACTIONS 2010-2011

Source: *2011 Employee Misclassification Legislation, National Conference of State Legislatures, 2012; NELP Summary of Independent Contractor Reforms, November 2011*

SOURCES:

Independent Contractor (Self-Employed) or Employee?, Internal Revenue Service, February 23, 2012

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Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries, National Employment Law Project, October 2011

Labor Works, Kentucky Labor Cabinet, July 2010

2011 Employee Misclassification Legislation, National Conference of State Legislatures, 2012

NELP Summary of Independent Contractor Reforms, November 2011