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THE EFFECTS OF MISCLASSIFYING WORKERS AS INDEPENDENT CONTRACTORS

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
INCOME SECURITY AND FAMILY SUPPORT

AND

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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THE EFFECTS OF MISCLASSIFYING WORKERS AS INDEPENDENT CONTRACTORS

TUESDAY, MAY 8, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON INCOME SECURITY AND FAMILY SUPPORT,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Jim McDermott (Chairman of the Subcommittee on Income Security and Family Support), presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON INCOME SECURITY AND FAMILY SUPPORT

FOR IMMEDIATE RELEASE
May 01, 2007
ISFS–6

CONTACT: (202) 225–1721

Congressman Jim McDermott (D–WA), Chairman of the Subcommittee on Income Security and Family Support, and Congressman Richard Neal (D–MA), Chairman of the Subcommittee on Select Revenue Measures, Announce a Joint Hearing on the Effects of Misclassifying Workers as Independent Contractors

Congressman Jim McDermott (D–WA), Chairman of the Subcommittee on Income Security and Family Support, and Congressman Richard Neal (D–MA), Chairman of the Subcommittee on Select Revenue Measures, today announced a joint hearing on the effects of misclassifying workers as independent contractors. **The hearing will take place on Tuesday, May 8, 2007, at 9:30 a.m. in room 1100, Longworth House Office Building.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Employers must generally take certain actions on behalf of their employees, including withholding income taxes, paying Social Security and Medicare taxes, paying unemployment taxes, providing workers' compensation insurance, paying at least the minimum wage, and permitting inclusion in qualified pension plans and other employer-provided benefits. In addition, employers must abide by certain workplace requirements that offer protections to employees. Employers are not required to provide these benefits or protections to workers who are classified as independent contractors.

The status of worker as an employee or an independent contractor is made under a facts and circumstances test that determines if a worker is subject to the control of the service recipient. The issue of control relates not only to nature of the work performed, but the circumstances under which it is performed.

In its last comprehensive estimate, the Internal Revenue Service (IRS) found that 15% of employers misclassified 3.4 million workers as independent contractors in 1984, resulting in $1.6 billion in lost Social Security, unemployment and income taxes (or $2.7 billion in inflation-adjusted dollars).

Studies suggest some employers misclassify workers as independent contractors in order to cut business costs. This gives these employers an unfair competitive advantage over employers who properly classify their workers as employees. These studies find that the problem of misclassification of workers has grown in recent

years. For example, one study found that the percentage of all workers misclassified in Illinois grew from 5.5% to 8.5% (a 55% increase) between 2001 to 2005. Another report found the percentage of employers misclassifying workers in Massachusetts (according to the most conservative estimates) grew from 8% between 1995–1997 to 13% between 2001–2003.

In announcing the hearing, Chairman McDermott stated, **"When workers are wrongly classified as independent contractors, they lose access to vital benefits, employers who play by the rules are unfairly disadvantaged, and State and Federal programs are starved of resources. We need a fair standard that is fairly enforced."**

Chairman Neal declared, **"Employers and the IRS need an easily understood set of rules in order to classify workers. I am concerned that workers may be disadvantaged by the current situation, and hopefully this hearing can shed some light on what can be done. "**

FOCUS OF THE HEARING:

The hearing will focus on the effects of the misclassification of workers as independent contractors.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*110th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=18*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business **May 22, 2007**. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman MCDERMOTT. The Committee will come to order.

Good morning. I am pleased today to convene this hearing with my colleague, Richie Neal, from Massachusetts. He chairs the Select Revenue Subcommittee and I chair the Income Security and Family Support Subcommittee, and we are here today to examine the effects on workers being misclassified as independent contractors.

For workers in America, one word can make all the difference in their well-being. That word is "employee." Without such a designation, a worker is excluded from most of the basic benefits and the protections provided in the workplace. Millions of workers now find themselves in this precarious position.

When a worker is classified as an independent contractor instead of an employee, he or she might be subject to huge back taxes because their employer did not withhold income taxes; they may be denied Social Security and Medicare when they retire because taxes were not paid on their behalf.

If they are injured on the job, they may not have access to workers compensation. Of great concern to my Subcommittee, they may be denied unemployment insurance if they are laid off. In fact, a study commissioned by the Department of Labor in 2000 estimated that 80,000 workers are improperly denied unemployment benefits every year because they are misclassified as independent contractors.

There are certain times when the term "independent contractor" is justifiably applied, such as when an individual is in a business for himself, but there are other occasions when a worker is under the control of an employer and should be designated as an employee.

Misclassification can occur because of definition uncertainties, but it likely happens at least as frequently because some employers are looking for an easy way to cut costs. Misclassifying a worker as an independent contractor lets a business off the hook for various payroll taxes and employee benefits.

When unscrupulous employers commit this type of fraud, it hurts more than the workers. Responsible businesses who play by the rules are placed at an unfair competitive disadvantage.

Just envision two construction companies bidding on the same contract, and then consider what would happen if one of them paid taxes and provided benefits for their workers, but the other did not.

As a tax avoidance scheme, misclassification also robs both the States and the Federal Government of revenue. Prior estimates from the IRS indicate billions of dollars of taxes go unpaid each year because of the misclassification.

The misclassification of workers is not a new problem. This is not something we discovered since the last election. However, the pressures of globalization and the rising costs of health and other bene-

fits as a portion of total payroll costs suggest it will become a growing concern. Indeed, some of the recent State-level studies find an increasing amount of risk classification over the last few years.

For all those reasons, I hope we will consider sensible solutions to prevent workers from being wrongly classified as independent contractors.

I would now like to yield to the Chairman of the Subcommittee on Select Revenue, Mr. Neal of Massachusetts.

Chairman NEAL. Thank you, Chairman McDermott and members of the panel. Author and publisher, Elbert Hubbard wrote that "We work to become, not to acquire." For many of us here today, that is true, our work is much more than a paycheck. From it we derive satisfaction and a sense of responsibility.

I remember very well one of my first jobs when I was just 17 years old. I worked in the hardware department of Two Guys Department Store in Springfield, Massachusetts, and Two Guys was really a great place to work. Despite the fun of working there, I also recognized that my job was a tremendous opportunity and carried with it responsibility.

I think that most workers treat such opportunities the same: They are eager to get their tasks done and to perform well, but as we hear today, some fall victim to misclassification. Some are so eager to work they simply do not hear that they are not employees, some are disadvantaged or may have language barriers and do not understand the implications, many do not understand the law in this area. Even Treasury and GAO have acknowledged that the law is confusing and conflicting. According to the testimony we will hear today, some have stepped into this gray area to take advantage of that uncertainty.

It also seems clear, though, that we must do something to reverse the trend. The GAO estimated that misclassification results in a Federal income tax loss of $4.7 billion in 1 year. Other experts have found that my home State of Massachusetts loses hundreds of millions of dollars in tax revenues each year from this problem. Legitimate businesses that play by the rules are also hurt here.

We are fortunate to have with us today one of my constituents from Springfield, Mr. John Kendzierski, a dry wall contractor for almost three decades. John will tell us that he is at a disadvantage when competing against other contractors who treat all of their workers as independent contractors.

Thank you for sharing your story with us today, John; I am delighted you are here.

I look forward to all the testimony today. In addition to suggestions about refining the law, we will also hear recommendations, additional—reporting that perhaps additional withholding will help address some of the tax gap and noncompliance issues surrounding independent contractors.

I know that the testimony today will help us find some reasonable solutions to help us deal with this problem. Thanks to Mr. McDermott.

Chairman MCDERMOTT. Thank you.

Now Mr. Weller from the Income Security and Family Support Subcommittee.

Mr. WELLER. Thank you, Mr. Chairman, and good morning. Welcome to all the witnesses and guests before us today in this first joint hearing of this Congress for our Subcommittee, as well as the Subcommittee on Select Revenue Measures, today.

Our economy continues to grow, creating about 2 million new jobs each year. In this dynamic workplace, both employers and millions of employees are seeking flexible working arrangements. The Bureau of Labor Statistics estimates that in February of 2005 there were over 15 million workers with alternative employment arrangements, including over 10 million independent contractors.

As we will hear today, these alternative work arrangements pose both opportunities and challenges for workers, business and government. Today, we will pay particular attention to issues related to the misclassification of independent contractors.

Independent contractors often fill a need for special skills or experience, providing flexibility for both the business needing assistance as well as the independent worker. Technical and often complex labor and tax rules determine who is an independent contractor. Confusion about these rules is one reason why some workers may be incorrectly classified as independent contractors, as we will hear today.

Other reasons are less benign. For example, some employers may be willfully misclassifying workers as independent contractors and some workers, including day laborers and others, may willingly go along, if they even understand all the complicated rules and their implications. These issues raise a number of questions involving unemployment compensation and other public and private benefits, as well as tax revenue issues.

I look forward to exploring these important issues in more detail both to ensure that workers get the benefits and protections they deserve and that all taxpayers are treated fairly and equitably.

Thank you, Mr. Chairman. I yield back.

Chairman MCDERMOTT. Thank you. Other members are welcome to enter a statement into the record.

We are going to begin today with Mr. Kendzierski of West Springfield, Massachusetts. You have got to tell me if I pronounced your last name correctly.

Mr. KENDZIERSKI. You did pretty good.

Chairman MCDERMOTT. I used to live in the second-largest Polish city in the United States, or in the world, Chicago, so I learned a few things. Go ahead.

STATEMENT OF JOHN KENDZIERSKI, PRESIDENT, PROFESSIONAL DRYWALL CONSTRUCTION INC., WEST SPRINGFIELD, MASSACHUSETTS

Mr. KENDZIERSKI. Good morning, everybody, and I am grateful to be here. This is something that is actually very important to me.

I have been working in this business for close to 30 years. I have worked in residential, and I primarily work in commercial business; I have worked with open shop labor and I have worked with—now I am involved with union labor, and I currently have around 150 carpenters and laborers working for me.

I want to just tell you about the difficulties and, really, the impossibility of people that are competing against people that mis-

classify and what we call "1099 their employees," these people that are avoiding Social Security taxes, workmen's compensation, and unemployment insurance.

A lot of them are avoiding their Federal and State tax liabilities, and these expenses add up to over 25 percent just on a simple cost basis. So, if you are competing against them on a price basis, that makes it virtually impossible to solve that problem.

It also causes your insurance rates to rise, unemployment insurance costs rise, workmen's compensation rates to rise, because if the pool of people paying into that shrinks because people are avoiding these taxes and fees and insurance fees, then obviously the rates have to go up to, as the—for those systems to work.

They also just save the expense of having to administer a payroll and administer paying all these fees for these people that effectively are employees, but who they have convinced to often, sign things that say they are independent contractors. Additionally, some tradesmen—it allows them to avoid any government scrutiny.

So, there are people that are trying to hide, their immigration status, their child support situations; they don't want to pay their Federal taxes, they have taxes, unpaid tax liens, and so they are avoiding—intentionally trying not to show up on anybody's radar screen as an employee, because as soon as you file a return or file information with the State and Federal Governments, they can track these people down who often have unpaid liabilities that they are trying to avoid.

You know, as an employer, I have always prided myself on the relationship with my employees. One of the troubles I have with this is you have a lot of people that have no insurance, they have no health insurance, but they also don't have any unemployment insurance, and have no workmen's compensation insurance.

We work in dangerous businesses. People do get injured, and when these people get injured, they have no place to turn, neither the government nor the workmen's compensation system is going to deal with them and everybody is going to turn their back on them. They can really get caught in a very difficult situation.

They are also generally not paying any Federal and State taxes they are obligated to pay. The kind of illegitimate contractors that trap these people, they say, well, look at all the money you are saving, instead of, you can deduct this or you can pay your own taxes. Generally, these people don't do that; for one reason or another, they tend to be living paycheck to paycheck.

When these people work as a subcontractor, sooner or later they find themselves caught in some kind of a trap where they come to work for someone like me, they report their earnings, then later on somebody they work for gets audited, they owe huge amounts of back taxes, and it is crippling for them. They can owe sometimes a year's wages in back taxes because they worked 3, 4 years in this kind of underground economy.

They will never escape that. They will be paying those taxes for the rest of their lives. It is really kind of sad.

What a lot of these contractors do, they prey on these employees and they take advantage of their lack of understanding of the law and the risks they are really taking. They convince these people that they are going to have more money, because they are avoiding

these taxes and fees, they are somehow beating the system, although they are the ones who—actually, I believe the employees are the ones getting beaten.

This is particularly true in the residential and small commercial markets. Here, people like myself, it is virtually impossible to compete with people that are paying these people, these—whether they are paying them cash or they are paying them as independent subcontractors, there is no way I can compete with that economically. As a result, we lose—you lose good jobs and you know people that want to have legitimate income and have benefits and have the kind of American life that a lot of us would like to have are closed out of those markets.

The whole issue of being paid cash is another huge problem. Owners would sometimes pay the contractors in cash. They, in turn, use that to pay their employees. Nobody is paying taxes on any of this money; nobody is paying any insurance fees, nobody is paying their unemployment insurance, workmen's compensation insurance. It is impossible to compete against. It leaves no paper trail.

These people—it is a huge, unregulated underground economy that is huge in construction, in particular, and like I said, in residential and smaller markets. Once you get caught in these things, and an employee gets caught working in this underground economy, they almost can never come out, they are captured because as soon as you show up somewhere or—where have you been for the last 3, 4 years?

They might not have filed Federal tax returns, they have shown no income, they haven't paid their child support or whatever the issues might be. It is really a system where these contractors that pay their people that way can trap and kind of control a workforce that for some reason eventually have to hide from any kind of scrutiny.

So, in conclusion, there are a couple of problems that are created by misclassification of workers, one of which is that it makes it—creates a competitive disadvantage for people like myself to go out and compete in markets where you have people that are paying their employees as independent subcontractors when, effectively, they are employees. They are telling them what to do every day, they work for them. It is kind of silly.

Second, it creates a second class of tradesmen who can be talented at what they do, but that takes huge personal, physical and financial risks that they might not even understand; and like I said, can get trapped in a way that they can eventually find very hard to escape from.

So, I really think the Federal Government needs to take kind of an active role in defining and regulating who can be paid as an independent subcontractor, specifically in construction. In following the money trail, there should be a limit to the level of subcontracting. At some point someone has got to be an employee in that relationship somewhere.

Chairman MCDERMOTT. Could you sum up your testimony?

Mr. KENDZIERSKI. So, besides that, just hopefully help, so these people can trace the cash, so that these people have some fear of getting caught paying cash—so we can avoid that problem.

So, thank you very much.

Chairman MCDERMOTT. Thank you.

[The prepared statement of Mr. Kendzierski follows:]

Prepared Statement of John Kendzierski, President, Professional Drywall Construction Inc., West Springfield, MA

Good morning, my name is John Kendzierski and I am the President of Professional Drywall Construction Inc., a regional commercial drywall contractor in western New England. I have been in the drywall business since 1979 and have worked in both the residential and commercial markets, with both open shop and union labor. Currently I am signatory with the carpenter and laborers unions, employing 150 tradesmen.

I am here today to tell you the difficulties of competing against contractors who misclassify their employees as subcontractors and "1099" them instead of paying them as the employees they truly are. These contractors thereby avoid paying Social Security and Medicare taxes, federal and state taxes, federal and state unemployment insurance, workman's compensation and liability insurance. These expenses add over 25% to the cost of labor, putting us "legitimate" contractors at a competitive disadvantage when competing for the same work. This also causes insurance and other rates to rise because there is less money being contributed in total therefore burdening the contractor who pays the appropriate taxes and fees. It also allows these contractors to save the expense of running a payroll and administering the payment of these taxes and insurances. (Additionally, it conveniently allows some tradesmen to avoid any government scrutiny such as immigration status and the paying of child support and back taxes, effectively not showing up on anyone's radar screen.)

As an employer who has always prided myself on my relationship with my employees, I find it troubling that some tradesmen have no insurance coverage of any kind, particularly workman's compensation insurance. We are in a dangerous business and people do get injured. Uninsured workers cannot collect unemployment when not working, are not paying into the Social Security and Medicare systems, and often are not paying the state and federal taxes they are obligated to pay. I can tell you many stories about employees who have worked as subcontractors, and not paid taxes, and then as a result of an audit find themselves owing the government several months wages in back taxes, which is crippling for your average worker.

What these contractors do is actually prey on their employees and take advantage of their lack of understanding of the law and of the risks that they are taking. They convince these employees that they are getting more money by avoiding the taxes and fees that they should have had paid for them, and that they are somehow "beating the system". In my experience the employees are just getting beaten. This is particularly true in the residential and small commercial markets. In those markets legitimate contractors have no real chance to compete, which costs good jobs and income for hard working Americans. There is an additional part of this problem caused by employers who pay cash. Often owners pay contractors in cash, which they in turn use to pay their employees. This cash economy is impossible to compete against and leaves no paper trail. In those situations no one is paying taxes or insurance premiums, nor are they verifying any legal status before they are paid creating a huge, unseen, unregulated economy that hurts real businesses and can capture workers in a trap from which they cannot escape. (They can never report income or come clean without the threat of huge tax liabilities.)

In conclusion, there are really two significant problems that are caused by the misclassification of employees. First, the contractors take work away from legitimate contractors that treat the employees fairly, because of the significant cost advantage of avoiding taxes, insurance and fees. Secondly, it creates a second class of tradesmen that are at huge personal, physical and financial risks and often get trapped in an underground economy from which they cannot escape.

I believe that the federal government needs to take an active roll in defining and regulating who can be paid as an independent contractor, specifically in construction, and in following the money trail on construction contracts to keep the "cash pay" contractors fearful of being caught. (They know it is illegal but have no fear.) For instance not allowing deductions for anything paid with cash would be useful.

Thank you for this opportunity to speak with you on this very important issue.

Chairman MCDERMOTT. Mr. Valencia is from Washington State.

Mr. Valencia?

STATEMENT OF GONZALO VALENCIA, CARPENTER, COVINGTON, WASHINGTON

Mr. VALENCIA. Good morning, sir.

I have been a carpenter for 18 years. I started my apprenticeship in 1989. When September 11 happened, jobs slowed down the market, and I was basically obligated to look for a new resource to bring income to my house. What I did, I went to a development of houses that was in process and I asked for employment.

Basically, one of the subcontractors hired me as a framer; and he asked me to see if I could come up with another two guys, to frame a house. I did, and we framed this house, we did a good job. They liked the way we frame, and asked me if I wanted another one.

Well, we built about five houses, and the superintendent from the job which he worked for, the general contractor, suggested to me if I could go and get my own license and go on my own because I was doing good. Basically, that is what I did.

I started working with those guys, and the development got done and they recommended me, did a recommendation for me with another contractor and—which is the contractor that I am still working with. I have been working with them off and on for 5 years, and I have been working with them—basically they've got their own way to frame and I've got to accommodate myself to their own standards—the windows, the way they want their corners.

If the house has upgrades, basically we're not making any more money for these upgrades. They said it is square footage for the houses, and this is what we get paid.

I think we are obligated to continue and frame this way; otherwise, they will get somebody else to do it. They say, start walking the houses. They have a system now where we're not even done with the second floor, and they start coming up with a list, telling us that we have to get the houses in a certain way, following a certain schedule that has to meet the standards and their expectations.

If I didn't show up to the job, I get yelled at; they start calling me up, say, where am I? So, basically I become one of the employees.

I have to walk my houses on a daily basis. I come up with a list for these houses, and the house has to pass several inspections which is city, one from the department, and I have to walk my own list.

I am pretty sure that they are conscious about what they are paying us. They know that it is not enough to pay our employees. They set the wages for us. Basically, it is quite foolish, we frame garages for free; we don't get paid anything for these garages. We have houses that have detached garages, and we didn't get a nickel for that.

Like I say, they can come up with new upgrades in these houses—porches, plant shelves, anything they want to make the house attractive to the customer? This doesn't increase our pay. It is all included and it is quite foolish. We have to set windows too.

So, from my own perspective, I think they are neglecting the pay. They are fully aware that this money is not enough to cover all the compensations for the employees that we have.

I have a son that is working with me right now and we are very proud of what we do, and he has seen me for years working with the union and working as a carpenter, and he knows that we are honest people. This is what we do for a living, and I can teach him how to be a good carpenter and I can teach him how to make a living out of it.

That is my statement.

Chairman MCDERMOTT. Thank you very much.

[The prepared statement of Mr. Valencia follows:]

Prepared Statement of Gonzalo Valencia, Covington, Washington

Chairman Jim McDermott and Chairman Richard Neal:

My name is Gonzalo Valencia. I have worked as a carpenter for 18 years.

I went through the Union apprenticeship starting in 1989. I worked for fourteen years on union jobs.

After 9–11–2001 work slowed down. I went out looking for work. I went up to a guy who was framing a house. He said, "Can you frame?" I said, "I can frame anything." He said, "Can you get two guys to work with you?" I said, "Sure". He paid me as a 1099. Then he recommended me to the homebuilder. I got my contractor license in August of 2003 and they hired me to frame houses. I've been there ever since.

I am good at building houses. I love to build houses. I am an honest man. I have tried to do it right. Many others don't even try to pay the taxes for the carpenters. The homebuilders have accountants and lawyers who decide how much it will cost to build a new house. I think they know that the footage rates are not enough to pay ourselves a wage and cover our own payroll taxes.

It is very difficult to be an independent contractor framing houses. The homebuilder is a big company. I am a carpenter working with my tools. The builder tells you how much you will be paid. On some houses there is not enough money to keep a wage for myself. The homebuilder provides all of the material. The homebuilder sets the schedule. The superintendent calls and yells at you when you don't show up for work.

The reason I work as an independent contractor is because nobody tells the homebuilders that they have to pay their carpenters as employees.

This homebuilder has a system for building houses. I do the work the way that they say to do the work. They like the windows a certain way, the corners framed a certain way. Now, they started walking through the house when you are halfway done and they make a list of things they want you to change or do-over. On my last house the list had 80 items.

They pay me by piece rate by square footage. This winter the boss told me that the housing market is slowing down and he cut my piece rate from $4.85 a foot to $4.50 a foot. Garages are not included in the footage rate, even detached garages. I am required to frame garages for free if I want to keep the job. If the homeowner wants plant shelves, or archways, or a vaulted ceiling the homebuilder says OK. It requires more hours of work, but it doesn't cost the homebuilder anymore. They require me to frame the extras and I make less money on the house.

I have framed for the same large homebuilder for five years. I understand that this is an ongoing job; so long as I continue to perform they will keep me on. Sometimes the boss says if I don't do something that he wants he will fire me. Recently he demanded that I fire one of the guys on my crew.

I'm not a contractor like a plumbing or electrical company. I don't bid work to other contractors, I don't have an office or a secretary. I don't have a company name on the side of my truck. I go to work everyday for the same builder. If this was a commercial job I would be a foreman. Building houses I am called a framing subcontractor.

My situation is very common in new home construction. In five years I have seen many framing crews, hundreds of workers. The workers often get paid less than they were promised or don't get paid at all. None of the tract homebuilders in our area hire carpenters as employees.

Today, my son is working with me. He is learning the trade. I can teach him to be a good carpenter. I can't teach him how to make a living working on houses.

I hope that you will help to fix this problem so that good carpenters can be proud of our work and proud of how we get paid.

Chairman MCDERMOTT. Mr. Nilsen, Dr. Nilsen. You work for the GAO?

Dr. NILSEN. GAO, Government Accountability Office, yes.

Chairman MCDERMOTT. Yes, sir.

STATEMENT OF SIGURD R. NILSEN, DIRECTOR, EDUCATION, WORKFORCE, AND INCOME SECURITY, GOVERNMENT ACCOUNTABILITY OFFICE

Dr. NILSEN. Chairman McDermott, Ranking Members Weller and English and other members of the Subcommittee, I am pleased to be here today to discuss our work on misclassification of employees as independent contractors. This is an important issue because being classified as an employee brings with it many benefits and protections that independent contractors do not have.

The information I am presenting today is based on findings from our July 2006 report on the size and nature of the contingent workforce of which independent contractors are a significant part. First, with regard to the size of the independent contractor workforce, the number of independent contractors has increased by 25 percent since 2000 to 10.3 million workers in 2005, now representing 7.4 percent of the total workforce. About two-thirds of independent contractors are men; they are, on average, 46 years old and at least two-thirds had some college education.

Independent contractors were employed in a wide range of industries, but in 2005, 23 percent were in professional services and 22 percent were in construction. Independent contractors were also in a range of occupations, such as sales, which accounted for 17 percent; management, 16 percent; and 15 percent in construction trades.

No definitive test exists to distinguish whether a worker is an employee or an independent contractor. The tests used to determine whether a worker is an independent contractor or an employee are complex, subjective and differ from law to law. For example, the National Labor Relations Act, the Civil Rights Act, the Fair Labor Standards Act and the Employee Retirement Income Security Act each uses a different definition of an employee and various tasks or criteria to distinguish contractors from employees.

Aside from the complexities of distinguishing employees from independent contractors, employers have economic incentives to misclassify employees as independent contractors. Namely, employers are not obligated to make certain financial expenditures for independent contractors that they make for employees, such as paying certain taxes like Social Security, Medicare and unemployment taxes, providing Worker's Compensation insurance, paying minimum wage and overtime wages or including independent contractors in employee benefit plans such as pensions and health insurance.

In addition, employees misclassified as independent contractors are generally excluded from coverage under laws designed to protect workers. In general, because these laws are based on the tradi-

tional employer-employee relationship, they generally cover only workers who are employees. Independent contractors, therefore, are not covered.

The Department of Labor detects and addresses employee misclassification when enforcing the Fair Labor Standards Act minimum wage and overtime pay provisions. Labor relies on complaints as a primary way to identify potential violations for investigation.

All FLSA investigations of minimum wage and overtime pay complaints begin with an examination of the worker's employment relationship because FLSA applies only to employees, not to independent contractors. If investigators determine that a worker is an employee and not an independent contractor, they continue with their FLSA investigation to determine whether the employee was provided the required minimum wage and overtime pay. Employee misclassification alone is not a violation of FLSA, but may contribute to minimum wage and overtime pay violation or violations of tax, Worker's Compensation or unemployment insurance laws.

According to Labor's field operations handbook, regional or district officials are required to share information with other Federal and State agencies whenever investigators find instances of possible violations of other laws. Labor officials in nine district offices told us they could not provide the number of misclassification cases they referred to other agencies because they do not track this information. However, their responses indicated that district offices vary in how often they refer cases to other agencies.

Some of Labor's district offices told us that they refer—they notified IRS and State agencies when they found misclassification, while others told us they had little or no contact with other agencies regarding misclassification issues. The district offices also reported that it was rare for them to receive misclassification referrals from other Federal or State agencies.

In conclusion, to help workers potentially misclassified get the protection and information they need, we recommended that the required FLSA workplace poster provide additional contact information that would facilitate the reporting of potential employee misclassification complaints. We also recommended that Labor make improvements in the process it uses to ensure that referrals of cases of misclassification are made to other agencies.

This concludes my prepared statement. I will be happy to answer any questions you may have.

Chairman MCDERMOTT. Thank you.

[The prepared statement of Dr. Nilsen follows:]

United States Government Accountability Office

GAO

Testimony before the Subcommittee on Income Security and Family Support and Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives

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EMPLOYEE MISCLASSIFICATION

Improved Outreach Could Help Ensure Proper Worker Classification

Statement of Sigurd R. Nilsen, Director
Education, Workforce, and Income Security

GAO-07-859T

GAO

Highlights

Highlights of GAO-07-859T, a testimony before the Subcommittee on Income Security and Family Support and Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

Some workers do not receive worker protections to which they are entitled because employers misclassify them as independent contractors when they should be classified as employees. Key worker protections include minimum hourly wage and overtime pay and access to unemployment insurance. The Department of Labor (DOL) enforces several labor laws to protect workers, including the Fair Labor Standards Act (FLSA). Misclassification can also have a negative impact on tax collection for Social Security, unemployment insurance, and other programs. This testimony draws upon a previous GAO report and focuses specifically on (1) the number and characteristics of independent contractors, (2) the workforce protections and benefits provided to employees that typically are not available to independent contractors, and (3) the actions that DOL takes to detect and address employee misclassification.

What GAO Recommends

GAO is not making new recommendations at this time. The Department of Labor generally agreed with the recommendations in the GAO report, which focused on improvements to a worksite poster reaching out to workers and DOL's efforts to forward misclassification cases to other agencies.

www.gao.gov/cgi-bin/getrpt?GAO-07-859T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Sigurd Nilsen at (202) 512-7215 or nilsens@gao.gov.

May 8, 2007

EMPLOYEE MISCLASSIFICATION

Improved Outreach Could Help Ensure Proper Worker Classification

What GAO Found

The number of independent contractors in the total employed workforce grew from 6.7 percent in 1995 to 7.4 percent in 2005. In 2005, there were 10.3 million independent contractors. Independent contractors, in 2005, had an average age of 46 years, were almost twice as likely to be male than female, and almost two-thirds had some college or higher education. Independent contractors were employed in a wide range of industries (such as professional services and construction) and occupations (including sales and management).

When employees are misclassified as independent contractors, they may be excluded from coverage under key laws designed to protect workers and may not have access to employer-provided health insurance coverage and pension plans. Moreover, misclassification of employees can affect the administration of many federal and state programs, such as payment of taxes and payments into state workers' compensation and unemployment insurance programs. Notably, the tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law.

DOL detects and addresses misclassification of employees as independent contractors by investigating complaints, but does not always forward misclassification cases to other federal and state agencies. DOL investigators detect and address employee misclassification primarily when responding to FLSA minimum wage and overtime pay complaints. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices GAO contacted vary in how often they forward misclassification as a possible violation of other laws. As one form of outreach to workers, DOL has an FLSA workplace poster that explains the act, but it is missing key contact information.

Mr. Chairmen and Members of the Subcommittees:

Thank you for inviting me here today to discuss the misclassification of employees as independent contractors. Some workers do not receive worker protections to which they are entitled because employers misclassify them as independent contractors when they should be classified as employees. Key worker benefits and protections include the guarantee of workers' rights to safe and healthful working conditions, a minimum hourly wage and overtime pay, freedom from employment discrimination, and access to unemployment insurance. In its last comprehensive misclassification estimate, the Internal Revenue Service (IRS) estimated that 15 percent of employers misclassified 3.4 million workers as independent contractors in 1984, resulting in an estimated tax loss of $1.6 billion (or $2.72 billion in inflation-adjusted 2006 dollars[1]) in Social Security tax, unemployment tax, and income tax.

The Department of Labor (DOL) enforces a wide range of labor laws that provide protections to workers, including the Fair Labor Standards Act (FLSA), which provides minimum wage, overtime pay, and child labor protections. Other federal and state agencies enforce laws that provide workers with additional workforce benefits and protections.

The information I am presenting today is based on findings from a July 2006 report, which examined various aspects of the contingent workforce.[2] Today, as requested, I will focus specifically on independent contractors, one of eight categories of contingent workers included in our report. I will discuss (1) the number and characteristics of independent contractors, (2) the workforce protections and benefits provided to employees that typically are not available to independent contractors, and (3) the actions that DOL takes to detect and address employee misclassification. To identify information on the contingent workforce, we analyzed data from the Bureau of Labor Statistics' (BLS) Current Population Survey (CPS),

[1]The $2.72 billion is intended to be an estimate of the magnitude of tax loss due to misclassification in 2006 dollars—not an updated estimate. The actual tax loss due to misclassification in 2006 may be higher or lower based on the tax rates, the level of independent contractors used in various sectors of the economy, and the types and levels of misclassification observed in 2006.

[2]GAO, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (Washington, D.C.: July 11, 2006). In this report, we define "contingent work" as work arrangements that are not long-term, year-round, full-time employment with a single employer.

which is used to survey people about their work and workplace benefits, and a CPS supplement developed to collect information on the contingent workforce; interviewed BLS officials and other researchers about contingent worker issues; and reviewed key workforce protection laws to determine coverage of contingent workers. To obtain information on DOL's efforts to detect and address employee misclassification, we reviewed DOL documents and interviewed DOL officials and reviewed literature and interviewed researchers about employee misclassification issues. We performed our work in accordance with generally accepted government auditing standards between July 2005 and June 2006.

In summary, the number of independent contractors in the total employed workforce grew from 6.7 percent in 1995 to 7.4 percent in 2005. In 2005, there were 10.3 million independent contractors.[3] Independent contractors, in 2005, had an average age of 46 years, were almost twice as likely to be male than female, and almost two-thirds had some college or higher education. Independent contractors were employed in a wide range of industries (such as professional services and construction) and occupations (including sales and management). The tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law. Nevertheless, when employees are misclassified as independent contractors, they may be excluded from coverage under key laws designed to protect workers and may not have access to employer-provided health insurance coverage and pension plans. Moreover, misclassification of employees can affect the administration of many federal and state programs, such as payment of taxes and payments into state workers' compensation and unemployment insurance programs. Finally, DOL detects and addresses misclassification of employees as independent contractors by investigating complaints, but does not always forward misclassification cases to other federal and state agencies. DOL investigators detect and address employee misclassification primarily when responding to FLSA minimum wage and overtime pay complaints. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices GAO contacted vary in how often they forward misclassification as a possible violation of other

[3]Estimates of the size and characteristics of the contingent workforce are based on CPS sample data and are subject to sampling error. For example, the 95 percent confidence intervals for percentages of the total workforce are within +/- 1 percentage point of the estimate itself. For a full explanation of the methodology that we used and for the magnitude of sampling error for CPS estimates, see GAO-06-656.

laws. As one form of outreach to workers, DOL has an FLSA workplace poster that explains the act, but is missing key contact information. GAO recommended in its July 2006 report that DOL revise a workplace poster to include additional contact information that would facilitate the reporting of potential employee misclassification complaints, and evaluate the extent to which misclassification cases identified through investigations are referred to the appropriate federal or state agency, and take action to make improvements as necessary. DOL generally agreed with both recommendations.

Background

The term "contingent work" can be defined in many ways to refer to a variety of nonstandard work arrangements. Broadly defined, "contingent work" refers to work arrangements that are not long-term, year-round, full-time employment with a single employer. For example, an employer may hire workers when there is an immediate and limited demand for their services, without any offer of permanent or even long-term employment. Independent contractors, temporary workers, and part-time workers are examples of contingent workers. Specifically, independent contractors can be seen as individuals who obtain customers on their own to provide a product or service (and who may have other employees working for them), such as maids, realtors, child care providers, and management consultants.

Research has shown that employers use contingent work arrangements for a variety of reasons. Employers may hire contingent workers to accommodate workload fluctuations, fill temporary absences, meet employees' requests for part-time hours, screen workers for permanent positions, and save on wage and benefit costs, among other reasons. Previous analyses of data from the CPS Contingent Work Supplement have indicated that workers also take temporary and other contingent jobs for a variety of personal and economic reasons. For example, workers in various types of contingent jobs indicated that they (1) preferred a flexible schedule to accommodate their school, family, or other obligations; (2) needed additional income; (3) could not find a more permanent job; or (4) hoped the job would lead to permanent employment. Studies using data from the BLS National Longitudinal Survey of Youth show that events such as the birth of a child or a change in marital status affect the likelihood of entering different types of employment arrangements and prompt some workers to enter contingent work arrangements.

Concerns arise when employers misclassify workers as independent contractors, who are excluded from certain worker protections. Employee

misclassification occurs when an employer improperly classifies a worker as an independent contractor when the worker should be classified as an employee. In 2000, we reported that because most key workforce protection laws cover only workers who are employees, independent contractors and certain other contingent workers, such as self-employed workers, are, by definition, not covered.[1]

DOL may encounter employee misclassification while enforcing worker protection laws. DOL's mission is to promote the welfare of job seekers, workers, and retirees in the United States by improving their working conditions, advancing their opportunities for profitable employment, protecting their retirement and health care benefits, helping employers find workers, strengthening free collective bargaining, and tracking changes in employment, prices, and other national economic measurements. In carrying out this mission, DOL enforces a variety of worker protection laws, including those guaranteeing workers' rights to safe and healthful working conditions, a minimum hourly wage and overtime pay, freedom from employment discrimination, and unemployment insurance.

In particular, DOL's Employment Standards Administration's (ESA) Wage and Hour Division enforces FLSA. The Wage and Hour Division—with staff located in 5 regional and 72 district, area, and field offices throughout the country—conducts investigations of employers who have $500,000 or more in annual sales volume. In addition, the division conducts outreach efforts for employers and workers to ensure compliance with FLSA. District directors oversee investigators, who play a key role in carrying out FLSA enforcement. Investigators are trained to investigate a wide variety of workplace conditions and complaints and enforce a variety of labor laws in addition to FLSA.[2] Regional and district offices conduct outreach to employers and workers through brochures, workplace posters, presentations or training sessions for individuals or groups, and Web-based information.

[1]GAO, *Contingent Workers: Incomes and Benefits Lag Behind Those of Rest of Workforce*, GAO/HEHS-00-75 (Washington, D.C.: June 30, 2000).

[2]Complaints are a key component of DOL enforcement efforts under many federal labor laws. DOL enforcement generally relies on two types of information to identify potential violations: (1) complaints from individuals who believe they may have suffered a violation and (2) analysis of data to specifically target problematic industries or work sites.

FLSA—which provides minimum wage and overtime pay protections—requires that employers pay those employees covered by the act at least the minimum wage and pay overtime wages when they work more than 40 hours a week. FLSA requires that an employer-employee relationship exist for a worker to be covered by the act's provisions.

Number and Characteristics of Independent Contractors

In 2005, an estimated 7.4 percent of the total employed workforce were independent contractors. By comparison, 6.7 percent of the workforce were independent contractors in 1995. During this time period, the number of independent contractors grew from an estimated 8.3 million to 10.3 million workers in 2005. (In 2005, there were about 42.6 million contingent workers in the workforce—representing an estimated 31 percent of the workforce.)

Independent contractors, in 2005, were on average 46 years old. The majority were men (65 percent), had attended or graduated from college, and 8 out of 10 were white, non-Hispanic. Independent contractors were employed in a wide range of industries, but in 2005, 23 percent were employed in professional services and 22 percent were employed in construction. Regarding occupations, the percentage of independent contractors in sales and related occupations (17 percent) and management (16 percent) were greater than in other occupations. In 2005, 9 percent of independent contractors indicated that they would prefer to work for someone else. About 11 percent of independent contractors reported family income below $20,000.

Misclassification of Employees Can Have Negative Outcomes for Workers and Government Programs

The tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law. Nevertheless, when employees are misclassified as independent contractors, they may be excluded from coverage under key laws designed to protect workers and may not have access to certain employer-provided benefits, such as health insurance coverage and pension plans. Moreover, misclassification of employees can affect the administration of many federal and state programs. For example, misclassification could affect payment of taxes and payments into state workers' compensation and unemployment insurance programs.

There Is Neither a Single or Simple Test Used to Determine whether a Worker Is an Independent Contractor or an Employee

No definitive test exists to distinguish whether a worker is an employee or an independent contractor. The tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law. For example, the National Labor Relations Act, the Civil Rights Act, the Fair Labor Standards Act, and the Employee Retirement Income Security Act each use a different definition of an employee and various tests, or criteria, to distinguish independent contractors from employees.

In determining whether an employment relationship exists under federal statutes, courts have developed several criteria. These criteria have been classified as the economic realities test, the common law test, and a combination of the two sometimes referred to as a hybrid test. The economic realities test looks to whether the worker is economically dependent upon the principal or is in business for him or herself. The test is not precise, leaving determinations to be made on a case-by-case basis. The test consists of a number of factors, such as the degree of control exercised by the employing party over the worker, the worker's opportunity for profit or loss, the worker's capital investment in the business, the degree of skill required for the job, and whether the worker is an integral part of the business. The traditional common law test examines the employing party's right to control how the work is performed. To determine whether the employing party has this right, courts may consider the degree of skill required to perform the work, who supplies the tools and equipment needed to perform the work, and the length of time the worker has been working for the employing party. When the tests are combined in some type of hybrid, a court typically weighs the common law factors and some additional factors related to the worker's economic situation, such as how the work relationship may be terminated, whether the worker receives leave and retirement benefits, and whether the hiring party pays Social Security taxes.

Aside from the complexities of distinguishing employees from independent contractors, employers have economic incentives to misclassify employees as independent contractors. Namely, 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.

Misclassified Employees May Be Excluded from Coverage under Key Worker Protection Laws

Contingent workers who are employees are generally protected under key laws designed to protect workers, but certain categories of contingent workers—such as independent contractors—may be excluded from coverage under these laws. While most of the key worker protection laws do not distinguish between types of employees (i.e., contingent and standard full-time employees), some laws contain requirements that exclude certain categories of contingent workers or contain certain time-in-service requirements that make it difficult for them to be covered. In addition, because these laws are based on the traditional employer-employee relationship, they generally cover only workers who are employees; independent contractors, therefore, are not covered.

Some of the key laws designed to protect workers but that only apply to "employees" include the following:

- Fair Labor Standards Act—establishes minimum wage, overtime, and child labor standards;
- Family and Medical Leave Act—requires employers to allow employees to take up to 12 weeks of unpaid, job-protected leave for medical reasons related to a family member's or the employee's own health;
- Occupational Safety and Health Act—requires employers to maintain a safe and healthy workplace for their employees and requires employers and employees to comply with all federal occupational health and safety standards;
- National Labor Relations Act—guarantees the right of employees to organize and bargain collectively;
- Unemployment Insurance—pays benefits to workers in covered jobs who become unemployed and meet state-established eligibility rules; and
- Workers' Compensation—provides benefits to injured workers while limiting employers' liability strictly to workers' compensation payments.

When employers have misclassified workers as independent contractors, workers may need to go to court to establish their employee status and their eligibility for protection under the laws. In addition, DOL may bring a lawsuit on behalf of the worker or group of workers to require that the employer provide the benefit or protection under the law.

Misclassified Employees May Not Have Access to Some Employer-Provided Benefits

Employees who are misclassified as independent contractors, because by definition they would not be considered employees, may not have access to certain employer-provided benefits, such as health insurance coverage and pension plans. Some states and professional associations have developed health insurance programs that help contingent workers access health care. While these public and private initiatives are relatively new and long-term outcomes have yet to be determined, the programs have succeeded in expanding health insurance options for some contingent workers.

Employee Misclassification Can Affect Administration of Government Programs

Misclassification of employees can affect the administration of many federal and state programs, such as payment of taxes and pension benefits. For example, if employers misclassify workers as independent contractors, then they may not be paying the payroll taxes required to be paid for employees. At the federal level, misclassification can reduce tax payments, Medicare payments, and Social Security payments. At the state level, misclassification can affect payments into state tax, workers' compensation, and unemployment insurance programs.

DOL Detects and Addresses Employee Misclassification Through Investigations, but Offices We Studied Vary in How Often They Forward Misclassification Cases to Other Federal and State Agencies

DOL detects and addresses employee misclassification when enforcing the FLSA minimum wage and overtime pay provisions. As part of its FLSA investigation process, DOL examines the employment relationship—whether a worker is an employee or an independent contractor—to determine which workers are covered. Investigators use various methods to test the employment relationship of workers, including interviewing employers and workers, reviewing payroll and related documents, and touring work sites. While misclassification alone is not an FLSA violation, it may contribute to FLSA violations or violations of other laws, such as tax violations. DOL's outreach efforts provide some information to employers and workers on employee misclassification issues. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices that we contacted vary in how often they forward misclassification cases as a possible violation of other agencies' laws.

Investigators Determine Workers' Employment Relationship

DOL relies on complaints as a primary way to identify potential violations for investigation. All FLSA investigations of minimum wage and overtime pay complaints begin with an examination of workers' employment relationship because FLSA applies only to employees, not to independent contractors. If investigators determine that a worker is an employee and not an independent contractor, they continue with their FLSA investigation to determine whether the employer has provided the minimum wage and overtime pay required by the act.

Employee Misclassification, though Not an FLSA Violation, May Contribute to FLSA or Other Violations

Employee misclassification alone is not a violation of FLSA, but may contribute to FSLA minimum wage and overtime pay violations or violations of tax, workers' compensation, or unemployment insurance laws. DOL investigations have identified FLSA violations associated with employee misclassification. For example, one misclassification case involved a valet parking company located in Arizona that provided services to local restaurants, sports venues, hotels, and theaters. In 2004, this company paid $66,947 in minimum wage and overtime pay back wages to 262 employees who had been misclassified as independent contractors. When reviewing the employment relationship, the DOL investigator found that the services provided by these workers were integral to the business, and that the employer had imposed strict policies and procedures to follow, and told them when they would work, where they would work, what their pay rate would be, and what uniforms they would wear. The investigator determined that the workers were not required to use initiative, judgment, or foresight to be successful as independent contractors, did not have any investment in facilities or equipment, and were not operating to make a profit.

DOL's Outreach Efforts Provide Some Information on Employee Misclassification Issues

As part of general FLSA outreach efforts to employers and workers, DOL provides some information on establishing the employment relationship. While these outreach efforts primarily focus on how to comply with provisions of FLSA—minimum wage, overtime pay, and child labor—they also include some information on the employment relationship. Specifically, information on employment relationship issues is available to employers and workers through brochures, pamphlets, fact sheets, and Web-based information. According to DOL officials, outreach efforts conducted specifically for industries likely to use independent contractors may also address the topic of employee misclassification.

Another form of outreach that DOL provides is its workplace poster. FLSA regulations require that every employer that has employees subject to the

act's provisions post a notice explaining the act in a prominent and accessible place at the work site. While DOL relies heavily on complaints from workers to enforce FLSA, the FLSA workplace poster does not provide a telephone number for workers or others to call to register complaints.

DOL Offices We Studied Vary in How Often They Forward Misclassification Cases to Other Federal and State Agencies

Employers' misclassification of workers as independent contractors may in some circumstances violate tax, unemployment insurance, and workers' compensation laws. According to the Field Operations Handbook, DOL regional or district officials are required to share information with other appropriate federal and state agencies whenever investigators conducting FLSA investigations find instances of possible violations of other laws. At the same time, however, the handbook cautions investigators not to interpret laws outside their authority. We discussed whether DOL forwards misclassification cases identified during an FLSA investigation. The DOL officials we spoke to in nine district offices could not provide the number of misclassification cases they referred to other agencies because they do not track this information. However, their responses indicated that district offices vary in how often they implement the procedures to refer cases to other agencies. Some of the DOL district offices told us that they notified IRS and state agencies when they found misclassification, while others told us that they had little or no contact with other agencies regarding misclassification issues. These district offices also reported that it was rare for them to receive misclassification referrals from other federal or state agencies.

Conclusions and Recommendations for Executive Action

DOL investigators identify instances of employee misclassification when responding to minimum wage and overtime pay complaints. However, because the FLSA workplace poster does not provide an easy method for workers to report complaints, DOL may be missing opportunities to address other instances of potential misclassification. Improving the workplace poster would reinforce DOL's complaint-based strategy and would help further protect the wages of employees who may be misclassified.

While DOL investigators conducting FLSA investigations are required to share information with other federal and state agencies whenever they find instances of possible violations of other laws, DOL district offices we studied varied in how often they forwarded misclassification cases to other agencies. DOL does not know the extent to which district offices refer misclassification cases to other agencies. DOL cautions investigators

not to interpret laws outside their authority, but referring misclassification cases identified through FLSA investigations would not require DOL to interpret other agencies' laws. In addition, referring this information may assist other federal and state agencies in addressing misclassification. Furthermore, when DOL does not refer cases of misclassification, other agencies lose opportunities to fulfill their fiduciary duties in conserving government funds.

To facilitate the reporting of FLSA complaints, we recommended that the Secretary of Labor instruct the Wage and Hour Division to revise the FLSA workplace poster to include national, regional, and district office telephone numbers and a Web site address that complainants may use to report alleged employee misclassification issues. Following the publication of our report, DOL notified the Congress that it was redesigning the poster and expected the work to be completed in spring 2007.

To facilitate addressing employee misclassification across federal and state programs, we recommended that the Secretary of Labor instruct the Wage and Hour Division to evaluate the extent to which misclassification cases identified through FLSA investigations are referred to the appropriate federal or state agency potentially affected by employee misclassification, and take action to make improvements as necessary. In addressing its referral mechanism, the Wage and Hour Division officials should consider building upon efforts by district offices currently engaging in referrals. Following the publication of our report, DOL notified the Congress that it was researching the nature and effectiveness of the referral of potential employee misclassification by different district offices to various federal and state agencies. DOL also noted that it will consider appropriate revisions to its procedures, and expected the work to be done by the end of September 2007.

Mr. Chairmen, this concludes my prepared statement. I will be happy to answer any questions that you or other members of the subcommittees may have.

GAO Contacts and Staff Acknowledgments

For future information regarding this testimony, I can be contacted at (202) 512-7215. Key contributors to this testimony were Brett Fallavollita and Linda Siegel.

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Chairman MCDERMOTT. Rebecca Smith is from the National Employment Law Project. Rebecca.

STATEMENT OF REBECCA SMITH, COORDINATOR, JUSTICE FOR LOW-WAGE AND IMMIGRANT WORKER PROJECT, NATIONAL EMPLOYMENT LAW PROJECT

Ms. SMITH. Thank you, Chairman McDermott, Chairman Neal, and other members for inviting me to testify here today.

Misclassification has been a large focus of my work and the work of the National Employment Law Project for many years; and as you will hear from the state of national studies, it is a large, growing and common problem in many industries across the country.

Why do employers misclassify? They stand to save in some cases up to 30 percent of their payroll tax costs by misclassifying and they hope to avoid their responsibilities under labor protective

laws, as has been mentioned. Misclassification has huge impacts on State and Federal revenue systems, on the tax gap and on employers and taxpayers who have to foot the bill.

My focus today is going to be on the impact on workers. I want to talk to you about Rhina Alvarenga.

Ms. Alvarenga works for Coverall North America, cleaning in an assisted living facility in Massachusetts. Shortly after she was hired, she was presented with a franchise agreement which cost her $10,000 to pay back to Coverall. Coverall dictated the methods by which she performed her work and provided a supervisor for her work in the assisted living facility. When she lost her job, she applied for unemployment insurance and there they sent her on a 3-year battle to make sure that she was classified as an employee and not an independent contractor, all the way to the Massachusetts Supreme Court.

Many workers who are in this position will not apply for unemployment insurance. They assume that if their employer tells them they are an independent contractor, then they must be an independent contractor. Others may not file because they fear they will never be rehired by that particular employer if they complain. Those who do file bear the burden of showing that they have been misclassified and at any point in the appeals process they either risk not being considered an employee or having a reversal of that determination and facing overpayment liability.

So, how do audits work for these employers? States are only required to audit 2 percent of employers in their UI systems and only 1 of these must be large employers. In cases like Ms. Alvarenga's, the fact that the company operates across State lines does not necessarily mean the company will be referred to the neighboring State where it operates or to the IRS for an audit.

The IRS is similarly hampered in its ways of auditing by the existence of Section 530 of the Internal Revenue Code. Under that section, as long as an employer has consistently classified certain workers as independent contractors, IRS may not inquire further about whether misclassification has occurred, may not assess penalties and may not even require the employer to prospectively reclassify workers as long as the employer has some reasonable basis for its classification of workers as independent contractors.

A reasonable basis can be supplied by the practice of a significant portion of an industry. So, in industries that are misclassifying 20 percent or more of their workers, Section 530 operates as an incentive for more to misclassify. Essentially, the more businesses that violate the law, the more businesses are allowed to violate the law.

Where penalties are assessed, there is a $50 penalty for failure to file the correct forms. So, it is no surprise that employers may choose to save on the payroll costs and risk a very small risk of an audit or any sort of penalty.

There are some straightforward answers to these problems. Congress should allow IRS to require employers to fix past wrongs, to reclassify their employees as employees going forward.

We should eliminate the "everybody else does it" defense. That doesn't work for my teenage children and it shouldn't work for employers who are doing wrong either.

We should enlist the help of workers in reclassifying. Although workers can ask for a determination from the IRS, they are not guaranteed confidentiality and they are not guaranteed protection from retaliation.

Finally, we need to step up enforcement. Audits show that when audits are done, workers are found whose rights have been violated. We need to step up targeted audits in industries we know to be misclassified, and we need more coordinated enforcement efforts across State lines. We also need to look at innovative ways to shut down the underground economy.

In the context of claimant fraud, the Department of Labor has financed creative pilot programs in the States, given States grants for new technologies and new detection systems and earmarked money for enforcement. We could do the same here. We could increase cross-matching, and we could increase reporting in order to get at not only 1099'ed workers, but workers paid in cash off the books. These steps would recover billions of dollars and would increase the equity and the fairness in the system.

Thank you.

Chairman MCDERMOTT. Thank you very much.

[The prepared statement of Ms. Smith follows:]

Prepared Statement of Rebecca Smith, Staff Attorney, National Employment Law Project

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 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.[1]

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 unemployed 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.

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,

[1] 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).

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.[2] 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.[3] 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.[4]

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 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.[5] 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.[6] 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

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[2] 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. Government 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.

[3] U.S. Government Accountability Office, *Tax Administration Information: Returns Can Be Used to Identify Employers Who Misclassify Employees,* GAO/GGD–89–107 (1989).

[4] Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers, Coopers & Lybrand (1994).

[5] 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.

[6] Lalith de Silva et al., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs* i–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.

found a misclassification rate of 8.2% in 1995–1997, but that rate grew to 13.4% in 2001–2003.[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	Kelsay et al. (2006)[8]
Maine	11%	573,000	1999–2002	(Carre and Wilson, 2006)[9]
Massachusetts	13%	126,000–248,000	2001–2003	(Carre and McCormack, 2004)[10]
New York	10%	705,000	2002–2005	(Donahue, et al., 2007)[11]
Average	13%			

[8] 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.

[9] 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.

[10] 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.

[11] 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.

Second, while misclassification rates are especially high in construction, (where as many as 4 in 10 construction workers were found to be misclassified),[12] 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,[13] home health care,[14] child care[15] and other industries. The Massachusetts study provides a helpful table documenting the scope of misclassification across industries.

Massachusetts Prevalence of Misclassification by Industry 2001–2003

	Moderate estimate (All Audits[16])
Transportation/utilities	28.70%
Information	28.70%
Construction	**23.70%**
Professional/business services	22.20%
Other services, private	20.00%

[7] Massachusetts, 7.

[12] 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).

[13] See, *Secretary of Labor v. Lauritzen,* 835 F.2d 1529 (7th Cir. 1988).

[14] See, *Bonnette v. Cal. Health & Welfare Agency,* 704 F.2d 1465 (9th Cir. 1983).

[15] 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—Continued

	Moderate estimate (All Audits [16])
Education/health services	18.70%
Natural resources	17.60%
Financial activities	15.70%
Manufacturing	15.30%
Leisure/hospitality	13.70%
Trade	13.40%

[16] "All audits," refers to a combination of both targeted audits and random audits. Targeted audits generally result in a higher rate of misclassification.

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 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.[17]

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.[18]

D. 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, in-

[17] Congressional Budget Office, *Family Income of Unemployment Insurance Recipients* (March 2004).

[18] Illinois, 10–11.

cluding 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.[19]

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 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.[20]

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.

E. 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—a 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.[21]
- 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.[22]

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[19] *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.

[20] NH Employment Security Appeal Tribunal, Decision of Appeal Tribunal, Docket No. 06–0463 6016–06.

[21] New York, 10; Illinois, 18; Massachusetts, 2.

[22] U.S. Government Accountability Office, *Tax Administration Information: Returns Can Be Used to Identify Employers Who Misclassify Employees,* GAO/GGD–89–107 (1989).

- 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.[23]
- 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.[24]
- The Massachusetts construction industry found that misclassification of employees resulted in annual losses of up to $278 million in uncollected taxes and premiums.[25]
- Total tax loss in California due to misclassification is as high as $7 billion.[26]

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.[27] 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.[28]

F. 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.[29] 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 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."[30] The provision was extended "indefinitely" in 1982, and subsequently amended again in 1996.[31] 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. . . ."[32]

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

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[23] Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers, Coopers & Lybrand (1994).

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

[25] Massachusetts, 15–17.

[26] Jerome Horton, California State Assembly Member, 51st 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#.

[27] 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.

[28] 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.

[29] 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.

[30] P.L. 95–600, Revenue Act of 1978, Senate Report No. 95–1263, 95th Cong., 2nd Session, 92 Stat. 2763 (1978).

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

[32] Section 530 of the Revenue Act of 1978, Section(b).

has a reasonable basis for its treatment of the workers as independent contractors.[33]

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."[34] 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.[35]

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 independent contractors.[36] In 2004, for the eighth year in a row, states audited only 1.7% of their employers, and focused their audits on small employers.[37] 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.[38]

States perform random, non-random and targeted audits. Some states conduct only random audits, which generally will show a lower rate of misclassification.[39] 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.[40] Nonetheless, USDOL permits states to conduct all of its required investigations by random, rather than targeted, audit.[41]

USDOL requires only 1% of the 2% of audited employers to be large employers of 100 or more employees.[42]

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.[43] State administrators with whom we have spoken cite the

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[33] 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.

[34] Department of Treasury, Internal Revenue Services, *Independent Contractor or Employee? Training Material* (October 30, 1996) I–26.

[35] U.S. Government Accountability Office, *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers*, 8 (September 1989).

[36] U.S. Department of Labor, Employment Security Manual, Unemployment Insurance Program, ¶ 3677.

[37] 2004 UI Performs, 38, *available at* http://www.workforcesecurity.doleta.gov/unemploy/pdf/ar_04.pdf.

[38] UI Performs, PY 2006, 37–39, available at http://www.workforcesecurity.doleta.gov/unemploy/pdf/ar_05.pdf.

[39] In Illinois, for example, 98% of audits are random. Illinois, 4.

[40] Maine, 13.

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

[42] Employment Security Manual, ¶ 3681.

[43] New York, 15.

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.[44] Two-thirds of the audits resulted in changes in the employer's reports of taxes. At least one state that uses the IRS process to target employers, New Jersey, has an even higher success rate, of 70%.

G. 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."[45] 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."[46]

- *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.[47] Elimination of the minimum $50 penalty was also recommended by the Advisory Council on Unemployment Compensation in 1996.[48] The funding generated by these new penalties could be designated to help fund more targeted en-

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[44] 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. 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 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.

[45] *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers,* 10.

[46] Id.

[47] 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.).

[48] Advisory Council on Unemployment Compensation, Collected Findings and Recommendations: 1994–1996, Recommendation 1995–15.

forcement 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 the 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.[49]

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.[50] 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 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.[51] 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.

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[49] 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.

[50] 29 U.S.C. Section 657(f)(1).

[51] 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.

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.[52]

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.[53] 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 "move your employees on paper into another type of organization to obtain more favorable rates."[54] 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.[55] 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. across state lines of

- *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.[56] The Planmatics study also recommended that USDOL develop a repository of information on independent con-

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[52] 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).

[53] 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.

[54] 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).

[55] "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.

[56] Planmatics, 94.

tractor issues, best practices, new initiatives, and legislative measures, to be updated, publicized, and its contents made accessible to agencies dealing with independent contractors.[57]

- *Regular reporting of data.*

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.

Chairman MCDERMOTT. Mr. Pinkham.

STATEMENT OF KELLY D. PINKHAM, ASSISTANT DIRECTOR, CENTER FOR FULL EMPLOYMENT AND PRICE STABILITY, DEPARTMENT OF ECONOMICS, UNIVERSITY OF MISSOURI—KANSAS CITY

Mr. PINKHAM. Good morning, Chairman McDermott, also Chairman Neal, Ranking Members Weller and English and other Committee members.

I have been asked to share with you the result of a study completed by Dr. Kelsay, Dr. Sturgeon and myself of the Department of Economics at the University of Missouri in Kansas City. Our study is entitled, The Economic Costs of Employee Misclassification in the State of Illinois, and it covers the time period of 2001 through 2005. Support for our research was supplied by the National Alliance for Fair Contracting, and I do want to publicly express my colleagues' and my appreciation to the employees of the Illinois Department of Employment Security. Without their thoughtful, and also their professional assistance, we could not have completed our study.

Since our time is short, I am going to focus on the conclusions of our study and move directly into those numbers, if that is all right. One of the things that we find is that the practice of misclassification, both as discovered in our study and in other studies that have been done, a growing problem across the country. It is particularly acute in the construction sector.

What our studies are not able to quantify is the extent of the problem embodied by the underground economy. That is simply outside the scope of the studies that have been done. So, surely any numbers that are reported by our study and others will underestimate the actual scope and extent of the problems that we are discussing.

The data for studies like ours come from the unemployment insurance audits performed by the individual States. Generally, three kinds of audits are conducted: the random audits that are mandated; nonrandom audits, which tend to be more benefit-related, which occur when an employee will apply for funding; and also targeted audits. States that perform targeted audits discover a greater extent of misclassification.

[57] Planmatics, 95.

Illinois is one of those States that do not perform targeted audits. In fact, for the 5-year period, 77 percent of the audits performed in Illinois were random audits.

In 2001, the State unemployment insurance audits found that more than 14 percent of the Illinois employers that they audited had misclassified workers as independent contractors. In 2005, the percentage was nearly 20 percent; this translates into approximately 64,000 total employers statewide. Given the fact that most of the Illinois audits are random in nature, the full extent of the problem is probably greater than what was covered by random audits.

It was also discovered that when an employer practices misclassification, the results showed that that practice is pervasive within that employer. The percent of violating firms' employees who have been misclassified has risen from 23 percent in those employers in 2001, to 28 percent in 2005. The practice seems to be habitual and intentional by certain employers.

That increase from 2001 to 2005 was a 21 percent increase. Total statewide employees in Illinois who were misclassified during that period grew from a level of 5.5 percent in 2001 to 8.5 percent in 2005, and by 2005 that number amounted to nearly 420,000 employees in the State of Illinois.

In terms of lost revenue to the unemployment insurance system, we estimate that during 2005 alone the State of Illinois lost $54 million in uncollected unemployment insurance premiums.

State income tax revenues: When workers are classified as independent contractors, IRS reports show that up to 32 percent of their income is not reported, not taxed. Other revenue studies show, that can go as high as 50 percent. Using those figures, we estimated—in Illinois, the lower figure of 30 percent of income—that in the State of Illinois in just 2005 the estimate would be that $149 million of State income tax was not collected.

Using the higher estimate of 50 percent of income not being reported by independent contractors—the practice of misclassification, if the higher percentage holds true, would have resulted in uncollected State income taxes in 2005 alone of nearly $250 million.

Worker's comp insurance premiums are one of the factors that drive the practice of misclassification. This can be particularly a problem in the construction industry. Statewide in Illinois the average work comp premium is around $3 per $100 of payroll. Within the construction industry, some trades, the work comp premium can be as high as $30 per $100 of payroll.

When an employer misclassifies, it is obvious they can displace and avoid a tremendous amount of employment-related cost. So, the problem of work comp insurance premiums being displaced onto those businesses who play by the rules is a very serious problem.

Basically, we recommended several steps be taken in Illinois that would probably apply to other States. We asked that the legislature empower the IDES, the Illinois Department of Employment Security, to perform targeted audits. We also asked that meaningful penalties be developed to deter those employers who intentionally and habitually violate the spirit of this law.

We are not after the person who employs the friend of the family for the summer when they graduate or the internships and those kinds of things that are an integral part of our economy. We are after habitual and criminal kinds of behaviors. We ask that the different agencies seek to align their definitions of what an independent contractor is.

We found that the work comp commission, the Illinois Department of Employment Security and the Department of Revenue all have different definitions. Then, just sharing information, in the State of Kansas we succeeded in helping a change in the law occur there, where the Department of Revenue and the attorney general's office, along with the Department of Labor, cooperated in that testimony.

They now have a Web site in that State, and we can discuss other things that have been done during the question and answer period.

Chairman MCDERMOTT. We thank you very much.

[The prepared statement of Mr. Pinkham follows:]

Prepared Statement of Kelly D. Pinkham,
Assistant Director, Center for Full Employment and Price

Introductory Remarks

Good morning Chairman McDermott, Chairman Neal, Ranking Member Weller, Ranking Member English and members of the Committee: thank you for allowing me the opportunity to make a few remarks about the growing national problem of the improper classification of employees as independent contractors, a practice known as "misclassification." I have been asked to share with you the results of a research study completed by Dr. Michael Kelsay, Dr. James Sturgeon and myself in the department of economics at the University of Missouri—Kansas City.

Our study is titled "The Economic Costs of Employee Misclassification in the State of Illinois" and covers the period of 2001 through 2005. Support for our research was provided by the National Alliance for Fair Contracting, a labor-management organization. We would also like to thank the staff of the Illinois Department of Employment Security. Without their thoughtful and professional assistance, our study could not have been completed.

Since our time together is short, my testimony will focus on the summary section of our study. The complete study, along with related supporting materials, will be submitted with our written statement. Given the amount of numerical data I am presenting, figures will be rounded when possible (for example, instead of 18.2%, I will say 18%).

Notes Regarding Misclassification Research Studies

Other studies in addition to ours have shown that misclassification by employers is increasing across the United States.[1] The prevalence of misclassification varies across different industries and is particularly acute in the construction sector. Moreover, the "underground economy" (that is, workers paid in cash) is outside the scope of these studies. Thus, the numerical estimates provided by these studies surely underestimate the full extent of the problems associated with the employer practice of misclassification.

The data for studies like ours comes from the unemployment insurance audits performed in the individual states. Generally, three kinds of audits are conducted by the states: random, non-random (normally benefit-related) and targeted audits. States that perform targeted audits discover a greater extent of misclassification. Illinois is one of those states that do not perform targeted audits. In fact, from 2001–2005, 77% of the audits in Illinois were random audits.

[1] In a report by the National Employment Law Project, it was reported that US DOL quarterly audits found 30,135 employees misclassified in 2002. This was a 42% increase from the prior year.

Employee Misclassification in Illinois

- In 2001, state unemployment insurance audits found that more than 14% of the Illinois employers audited had misclassified workers as independent contractors. By 2005, this percentage was nearly 20%. This translates into approximately 64,000 total employers statewide.[2] Since 77% of these audits were the random kind of audit, **the rate of misclassification found in Illinois suggests that the actual extent may be higher in Illinois than in other states that have been studied.**
- **When an employer practices misclassification in Illinois, the results show that this behavior is pervasive.** The percentage of employees that are misclassified at a given company indicates that it is a common occurrence, not a random one, in those companies that do misclassify. In 2001, 23% of the violating firms' workers were misclassified; this had increased to almost 28% in 2005. **That means the rate of misclassification by violating employers increased 21% from 2001 to 2005.**
- We estimate that an average of almost 8% of employees in Illinois was misclassified annually for the period 2001–2005. This grew from a level of 5.5% in 2001 to 8.5% in 2005. **This represents a 55% increase in the rate of misclassified employees.**
- The number of employees statewide that were affected by the improper practice of misclassification averaged nearly 370,000 annually from 2001–2005. For 2005, this estimate increased to almost 420,000.

Estimates of Revenue Losses to the State of Illinois

1. Unemployment insurance system: We estimate that the unemployment insurance system lost an average of over $39 million every year from 2001–2005 in unemployment insurance taxes that were not levied on the payroll of misclassified workers as they should have been. During 2005, we estimate that the unemployment insurance system in Illinois lost almost $54 million.

2. State income tax revenue: According to published data, workers classified as independent contractors are known to underreport their personal income; **as a result Illinois suffers a loss of income tax revenue when employees are misclassified**. According to the IRS reports, wage earners report 99% of their wages whereas **non-wage earners (such as independent contractors) report approximately only 68% of their income. This represents a gap of 31%.** Other reliable studies estimate this gap to be as high as 50%.

- Based upon IRS estimates that 30% of the income of misclassified workers is not reported, **we estimate that an average of $125 million of income tax was lost annually in Illinois for 2001 through 2005. In just 2005, we estimate that $149 million of income tax was not collected in Illinois.**
- Based upon the higher estimate that up to 50% of the income of misclassified workers is not reported, **an average of $208 million of state income tax was lost annually in Illinois from 2001 through 2005. For just 2005, we estimate this loss to have been $248 million.**

3. Worker's compensation insurance: Misclassification also impacts worker's compensation insurance. Among other effects, costs are higher for employers that follow the rules placing them at a distinct competitive disadvantage. A national study reported that **the cost of worker's compensation premiums is the single most dominant reason why employers misclassify** (Planmatics, 2000). Employers who misclassify can underbid the legitimate employers who provide coverage for their employees. **The practice of misclassification shifts the burden of paying workers' compensation insurance premiums onto those employers who properly classify their employees. It has the further effect of destroying the fairness and legitimacy of the contract bidding process.** The same national study (Planmatics, 2000) reported that many previously misclassified workers were later added to their company's worker's compensation policy by their employer after they were injured, resulting in the payment of benefits even though premiums had not been collected.

- Based upon the statewide average worker's compensation insurance premium rates published by the State of Illinois, we estimate that, on average, $96 mil-

[2] According to the Illinois Department of Employment Security, the average number of employers over 2001–2005 was 34,954 in construction and 319,054 in all industries. In 2005, there were 36,154 construction employers and 326,945 in all industries. These numbers exclude local, state, and federal government.

lion annually of worker's compensation premiums were not properly paid for misclassified workers.

- **Worker's compensation premiums are much higher in the construction industry.** In Illinois the statewide rate for all industries is less than $3.00 (per $100 of payroll). However, within construction, rates can range from $8.01 for electrical wiring to $27.94 for concrete construction. Using an average premium rate of $10 per $100 of payroll, **we estimate an annual average of $23 million of worker's compensation premiums were not properly paid by construction employers in Illinois.** Using a higher average premium rate of $15 per $100 of payroll, **we estimate this average annual amount to be $35 million.**

Concluding Remarks

- **Misclassification of employees has a negative financial impact on individual workers, the Illinois state government, and the private sector in Illinois.** The workers are directly impacted by being denied the protection of various employment laws and by being forced to pay costs normally borne by employers. State income tax revenues and the unemployment insurance system in Illinois are adversely affected. Misclassification also imposes additional costs on honest employers who play by the rules, on taxpayers, and the public at large. **Furthermore, the operation of fair, competitive markets is profoundly compromised when the bidding process is undermined by the practice of misclassification.** Illinois 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.

Recommendations

As a beginning, we recommend the following steps for consideration by policy makers and public officials in Illinois: (1) the Legislature empower the IDES to perform "targeted" audits on problem employers like those done in other states,[3] (2) develop meaningful penalties to deter those employers who intentionally and/or repeatedly violate state laws on misclassification, (3) seek to align the three different definitions for what constitutes an "independent contractor" currently applied by the IDES, the Department of Revenue and the Worker's Compensation Commission, and (4) review current authorities and procedures for the sharing of information among state agencies so that violations of state statutes will receive a comprehensive and coordinated response with the intent of recovering all payroll-related funds that are due and of deterring future willful violations.

Chairman MCDERMOTT. Mr. Satagaj.

STATEMENT OF JOHN SATAGAJ, PRESIDENT AND GENERAL COUNSEL, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Good morning, Mr. Chairman. We have Polish bookends, by the way. I am also Polish. I am down the river from Middletown, Connecticut. So, we are Polish bookends here.

Thank you. I am John Satagaj, President of the Small Business Legislative Council. I was thinking this morning, preparing myself for this hearing, I don't know how many Members of the Committee are familiar with Tom Sullivan. Tom Sullivan is the Chief Counsel For Advocacy at the Small Business Administration, and one of his jobs is to provide information to all of you about the state of the economy.

I was thinking, what would happen if Tom had appeared before the Committee on Small Business, and he reported that there is a

[3] Targeted audits are those audits identified where a higher degree of misclassification may be observed. For example, targeted audits might be audits of employers with (1) delinquent filings or (2) multiple delinquent quarters of unemployment insurance due. Planmatics (2000) encouraged states to maintain audit selection criteria that reflect potential noncompliance (e.g. high employee turnover, type of industry, and prior reporting history).

trend, the number of small businesses are going down in this country? I suspect all of us would react with alarm because they are the job creators, the innovators; they provide the economic diversity that is important to the communities. We would get very concerned because the truth is, we try to promote small businesses—we have loan programs, we have investment programs, all of them with risk associated with them.

We have made a choice. We are going to take a chance and, yes, we are going to lose some loans, some investments are not going to work; but we support it because we want small businesses.

The same is true of the tax policy. We do things there to promote small business. Particularly in this area we have to decide whether folks are independent contractors or employees.

Those independent contractors are the professional drywall company of tomorrow. If we have a rule—I would agree, yes, there are folks that are abusing the law, but if we have a rule, we have got to find where you draw that line, because, while I want to catch the abusers; at the same time if I lose one independent contractor, then it might be that business of tomorrow with a bunch of employees, it is a big loss for us, too.

Now, our organization has been involved in this for 30 years—unfortunately, 29 myself. I have gone through more definitions of where you draw this line. It is a very humbling experience to try to do it, things have changed dramatically in the 30 years. The last time we tried—it was in the 107th Congress—to come up with some rules, just between the 107th Congress and today, look what has changed. You would need to be more flexible than ever in an economy, be adaptive to these things. So, it is very important that we protect that at all costs.

Now there are other things that we can do in addition to looking at these rules. My colleagues, N.F.I.B—the Chamber and myself, have been meeting with the IRS, with Treasury, with our friends at GAO, with other Hill folks, to talk about what other things we can do, mostly in the context of the tax gap of how we can we do it better.

The IRS has been very generous with their time. The Assistant Commissioner for Small Business/Self-Employed, Kathy Petronek, has met with us; her predecessor, Kevin Brown has met with us. We are constantly talking, looking for ways we can get a good tax compliance system without killing the entrepreneurial spirit. It is important we do that. So, we work constantly with them.

One of the things we set out 10 years ago, we said to the IRS, you need to do a better job of not just using the stick, but you need to teach. You, Congress, said to the IRS you need to go out and engage in outreach and education.

They have been doing a good job over that 10 years of increasing their outreach. We meet with them formally every 2 months to talk about that very subject. How are you doing? What can we do better to make sure we are reaching people so they understand the responsibilities? Those who are starting out, that they understand what it is to be a small business, their responsibility to pay taxes, all those things. We meet constantly to update and improve that.

We are getting better at it; we have a long ways to go, but we are making great progress and we are making sure everybody does

understand that. At the end of the day whatever we do in this thing, at the same time we have to prevent the abuses, we also have to make sure we are protecting that entrepreneurial spirit. So, whatever we do, let's keep that in mind. We have got to reach both of those objectives.

Thank you, Mr. Chairman.

Chairman MCDERMOTT. Thank you.

[The prepared statement of Mr. Satagaj follows:]

Statement of John Satagaj
President and General Council
of the Small Business Legislative Council

Before the House Committee on Ways and Means

On

The Classification of Individuals as Independent Contractors or Employees

May 8, 2007

Chairmen McDermott and Neal, Ranking Members English and Weller and members of the Committee, my name is John Satagaj and I serve as President and General Counsel for the Small Business Legislative Council (SBLC). SBLC is a permanent, independent coalition of nearly 60 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views. I wish to thank the Committee for the invitation to testify on the issue of the classification of individuals as independent contractors or employees.

Small Business Philosophy

SBLC was founded in 1977. We have been involved in the debate on this topic since 1977. We can make one observation with certainty. Our economy is far more complex and diverse and the challenge of having any third party, including the federal government, determine the classification of individuals as an independent contractor or an employee, is many times more difficult today than when SBLC entered this debate in 1977. Over that 30-year span we have tried many times to provide clarity and assist small business in classification certainty. What small business owners will tell you about any government regulation is that they appreciate certainty. However, at the same time the rules need to be sufficiently flexible to deal with the diverse nature of our economy.

The delegates to the 1980 White House Conference on Small Business agreed there was a need to articulate a small business "bill of rights." Their recommendation, while not expressly addressing the independent contractor issue, established a framework for why encouraging independent contractors to pursue the American Dream is essential to our economy and society. They said:

> "The American Dream is to be an owner of one's own business. Almost everyone has had the dream, and millions of Americans have lived it. The American Dream is the cornerstone of our 200-year-old American Heritage and also is the reason for our

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country's position as the most economically powerful nation in the world today. Could we have achieved this status as a nation if we had not been presented with opportunity unencumbered by government regulation? Could we have achieved this nation's status if entrepreneurs had not had the fortitude and shown the initiative to take advantage of opportunity when it presented itself? America was founded on the principle of each individual's fundamental rights, i.e., Freedom of Speech, Freedom of Religion, Freedom of the Press, Freedom of Assembly, Freedom to Bear Arms, etc., fundamentally, the Right to 'Life, Liberty, and the Pursuit of Happiness.' The Pursuit of Happiness can and does take the form of one going into business for oneself, the fulfillment of the American Dream.

"Now, therefore, in consideration of the foregoing and; whereas the Small Business Community is represented by some 14 million small and independent businesses, and; whereas these 14 million businesses represent 100 million people and 58 percent of all private sector jobs in America and; whereas 97 percent of all newly-created jobs in the past seven years have been created among these 14 million small and independent businesses representing 48 percent of America's gross business product and; whereas 50 percent of all new inventions, innovations, and patents are developed in the small and independent sector of American business…

"Therefore, be it resolved that said 14 million small and independent businesses have fundamental, inalienable, and constitutional rights:

The right to start, own, and manage a business without government interference.

The right to compete fairly for capital with the assurance that capital will be available for private use.

The right to reward for the risk, effort, and genius necessary to make an independent business work.

The right to determine price just as the buyer has the right to buy or not at that price.

The right to be governed by reasonable and understandable laws set forth by elected representatives, not by bureaucratic dictate.

The right to be innocent until proven guilty by a jury of our peers; not by administrative edict.

The right to equal representation with Big Business, Big labor, and Government on matters relating to America's economic policies." [emphasis added]

"The right to start, own, and manage one's own business"—the American Dream. It seems like a principle we all automatically assume is as much a part of our nation's heritage as the Constitution and the Bill of Rights. After all, Thomas Jefferson's independent yeoman farmers were the forbearers of our entrepreneurial sector. Our nation is built upon a foundation of individual opportunity.

Back in the 1970s, Milton D. Stewart, the first chief Counsel for Advocacy for Small Business, articulated the need for an economic bill of rights. In addition to the right to start, own, and manage one's own business, Stewart also asserted that the economic bill of rights should include the right to live in an economically-diverse society and that all citizens have an equal entrepreneurial right to participate in our free enterprise system, regardless of such factors as race, creed, or sex. He once observed:

> "As Jefferson realized at the nation's birth, economic independence is the only guaranty of political liberty. This country's 14 million small businesses provide 14 million sources, not only for economic opportunity, but also for that liberty. Every one of this nation's business owners can say anything he or she pleases. No one can fire these people or take their jobs away. If you spread the wealth and power in society, you inevitably spread freedom. The larger the small business sector, the more equality of opportunity we have for individuals and the safer our freedom of expression is from abuse. Small business fosters creativity and innovation. It is the bulwark against concentration and the remorseless abuses of power to which that leads."

While our society seems to accept the belief that there is a right to start, own, and manage one's own business, there has never been a formal game plan to ensure that right is encouraged, promoted, and exercised.

Independent Contractors as Entrepreneurs

Independent contracting is both the embodiment of the American Dream and the means by which it becomes an achievable dream. The essence of the American sprit is individual opportunity. For most "would be" entrepreneurs, the only asset they can bring to their new business is their own skills. Few small businesses start out with the venture capital, informal or formal, to open their business on day one, complete with employees, assets, suppliers, and customers. Independent contractor status is, in fact, the first step on the small business ladder. The risk of becoming an independent contractor is a very limited but direct risk. *If I fail, I do not eat. I do not have the comfort of punching a time clock and knowing the check will be there on payday. But if I am a success, I do not carry the burden of that time clock on my back.*

It seems clear why individuals would seek to become entrepreneurial, independent contractors. The choice is theirs to make and the risks and rewards theirs to evaluate. Likewise, it is equally clear to us why the nation benefits. Not only does entrepreneurial activity reflect our heritage of individual opportunity, but it also brings with it innovation, creativity, productivity, and economic growth.

Therefore, Congress should recognize that encouraging independent contractors is consistent with our nation's economic heritage and social philosophy. Public policy should be built around the presumption that Americans should be encouraged to start, own, and manage a business, not the presumption they are "misclassifications."

Although it is clear to us why independent contractors seek the status and why the nation benefits, we are not convinced it is well understood in public policy circles exactly why the availability of independent contractors is critical to the survival of other small businesses. To explain why they are a critical cog in a functioning small business economy, we must lapse briefly into public-policy speak. A service provider is an independent contractor. The service

recipient is the business that utilizes them. It might be more accurate to refer to the service recipient as a service expediter, for frequently the general public or other customers are the beneficiaries of the service, not the so-called service recipient.

Nevertheless, the service recipient does benefit from the independent contractor relationship. As remains too often the case, sinister motives are attributed to the business that utilizes an independent contractor. Many of these motives relate to tax liability. The truth is, behind most decisions to use independent contractors you can find the word *flexibility*—the hallmark of a successful small business.

In the dynamic tension between big and small business, the tradeoff is between economies of scale and flexibility. In a big business, enough work may be found to employ one individual with a particular skill or asset. If the market or technology changes, many big businesses find themselves caught with resources that are no longer productive or efficient.

On the other hand, if the work is not there for the skill or asset which the individual can provide, the small business owner is either going to tap an independent contractor or not provide the service. Too often, big businesses must try to force the market to adjust to them. In the small business sector, the business adjusts to the market. If a market or demand changes, the small business is able to adapt to it. If new skills and new technologies are needed, the small business can re-tool itself for those changes. Responding sooner, faster, better, and more efficiently is what allows small businesses to survive, compete, and prosper. Utilizing independent contractors is part of that success story. Mandating that the individual be reclassified as an employee solves nothing because inefficiency and excess capacity is a quick route to bankruptcy.

At the same time, an independent contractor can maintain a standard of living and a way of life, and keep skills and assets in the marketplace available to a number of industry participants. Utilizing an independent contractor facilitates the sale of the service recipients' goods or service. Because the services or assets of the service provider and service recipient are mutually interdependent, they do not, and should not, lead to the conclusion that the relationship should be that of employer-employee.

As I said, we have participated in efforts in the past to provide standards. We have been involved in several legislative projects, the most recent in the 107th Congress. Each effort encountered the same extraordinary challenges of providing a set of standards than can be applied reasonably and fairly. I can tell you that, if anything, the challenges of developing a set of standards today are far more difficult than ever, given the changes in our economy just since the 107th Congress.

Tax Gap Implications of Independent Contractor or Employee Classification

We are all well aware that overshadowing this discussion is the broader debate on the nature of the tax gap and how it can be closed. With my colleagues at the United States Chamber of Commerce and the National Federation of Independent Businesses, we have established Coalition for Fairness in Tax Compliance (CFTC). While it is the position of the CFTC that every individual and business should pay in a timely manner their fair share of taxes, and those taxpayers that do not fulfill this obligation place compliant taxpayers at a disadvantage; regulatory and legislative strategies to collect outstanding obligations can place excessive and obtrusive burdens on the backs of honest taxpayers.

Honest small business taxpayers are especially at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture the few "bad actors" that do not fulfill their tax obligations. Small businesses already bear a disproportionate share of the cost of regulation.

The CFTC is a coalition of small business organizations that will fight for the rights of these honest small business taxpayers as the executive and legislative branches develop strategies to address the "Tax Gap." It is the mission of the Coalition for Fairness in Tax Compliance to fight for the rights of tax compliant small business owners by:

- Supporting the accurate use and collection of information on the source, size, and scope of the problem of tax non-compliance that forms the foundation for policy decisions.
- Supporting targeted, sensible regulatory and legislative measures that will reduce tax non-compliance without generating undue burdens on the small business community.
- Encouraging tax compliance by developing tax simplification proposals for sections of the tax code that are confusing and complicated.
- Opposing regulatory and legislative strategies proposed by lawmakers in an attempt to increase tax compliance that impose excessive and obtrusive burdens on honest small business owners.

The CFTC is eager to facilitate a dialogue. To that end, we have established a website www.taxcompliancefairness.org, which we invite people to utilize.

We have invested an enormous amount of time in trying to find the best way to address the parts of the tax gap that might be closed. For last two years, we have held many meetings with the IRS and others to explore ways we can address this issue in a fair and reasonable way.

When you look at the information available, two observations immediately jump out. The aggregate "Tax Gap" is simply a collection of dozens of tax-compliance functions, business activities, and taxpayer profiles which have little or nothing in common. Solutions must be up to the task of yielding tax revenues without placing a disproportionate burden on the affected taxpayers. Second, the data and research necessary to make informed decisions does not appear to exist. There are so many questions in need of answers before policymakers can begin to craft solutions that will be effective and not burdensome.

The tax gap report suggests that sole proprietors, taxpayers reporting business income on a Schedule C, underreport their income. The group we are discussing today is a subset of that Schedule C universe. While the Department of Labor has published some estimates of contingent workers, a subset of which are characterized as "independent contractors," we do not have high degree of confidence in how much we collectively understand about Schedule C filers, based on our experience with IRS data on sole proprietors. Are there other characteristics that distinguish this subset or subsets of the subset that might be relevant to this discussion? From experience, I can say, one size does not fit all.

I know there is some discussion of what the states are doing to address the classification issue. First, this historically has been an issue in which the states have been eager to preserve their own systems for classification. Past efforts to establish a uniform system have not worked. Second,

to the extent some states have developed new initiatives, I would think we need to wait to see how those initiatives ultimately take shape. Our experience is that there is often a pendulum effect, as businesses, employers, employees, and the state governments discover the unanticipated ramifications of employment classification policy changes.

This leads me to one other point about revenue collection, benefits, and particularly the unemployment compensation system. We would ask whether there has been sufficient study of the impact on states of the reclassification of independent contractors as employees not only in terms of an increase in unemployment insurance tax paid by employers into the system but whether there are concurrent increases in the amount of benefits paid out thus offsetting the revenue projections. Indeed, we have some similar concerns about some elements of the tax gap data, that is, whether the data accounts for some offsetting effects.

Conclusion

Our nation has made an investment in entrepreneurial activity, and we do not want to damp that spirit unnecessarily. The majority of small businesses are compliant taxpayers. For a variety of reasons, not the least of which is for competitive purposes, they want other business taxpayers to be compliant. We have working hard to find proposals that would facilitate compliance without placing greater burdens on the compliant small business taxpayers.

Thank you for the opportunity to testify on behalf of SBLC.

Chairman MCDERMOTT. We thank all of you. Your full statement, your written statement will be entered into the record. We appreciate your coming here to do this today.

I want to start by asking a question, first, to Mr. Valencia.

If I understood you correctly, you say that you have become not a foreman, but an independent contractor who has a team of people working for you; is that correct?

Mr. VALENCIA. Yes, it is.

Chairman MCDERMOTT. Do you have liability responsibility if one of them gets injured?

Mr. VALENCIA. Yes, I do.

Chairman MCDERMOTT. So, are you paying Worker's Comp insurance?

Mr. VALENCIA. Yes, I am.

Chairman MCDERMOTT. You are getting that from the company you work with? Is that an item that is passed through you from the employer or from the homebuilder?

Mr. VALENCIA. No. Basically, everything—all they pay me is my square footage; and based on that price, they pay me like a dual invoicing twice a month. It is in that price that I got to pay my people.

I have to pay the taxes. I have to pay the L&I and still at the end of the year, I have to come up with my 941s. For just this year, 2006, last year—I had to refinance my house this year because I have to pay $60,947 to the IRS right now out of my pocket. I have to refinance my house to pay this money out. So, 2005, I refinanced my house again to pay again the IRS.

Chairman MCDERMOTT. Do I understand, though, that the homebuilder tells you when to go to work, where to work, what to build, and how much you are going to get paid; is that correct?

Mr. VALENCIA. Yes, it is correct.

Chairman MCDERMOTT. So, you don't have any flexibility in when you want to work or anything? You are building to his specs as to how the house looks and what the size of the rooms are and so forth. It is all according to his specs?

Mr. VALENCIA. Right.

Chairman MCDERMOTT. They can make changes at any time?

Mr. VALENCIA. They provide—they provide me with the blueprints and give me the lumber and all. What I provide is the labor.

Chairman MCDERMOTT. Let me ask a question of you, Ms. Smith. If I understand correctly, Mr. Valencia does not get credit for Social Security, he doesn't get credit for Medicare coverage unless he pays it?

Ms. SMITH. Right.

Chairman MCDERMOTT. He is not included in any kind of retirement plan or anything else. That has to be independently set up, whatever he has?

Ms. SMITH. Yes.

Chairman MCDERMOTT. He has no unemployment benefits if he is laid off; if there is no work, he can't go and apply for unemployment insurance benefits?

Ms. SMITH. Right.

Chairman MCDERMOTT. He is not covered by minimum wage requirements. If he doesn't make money out of this per foot stuff, he winds up working for $3.70 an hour. There is no requirement that he be given enough money to get the wages out of it?

Ms. SMITH. That is what it sounds like.

Chairman MCDERMOTT. No family and medical leave requirements?

Ms. SMITH. No.

Chairman MCDERMOTT. No right to collectively organize as a union?

Ms. SMITH. No.

Chairman MCDERMOTT. Is there a prevention in the law that says if you are an independent contractor that you cannot organize a union?

Ms. SMITH. The National Labor Relations Act covers only employees.

Chairman MCDERMOTT. Employment discrimination, he has no protections in that area?

Ms. SMITH. No, not if he is truly considered an independent contractor.

Chairman MCDERMOTT. OSHA does not apply? There is no workplace safety?

Ms. SMITH. Not for independent contractors.

Chairman MCDERMOTT. Now does the OSHA cover his workers that are on his team? The workers that he has gathered up, does that cover them?

Ms. SMITH. Yes. If he is considered the employer of others, then he incurs all the liabilities for payroll costs, payroll taxes, and to

comply with labor protective laws like minimum wage and overtime and health and safety.

Chairman MCDERMOTT. If this Committee were to make one change in Federal law, what would be your suggestion to us?

Ms. SMITH. My recommendation—I think the most immediate problem is the Section 530 loophole. It makes no sense to me that we would prohibit the IRS from correcting problems that occurred in the past and that we would allow industries to say, I do this because everybody else does it, whether or not it complies with the law.

I think that is the most immediate problem and the most immediate thing that we can fix.

Chairman MCDERMOTT. My understanding is, the Treasury recommended that almost 10 years ago, that it be done; is that correct?

Ms. SMITH. Yes, it is.

Chairman MCDERMOTT. Is that a study by the Treasury Department on that issue?

Ms. SMITH. There was a study—my recollection is, there was a study by GAO, and GAO recommended some changes and that IRS's response to the study was that, yes, indeed, there should be some changes to the IRS safe harbor.

I think that was back in 1989.

Chairman MCDERMOTT. Okay. Do you know that to be true, Dr. Nilsen?

Dr. NILSEN. Yes. That was a 1989 study when we made that recommendation, that Congress direct the IRS to make some changes to 530 to ensure better coverage of their investigations.

Chairman MCDERMOTT. Thank you.

Mr. Neal will inquire.

Chairman NEAL. Thank you very much, Chairman McDermott.

Mr. Kendzierski, you have referred to these misclassified workers as a second class of tradesmen who work in dangerous business where workers often get injured. What happens to these workers if they do get injured?

Mr. KENDZIERSKI. Well, they are ineligible to collect any unemployment. Generally their lives just become very distraught and they have no place to turn.

Chairman NEAL. Are there any government initiatives that you are aware of that come to their assistance at that moment?

Mr. KENDZIERSKI. None that I am aware of, sir.

Chairman NEAL. Mr. Valencia, when you started that first job as a framer, did you have a full understanding of why the builder sent you a 1099 form, or was it a surprise to you?

Mr. VALENCIA. Back then it was a surprise for me, but when I learned the whole process of that, I was assuming the taxes and everything at the end of the year, it shocked me.

Chairman NEAL. Mr. Satagaj, you have heard the comments of the last two witnesses, Mr. Kendzierski and Mr. Valencia, about the types of construction workers probably misclassified as independent contractors. Your testimony seems to suggest that independent contractors are really just entrepreneurs in the embodiment of the American dream.

Would you disagree that these gentlemen—disagree with these gentlemen that these workers really need the protection of employee status, given the risks that they run every day?

Mr. SATAGAJ. As I said, there are certainly those that abuse the system, but the funny thing, the truth of the matter as I sit here—and I have to be very honest—I am hopeful about the future of Mr. Valencia. I am expecting 5 years from now, you are going to see a better businessman who is going to have more employees, work for more builders, and be successful. I see this as a positive entrepreneurial opportunity here. That is the good thing about it.

Yes, let's get rid of the abuses, but let's encourage him to be a better small business. That is what we should be doing.

Chairman NEAL. I don't think anybody disputes that. I think one of the concerns that we legitimately raise is what happens to that injured worker.

Mr. SATAGAJ. Well, the owner of a business has similar issues, too. One of the risks of becoming a business owner, you take some of the risks. I want everybody to have the coverage, but the employer has the same problem as the employees or the independent contractor there. Keep that in mind.

So, there is risk there for everybody. There are no owners in the Worker's Compensation system.

Chairman NEAL. No. We accept the notion of risk in successful entrepreneurship. What happens if the employee that Mr. Kendzierski referred to is an Iraqi veteran or a veteran of the Afghan war, but he is injured on the job?

Mr. SATAGAJ. I am not disputing. Where it is appropriate, it should be there, under those circumstances, but as I said, you show me where we draw that line. It is going to be extraordinarily difficult to find the place to draw that line.

Chairman NEAL. If the injury prevents you from going to work, would you object to Medicaid coverage for that individual?

Mr. SATAGAJ. Beyond my level. It is beyond my level, Mr. Chairman.

Chairman NEAL. Thank you.

Ms. SMITH, your testimony shows that one Massachusetts survey found that construction was not the leading industry for misclassified workers. That survey seems to show that misclassification can occur in lots of different work sectors, including some with highly educated workers who might otherwise be predisposed to understand the downside.

Do you know why the information industry would have more misclassified workers than construction workers?

Ms. SMITH. I don't know why that is. Some of the folks who have done some of the studies might know the answer to that question.

One thing that I did want to say is that oftentimes in these cases the impetus to create a new business and a new independent contractor is not coming from an individual entrepreneur. It is coming from the company for whom that person would like to work, as in my example, as in Mr. Valencia's example and other examples in our testimony.

So, it is really not misclassification by accident, but misclassification as a business model.

Chairman NEAL. If the employee that I have described, based on Mr. Kendzierski's testimony, were called to duty in Iraq and then to return, would he be able to reclaim his status necessarily as an employee?

Ms. SMITH. If it were someone in Mr. Valencia's situation, I am not certain. My guess would be "no."

Chairman NEAL. Okay. Thank you.

Thank you, Mr. Chairman.

Chairman MCDERMOTT. Mr. Weller will inquire.

Mr. WELLER. Thank you, Mr. Chairman. Again thanks to our witnesses and panel for joining us this morning.

Dr. Nilsen, what is the breakdown of the type of workers that tend to be independent contractors? Mr. Valencia is in the construction business. He is a framer; he is a carpenter; he has people who work with him.

Are all independent contractors in the construction trades? Can you give us kind of a breakdown of who they are?

Dr. NILSEN. It covers a wide range of occupations and industries. Construction is significant, but also business services and professional services, as we heard, are also significant. It goes across the spectrum in terms of industries and workers, as well, occupations as well.

So, it is not—it may be concentrated. As I said, about 22 percent are in construction, 23 percent another—23 percent in professional services; but then the other roughly 50 percent are spread across all other industries.

Mr. WELLER. You studied all the various reports and studies that have been done and analyzed them as part of your responsibility. When it comes to those who are misclassified as independent contractors, is there a trend in which particular industry they may be in, or is that across the board as well.

Dr. NILSEN. It seems to be across the board. We haven't found any particular concentrations in particular industries that I recall.

Mr. WELLER. Mr. Pinkham used the word "criminal" when he was describing the use of independent contractors by certain employers. For those who misclassify, is that a criminal act in our States? Illinois is an example in his study, my home State.

Dr. NILSEN. It is more the consequences of misclassifying that could be. If people are misclassified, and it is found that they have not been paying minimum wages, overtime wages, then that would be a violation.

Mr. WELLER. What are the current penalties?

Dr. NILSEN. I can't answer that. Perhaps Ms. Smith can answer that at this time.

Mr. WELLER. Mr. Pinkham, you are the one——

Dr. NILSEN. Certainly back wages need to be compensated.

Mr. WELLER. Mr. Pinkham, you are the one who used the word "criminal." Can you describe the penalties for someone who intentionally misclassifies an independent contractor in Illinois, since you did the study there?

Mr. PINKHAM. Yes. I was recalling testimony provided by a former official with the Department of Labor and Industrial Relations with the State of Mississippi during the hearings in Kansas where she described a Kansas contractor who had a prevailing-

wage job in Missouri where he had 150 employees building a dormitory in Merriville, Missouri. Every employee was classified as an independent contractor.

The same individual had a similar set-up going on on a publicly funded construction project in Iowa. The State did seek back payment, and there was a court case in which there was a settlement of over a half million dollars.

Now, the use of the word "criminal" would apply in this case more in terms of the illegality. The actual penalties may be more civil in mind, but there are cases where people are facing jail time. There is a developer who lives in the Kansas City area who is currently in court and is facing some jail time for abuses in the Lake of the Ozarks area of Missouri.

Mr. WELLER. Mr. Pinkham, you indicated this was a prevailing-wage contract. Was the employer in this case paying the prevailing wage as honoring his contract with the university for that dormitory?

Mr. PINKHAM. When you use independent contractors, that is a way in which you are not accountable to the prevailing wage and benefit requirements.

Mr. WELLER. Even though the contract required it?

Mr. PINKHAM. Even though the State normal contract would require that, yes.

Mr. WELLER. Mr. Pinkham, you had also noted in the Illinois report, that 18 percent of audited employers had misclassified at least one worker as an independent contractor and about 7½ percent of all workers were misclassified. In your Illinois study did you determine that the employers of these workers that were misclassified, that they did it intentionally?

Mr. PINKHAM. What we noticed is that the activity tends to be concentrated within certain employers. That when you do find employers who misclassify, they tend to misclassify a higher percentage of their employees than what the random practice would show; and that in States where targeted audits are allowed, where they will focus audit activity on businesses who have problems with filing their paperwork or other kinds of indicators that are used, for instance in Massachusetts, the incidents of misclassification there that was discovered was quite high.

Mr. WELLER. So, you are saying there are certain bad actors, but not all employers are bad actors if they misclassify; some may have made a mistake?

Mr. PINKHAM. No, of course not.

Mr. WELLER. One last follow-up, if the Chairman would indulge me here. In your study you talked about the loss of revenue to the Unemployment Insurance Fund because of the use of independent contractors. If their classification would change, did you also analyze what the outflow of money to pay unemployment benefits would be? What would be the impact on the Unemployment Insurance Fund if those workers were not classified as independent contractors or fully covered by unemployment insurance; what would be the impact from the standpoint of money going out?

Mr. PINKHAM. In terms of the increased claims that might occur for unemployment insurance?

Mr. WELLER. That is correct.

Mr. PINKHAM. I don't know of anyone that has actually analyzed that phenomenon, but I do know that what we have heard from—again, when I was providing testimony in Kansas, I was approached by some masonry contractors in the rotunda who were talking about some of these issues and about people that worked for them. I don't have a projection for what would be the incidence of people who would file for claims, but there are a lot of people who have casual work relationships that are not filing.

Mr. WELLER. It is one thing to say we are not collecting enough tax, and there are always people that want to raise taxes and collect more tax revenue, but I think it would be useful from our perspective to not just look at the standpoint of what this means to the tax collector, but what is also the impact in money going out the door for unemployed workers on their ability to collect. To me it would be useful to look at both the inflow as well as the outflow. I know as a Member of this Committee, I would appreciate it if you would take a look at that and provide that.

Mr. PINKHAM. I would be very happy to carry that request back to my colleagues.

Mr. WELLER. I would ask unanimous consent that be included as part of the record.

Chairman MCDERMOTT. So ordered. Thank you.

Mr. WELLER. Thank you, Dr. Pinkham.

Chairman MCDERMOTT. Mr. English will inquire.

Mr. ENGLISH. Thank you, Mr. Chairman. Since I was not here at the beginning of the hearing, I wonder if I can seek unanimous consent for the record to have my statement inserted?

Chairman MCDERMOTT. It has already been granted, so, yes, you may.

Mr. ENGLISH. Thank you very much.

[The prepared statement of Mr. English follows:]

Prepared Statement of The Honorable Phil English, a Representative in Congress from the State of Pennsylvania

Chairman McDermott and Chairman Neal, thank you for calling this hearing on this subject. The issue of worker status as employee or independent contractor is not a new one to the Committee. This is a complex area of the law with valid concerns on both ends of the spectrum and I look forward to exploring this issue as others who have sat at this dais in many previous Congress have done.

Let me start by saying that this Committee should have little patience for those taxpayers who willfully flaunt the law. Those employers and workers who do so should be dealt with appropriately. But for those whose non-compliance with the law is not a product of malfeasance but is, rather, an act of nonfeasance, we must inquire why. If non-compliance is the result of unnecessarily complex or nebulous tax rules, then Congress should seek to lighten this burden on employers and workers.

I look forward to hearing the viewpoints of the witnesses today on this issue.

Mr. ENGLISH. I guess listening to the testimony, Mr. Satagaj, I am intrigued by some of the testimony we have heard with regard to the tax gap, which seems to suggest that there is a lower compliance rate among independent contractors than employees. In your view, is this directly the result of misclassifications of employees as independent contractors?

Mr. SATAGAJ. Unfortunately, I spend what seems like every waking moment thinking about the tax gap these days. We have spent a lot of time looking at the data and how it affects results to close the tax gap. I cannot come to that conclusion, that it is driven by this.

GAO had mentioned the diversity of the independent contractor community. There are so many different reasons for why the gap exists, and the solutions are going to be a lot of tiny, discrete solutions, and they are not going to add up to a lot. We are not going to go much beyond the 84, 85 percent compliance rate. We have a pretty good compliance record right now voluntarily compared to the rest of the world. Historically it has been very consistent. So, the answer is it is not this. There are a lot of different things.

Mr. ENGLISH. I noted last year Congress enacted the 3 percent independent contractor withholding provision, and that was targeted at increasing the compliance rate among independent contractors. This only applied in situations where the contractors were doing business with the Federal, State and local governments.

Can you comment on your view of the consequences if we were to impose withholding on all independent contractors, including their nongovernmental contracts?

Mr. SATAGAJ. Well, as you know, Mr. English, that hasn't gone in effect yet. I happen to believe before it does we are going to be revisiting it, because I don't think it is going to work. It is not going to work at the level with the government. Frankly, it is an even more difficult challenge if you try to impose it in nongovernmental settings. You have got to deal with net profits, the net income versus gross income. It is different in every industry where you pick a number for it. It is different for every business. Let's say you want to enter a new market and you might be very aggressive. Your margins are going to be different. The notion that you can pick a number that would work across all industries or even for an individual business in a given year, given circumstances, is impossible. I still believe that we are going to be coming back to the government withholding one, because I don't believe it is going to work there.

Mr. ENGLISH. Stipulating that we have seen situations where there is clear misclassification going on there is a real issue here. I have been on this Committee for 13 years. I have come to appreciate that there are very legitimate concerns about misclassification. I am very grateful, by the way, to the two chairmen for creating an opportunity here to freshen our understanding of what is going on.

Nevertheless, it strikes me that there are some situations where small businesses could be dramatically impacted by a lack of access to certain kinds of independent contractors. After all, small businesses as the most dynamic sector of our economy are also able sometimes to import expertise or technology by tapping into certain kinds of people who can be brought into the organization with the status of independent contractor temporarily or on something short of a full-time basis. It seems to me that is very significant for certain parts of our economy, that there is access to independent contractors.

Stipulating that we may want to revisit the rules, are there specific concerns on that front that we need to be cognizant of?

Mr. SATAGAJ. I think you raise a point, and I don't recall whose opening statement mentioned globalization, but one of the reasons we are competing in a global market with the changes in technology is our ability to be flexible in certain industries and address whatever we need to compete globally. I am certain there are industries where the flexibility has only grown exponentially in the direction of flexible arrangements.

You look, again, at our economy, for a lot of women in our economy who are getting opportunities, that very ability to be in a flexible market allows you to do that. It is providing more opportunity, so it is a very positive.

Mr. ENGLISH. That is a very important caveat.

My time is expired. Mr. Chairman, again, I want to thank you for creating the opportunity for maybe some of the Members who haven't been as involved as we have over the last 13 years to freshen the understanding and maybe appreciate how substantial an issue this is perhaps not only of worker rights, but also of the dynamics of our economy. Thank you all for testifying.

Chairman MCDERMOTT. Thank you.

Ms. Berkley will inquire.

Ms. BERKLEY. Thank you, Mr. Chairman, for holding this hearing, and I would request also unanimous consent to submit my opening remarks.

Chairman MCDERMOTT. So ordered.

[The prepared statement of Ms. Berkley follows:]

Prepared Statement of The Honorable Shelley Berkley, a Representative in Congress from the State of Nevada

Thank you, Mr. Chairman. I am happy to have this opportunity to work with my colleagues from both subcommittees to address the misclassification of employees as independent contractors.

Over the years, Congress has taken steps to ensure that employers are providing their workers with a certain level of security. Employees are entitled to a minimum wage, overtime pay, and safe and healthy work places. If an employee is hurt at work, he or she receives workers' compensation; if that worker is let go they receive unemployment benefits.

Employers of these individuals pay unemployment taxes and workers' compensation insurance as well as their half of Social Security and Medicare or (FICA) taxes.

My district of Las Vegas is one of the fastest growing areas in the country and a significant portion of my constituents are employed in construction—an industry where misclassification is quickly becoming common practice.

Unfortunately, when employees are incorrectly classified as independent contractors, they are robbed of these important protections. These misclassified workers are also often excluded from employer provided retirement accounts, health insurance and other benefits.

It is vital that Congress do everything in its power to ensure that individuals receive the benefits and protections they deserve.

I look forward to hearing the witnesses' testimony and I thank you all for being here today.

Ms. BERKLEY. Thank you. I want to thank all of you for being here. I am new on this Committee, and this is an issue that I haven't been exposed to. I represent Las Vegas, Nevada, and we have a tremendous amount of building going on and a number of abuses that I checked into when I knew that this hearing was

going to take place. So, it is an issue that I know affects the people in my community.

Now, I have been hired as an independent contractor in a past life, and I have also been an employee in a past life. It seems to me that I knew the difference when I was hired of which way I was being hired and for what services I would be performing.

I wanted to ask Mr. Valencia, if I may, now, you have been a carpenter for over 18 years. In your view, does it seem that employers in the construction industry are more likely to classify workers like you as an independent contractor now than they were 18 years ago, or has it been the same problem all of these years and I just didn't know about it?

Mr. VALENCIA. No, I think it has been an issue that has been going on forever.

Ms. BERKLEY. Do you think that most workers know when they are given independent contractor status, do they have an understanding that they are going to be losing certain protections when they are not characterized as employees? Do they know that?

Mr. VALENCIA. They do, but the situation as an employee, they are obligated to work. So, even if they acknowledge the situation, there is not much they can do.

Ms. BERKLEY. They need the job, they need the work, they need the cash?

Mr. VALENCIA. Right, they do.

Ms. BERKLEY. So, is there anything in your experience that if an employee goes, gets a job with a contractor, and the contractor says, well, you are an independent contractor, so I don't have to pay you any benefits, I don't have to do this, I don't have to do that, is there any recourse that the employee has, other than either you don't take the job or you take the job? Is there another option for them?

Mr. VALENCIA. Of course, yes. Basically the way it is set up is the general contractor sets the rules. They tell you that you have to go get a bond and insurance. In my situation I am covered by an umbrella with a wrap insurance. They take 3 percent out of my contract on top of whatever they pay me. They pay me certain money for square footage. They take 3 percent out of that to cover my insurance. On top of that I got to pay my employees, I got to pay all the liabilities and provide my own salary after that, too.

Ms. BERKLEY. Mr. Nilsen, you stated in your testimony that the test used to determine whether a worker is an independent contractor or an employee is very complex, subjective, different from law to law, and you discussed the impact of a worker who is misclassified. Do you believe that the growth in the misclassification of workers is attributable solely to the fact that the laws are very complex and subjective, or are there other factors that play a part in determining whether a worker is classified as an employer or independent contractor?

Dr. NILSEN. We haven't specifically looked into what is driving this, but there are certainly benefits for both a potential employer and for the worker.

Ms. BERKLEY. What are the benefits to the worker of being misclassified?

Dr. NILSEN. The benefits to the worker are, as Mr. Pinkham said, the rate of which people pay taxes decreases if you are working as an independent contractor that they found. I think some of the estimates, Meyer-Emco, people pay taxes on 30 to 50 percent of their income.

Ms. BERKLEY. Do you think that is the main reason that contractors are misclassifying?

Dr. NILSEN. I think it is driven by both sides, as we said. Also, there are a lot of drivers for savings and simplification for the employer in terms of not paying a whole host of costs and taxes. As you have heard from others, one being workers' comp is a major expense that employers probably are trying to avoid. I think you have heard that from Mr. Valencia here as well.

Ms. BERKLEY. Let me make sure. You have the most charming name, and I don't want to insult you by not pronouncing it right.

Mr. SATAGAJ. That is all right. Everybody does.

Ms. BERKLEY. Satagaj?

Mr. SATAGAJ. Satagaj.

Ms. BERKLEY. Satagaj. Very lovely.

Your testimony describes the benefits to the small business of having the flexibility, and I understand that. How do you respond to business owners who properly classify their workers and then suffer a distinct competitive disadvantage for obeying the law? That had to do with Mr. Kendzierski's testimony. What are we going to do about these employers that follow the law?

Mr. SATAGAJ. The distinction is what is the law and what are you making the choice on. There are things you make a choice on in terms of benefits that you might offer regardless of what the law is. If I offer health care or I offer a type of health care, you are making competitive choices. That is the marketplace. I would be fully supportive of where there are violations of the law.

Certainly we talked about cash, paying under the table. I have no patience for anybody who pays that way. I don't know any business owner who wants to have a competitor that is paying under the table. Nobody wants that, I don't care who you are. So, the answer is, yes, the things that are the law, but you have to make a distinction between what is the competitive marketplace and competitive because of the law.

Ms. BERKLEY. Mr. Chairman, may I ask one more question?

Chairman MCDERMOTT. Maybe we can come at a second round.

Ms. BERKLEY. I don't think I will be here for a second round. Could I just make this one question?

Chairman MCDERMOTT. All right. If it is short.

Ms. BERKLEY. It is very short. It may be a long answer, but a very short question.

What recommendations does your organization have in addressing this chronic problem of worker misclassification?

Mr. SATAGAJ. Our view is it is going to be extraordinarily difficult to deal with it in the notion of having some set of standards, as I have mentioned. I believe you were here. We have been involved in other legislative activities to draw the bright line for this, and it is very, very difficult to do. I am willing to try again.

I think some of the other things we are doing, we are trying to identify tax gap solutions. There are reporting issues, how you would report if you are an independent contractor. Do you report a line item that says I have got X amount of cash?

There are things that we can do. I mentioned we are part of a coalition on the tax gap. It is not against the tax gap, it is to find solutions. You can go to our Web site, and we talk about things. So, we are looking for solutions. We met with the small business commissioner yesterday in an ongoing series to talk about other things we are going to do. So, there are other things you can go to tighten up the system somewhat in reporting and so forth.

Ms. BERKLEY. Thank you. I yield back the balance of my time.

Mr. SATAGAJ. I think I took most of it.

Chairman MCDERMOTT. I will mark it down for the next hearing.

Mr. Porter will inquire.

Mr. PORTER. Thank you, Mr. Chairman, and thank you all for being here. It is a very complex issue, and I am sorry I missed part of the opening presentation, but I grew up in a family where my dad was an electrical contractor, and my mom worked in the family business, and my brother and I worked in the family business. I remember the debates at the dinner table in a small town in Iowa, how it was difficult for my father to compete with someone that wasn't following the rules, where some businesses would hire individuals or some individuals would act as a business and would intentionally not want to follow the rules so they would try to fudge the system.

So, there are folks on both sides of the employees. There are some that abuse their position and plead with businesses to work as independent contractors. Then you have the legitimate employees that want to follow the rules, but you also have businesses that are trying very hard. So, I understand the complexity of it.

I had my own business for 20 years, and I can tell you time and time again of potential employees that pleaded with me to pay them as independent contractors.

Now, what I have also found through the years, the businesses that are abusing the independent contractor rules are also the ones that are abusing workmen's comp, and they are abusing an array of other areas of not paying taxes. So, there are definitely bad businesses.

Now having said all that, my question is I see lots of stats, and, Mr. Pinkham, you mentioned misclassification in Illinois, so I am going to use you as an example. On page 3 you give three or four examples, and I am a little confused as to how many are misclassified. Is it 20 percent, is it 23 percent, is it 8 percent? I am sorry I didn't hear your testimony, but could you clarify for me?

Mr. PINKHAM. Sure. We try to identify the employers who are practicing misclassification. Then we look at the employees within those employers who are misclassified. Then we also look at the total number of employees across all industries.

Mr. PORTER. So, was it about 13 percent?

Mr. PINKHAM. Across all industries statewide in Illinois, the level of misclassification grew from 5½ to 8½ percent.

Mr. PORTER. So, out of 8½ percent, how many do you think are doing it intentionally?

Mr. PINKHAM. Out of that 8½ percent that were misclassified according to the unemployment insurance audits, how many were intentional and habitual? You probably would need to refer back to the employers who have an incidence of as high as 28 percent of their employees, whereas the State average is 8 percent, and look at the percentage of employers who are doing that. I think that would be a way of arriving at——

Mr. PORTER. You are not assuming they are all guilty of doing this on purpose?

Mr. PINKHAM. No, of course not.

Mr. PORTER. How many do you think are doing it on purpose? What percent of employers are doing it on purpose?

Mr. PINKHAM. It is hard to tell without knowing the track record of the employers and if they have been fined in the past.

Mr. PORTER. When you did your research, did you look at these businesses if they were violating other laws or had a track record?

Mr. PINKHAM. The data that you obtain when you do a study like this is necessarily deidentified. There are no company names, addresses, ZIP codes, Social Security numbers or anything else.

Mr. PORTER. Could you guess how many do it on purpose?

Mr. PINKHAM. There might be statistical methodologies for backing into something like that, but we didn't attempt to do that.

Mr. PORTER. Let us assume for a moment it is—did you say 28 percent?

Mr. PINKHAM. Twenty-eight percent of the employees at firms who were engaged in misclassifying were misclassified. When you had a business that was misclassifying its workers, they weren't just doing it a little bit, they were doing it a lot.

Mr. PORTER. So, they would be more apt to be intentionally doing it?

Mr. PINKHAM. They would be more apt to be doing it a lot, the intentional ones.

Mr. PORTER. So, what percentage of businesses in Illinois do you think are intentionally doing this?

Mr. PINKHAM. Well, the employers who were found to be misclassifying, in 2005 it was nearly 20 percent.

Mr. PORTER. So, 20 percent?

Mr. PINKHAM. Twenty percent of the employers were misclassifying, but not all of them would be habitual.

Mr. PORTER. My point is having been in that position where I had accountants and bookkeepers and attorneys trying to help me as a small business owner myself for 20 years, I tried so hard not to make mistakes. I think it is very complex, and I don't think every mom-and-pop business can afford to have all the experts look at how to hire.

I would like to believe—there is no doubt there are a lot of businesses out there abusing rules, laws, taxes, there is no question. Most family business and most businesses and corporations want to follow the rules. So, having been there firsthand and trying to decipher what the laws are, is there a way we can simplify this so we could penalize those businesses that abuse employees, but also provide the rules that are easy to follow for a small business? Are

there some things that you have determined that would make it easier for businesses to follow the rules?

Mr. PINKHAM. I think one of the points that has been made today is how delicate it is to fashion a statute that will satisfy the needs of work comp commissions, unemployment insurance agencies and the Department of Revenue. It is necessarily an area that has some complexity to it.

I think it is important because all of us who have grown up in this country—particularly myself, my father was an entrepreneur. He was a contractor developer. I grew up picking up wood scraps under subfloors at the age of 10 and began framing and did all those kinds of things for my father's business, so I have a deep appreciation for the need for flexibility and how unintentional errors can occur. I think it is important to have safeguards that the presumption is that you are not out to use a sledgehammer, you are out to prohibit and prevent the habitual and intentional recurrence.

Mr. PORTER. If I may interrupt, because I know we are kind of short. In Nevada we have grown from 66,000 small businesses in 1997 to 151,000 in 2004. I just can't believe that 20 percent of these businesses are intentionally—and I know we are talking Illinois to Nevada—I just don't believe that intentionally they are trying to break the law. There is no question there is a percentage, but what I ask of this Committee and Mr. Satagaj——

Mr. SATAGAJ. Satagaj.

Mr. PORTER. Satagaj, I am sorry—if you could just briefly say what could we do to make the business environment easier so employers can hire more people and follow the rules, because most really want to follow the rules.

Mr. SATAGAJ. I couldn't agree more the line you are pursuing here. In simplification, the challenge—for the small business owner, is that the Tax Code in its entirety is too complex. To get to these individual classification issues, we are trying to get in the heads of these people and trying to think about their decision. We need to be focused on, okay, here is what your responsibilities are; that we will help you through it, provide the outreach and education—I talked about the IRS, otherwise we will just never get there.

Mr. PORTER. Again, there are bad businesses, and I think they should be penalized and held accountable, but I don't think the businesses who are trying to follow the rules should fall in this area. They just need to know what they are.

Mr. Pinkham, you grew up in a family business, as did I. You know that your dad was there at 6:00 in the morning and left at midnight and was worried about all these things to try to follow the rules, as most businesses are.

Mr. PINKHAM. One of the things that was done in Kansas is the Department of Revenue and other agencies after the new law was passed conducted a series of statewide training sessions for employers to attend before they implemented the information sharing between departments. As a heads up, I think States, if they are going to ratchet up the penalties and increase the oversight, need to reach out and do attempt to provide the kind of education that would be important.

Mr. PORTER. Again, as a business owner nothing infuriates me more than having to compete with someone who is not following the rules. So, again, very complex. I appreciate all of your testimony today, and I agree, there are those that need to be held accountable, and we need to simplify the systems. Thank you all very much.

Chairman MCDERMOTT. Thank you.

I have one more question here. Mr. Valencia, your contract of $4.85 cents a foot, that is a square foot, is it?

Mr. VALENCIA. Correct.

Chairman MCDERMOTT. Is that a negotiated price, or he just tells you that is what he is going to give you?

Mr. VALENCIA. That is what he tells me I am going to do. He says $4.85 a square foot, whether the house has so many arches, how many shelves, so many columns that we got to frame, soffits, whatever. Whatever he wants to add on the house, that is what I got to make. On top of that, we got to set windows.

Chairman MCDERMOTT. It is take it or leave it? You can't say "five and a quarter, I didn't make any money off the last house we built?"

Mr. VALENCIA. Yes. As a matter of fact, last January he lowered my price from $4.85 to $4.50 because he said that the sales of the houses were decreasing. I told him that, last year, the year before, I was short in my taxes, and I wasn't making enough money, and if he lowered my price, it was going to be worse. He said, well, you have a choice: You either do it, or you walk out.

Chairman MCDERMOTT. Did he ever tell you what being an independent contractor meant? Did you have a training session?

Mr. VALENCIA. No.

Chairman MCDERMOTT. He just said, this is what I pay, and you are on your own?

Mr. VALENCIA. Yes.

Chairman MCDERMOTT. How did you get from there to then hiring a crew? He said, "why don't you be in charge of finding some other guys to bring in; we need 5 people instead of just you?"

Mr. VALENCIA. Right. Well, you are obligated. If you are a subcontractor, and you come over to build a house, and the house is so big that you can't do it on your own, you have to go and hire some more people to help you out. That is basically what it is. You are subject to do it in their own terms.

Chairman MCDERMOTT. So, you get $4.50 per foot for everybody on your team, right?

Mr. VALENCIA. No. Basically, if the house, for instance, is a 5,000-square-foot house, he pays me—every house is a contract. He pays me $4.50 a square foot times 5,000 square feet. That is my pay. That is what I pay. I got to pay my guys with the liability, and I got to pay all of my——

Chairman MCDERMOTT. Out of the $4.50 per square foot.

Mr. VALENCIA. Exactly.

Chairman MCDERMOTT. So, you could do it all yourself and take a while? That would be okay?

Mr. VALENCIA. Basically that is what it is. You haven't asked me this question, but if you ask me why did I propose to change the system, I will tell you from my own experience. One of the peo-

ple here is saying, educate subcontractors. If the government obligates whoever wants to become a subcontractor to go to a program and tell them the way it is going to be learning the process and learning how to bid, because if you are not going to bid, you are going to do something illegal, so you are subject to attend these courses. If you are going to make $4.50, are you going to have enough money to pay the liability, to pay your own expenses and your family. So, that will make people think more than once before they go and do it.

Chairman MCDERMOTT. Mr. Smith or Mr. Pinkham, in the information industry, people working in software and computer programming and that kind of stuff, that is another different level of work that is done by independent contractors. Are those people instructed as to what this means in terms of no unemployment insurance, no workers' comp? Is that all part of the training in those operations?

Ms. SMITH. I don't have that much experience in the information technology system. I can tell you about my experience in my home State, Washington State, with forestry workers who were hired by large forestry companies to harvest ferns and salal that go into the making of floral evergreen wreaths and bouquets. It is an industry that operates around the world and is exported from Washington State.

I had a series of clients coming in my office who had been told by the forestry company that they could only work for the forestry company if they worked as independent contractors. They certainly weren't told what that meant. My task then was to tell these folks, most of whom were immigrants from Mexico and Guatemala, who spoke Spanish, who had no familiarity with our legal system, what that meant in terms of their tax obligations, what kind of licenses they had to get, what kind of liability insurance they had to get.

At a certain point I really decided that this just wasn't right. I couldn't in all good faith tell folks exactly what they needed to do because it was my judgment that they were just not capable of complying. This again was not their idea. It was the idea of the company that they become entrepreneurs, and they just did not have the wherewithal to comply with all the things that you have to do to set up a business.

Chairman MCDERMOTT. Does an independent contractor have to be licensed? In other words, if you are working for a large computer maker or a large instrument maker, and you are hired as an independent contractor, do you have to go down and get a license?

Ms. SMITH. You might need to get a business license. In Washington State these folks were having to get business licenses. Then they had to get licensed as farm labor contractors. Then the company was insisting that they have liability insurance. So, the company was really dictating all the things that they had to do as an independent contractor. Of course the company dictating all those things is a pretty strong indication that they are not independent contractors, they are employees.

Chairman MCDERMOTT. Mr. Weller has something, a unanimous request.

Mr. WELLER. Thank you, Mr. Chairman. Mr. Chairman I had directed a request to Mr. Pinkham, and I would also ask others

that are participating in the panel if they have information as well. As we look for good information and look at the facts strictly on the impact on the Unemployment Insurance Trust Funds of the misclassification. Of course the study Mr. Pinkham had prepared dealt with the issue of tax collection, but it did not address the issue of unemployment benefit collection, the outflow of dollars.

Mr. Chairman, I would note that in February of 2000 during the Clinton Administration, the Department of Labor did have a report that was prepared regarding independent contractors, particularly pages 65 through 71. That particular report did look at the impact and misclassification in trust funds, and that particular study, which looked at years in the 1990s, actually addressed the issue, as many have suggested, of misclassification. Actually, there was a net negative impact on the unemployment insurance trust fund because of the money that went out. Now, that was in the 1990s. We are now in the 21st century, and it would be useful to have more current data.

Mr. Chairman, I would like to put this report in the record, particularly noting pages 65 through 71, and ask unanimous consent for that purpose. Again I ask all the participants today if you have information on the impact on the unemployment insurance fund, particularly the outflow, as well as the inflow, of funds, that would be greatly appreciated and we would put it for the record with unanimous consent.

Chairman MCDERMOTT. Without objection it will be in the order.

Ms. SMITH. If I may, we have looked at the climate report, the report that you are referring to, and it estimated that the loss to the UI Trust Funds was about $200 million a year at that time. We sort of carried that forward to today's economy, and the number that my colleague came up with was $343 million that is now projected to be lost to the UI systems for nonpayment of UI payments because of misclassification.

Chairman MCDERMOTT. Is that input or outgo?

Ms. SMITH. That is taxes that are unpaid by employers.

Mr. WELLER. Ms. Smith, the question is if you change the classification here, and if the tax revenue is being collected, then also these workers would have the opportunity to collect unemployment benefits, what is the impact? You don't address that with the information you have, and that is why I have requested it, because obviously if more workers go into the system, there is going to be more tax revenue collected. The question is if more workers go into the system, what is the impact going to be on unemployment benefits? So, what is the net overall benefit coming and going? That is the information that I hope that we can obtain.

I do note that the Clinton Administration did commission a study which looked at the 1990s. Well, let us look at the current decade and what that impact will be because of the larger number of workers impacted.

Dr. NILSEN. If I might add also, to me, I have done a lot of work at GAO on the UI system, and ultimately it is a self-financing system. So, I am not sure exactly how they got the net outflow.

We did a study last year that showed that certain industries pay more than their fair share into the system than they get out for

their workers. Other industries get more benefits than the taxes, but in the end basically the UI system is funded out of UI taxes, so ultimately I think it nets out to zero in the end.

Mr. WELLER. Well, again, if the individual has the information.

Dr. NILSEN. Yes. Each individual business does not necessarily pay its fair share.

Chairman MCDERMOTT. We want to thank all of you for coming. You have been helpful. Without some kind of understanding of the problem, it is hard to fix the problem. So, we thank you for coming.

[Whereupon, at 11:10 a.m., the hearing was adjourned.]

[Submissions for the Record follow:]

Associated Builders and Contractors
May 9, 2007

The Honorable Jim McDermott
Chairman, House Ways and Means Subcommittee on Income Security and Family Support
B–317 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Richard Neal
Chairman, House Ways and Means Subcommittee on Select Revenue Measures
1135 Longworth House Office Building
Washington, D.C. 20515

Dear Chairmen McDermott and Neal:

On behalf of Associated Builders and Contractors (ABC) and its more than 24,000 merit shop contractors, subcontractors, materials suppliers, and related firms from across the country, we appreciate the opportunity to submit the following letter for the official record. We appreciate Chairmen Jim McDermott and Richard Neal for holding this hearing on "The Effects of the Misclassification of Workers as Independent Contractors."

While Congressional action may be necessary to clarify the entire independent contractor regime, we caution this Committee and Congress to carefully consider the impact of any such action to ensure that good-honest hard working businesses and their workers are not overrun with increased and costly regulatory requirements.

ABC will address three topics:

- First, ABC supports a level playing field for all businesses and ABC supports efforts to ensure that workers who are misclassified receive appropriate relief;
- Secondly, Independent Contractors are integral to our industry and our country's dynamic economy; and
- Lastly, what potential resolutions are available to address worker misclassification.

1. All Parties Desire a Level Playing Field

While the construction industry provides significant opportunities for independent contractors, all parties must function under a confusing framework of rules that inadequately address the classification of workers as either employees or independent contractors. Initially, it is critical to distinguish between *wrongful* classification and misclassification. In construction, *wrongful* classification by a competitor can result in a competitive disadvantage to other contractors. Contrast this with misclassification, which can easily occur because current law and rules are extremely complex.[1]

Those companies not paying employee taxes or worker's compensation by *wrongful* classification can undercut the competition by offering lower bids. ABC in no way condones intentional misclassification by businesses that shirk their duties to society and their workers. We endorse a level playing field for all businesses and workers. For those workers who are faced with improper misclassification we believe

[1] Consider that the instructions for the three pages Form SS–8 (Rev. 11–2006), Determination of Worker Status for Purposes of Federal Employment Taxes and Income Withholding, that the IRS requires to secure a determination letter on the status of a worker, reflects 22 hours for recordkeeping and two hours to complete.

they should be accorded every opportunity to have their financial situation corrected. Also employment agencies that do not properly pay workers should face severe enforcement.

Under current tax law, taxpayers use a 20-factor common law test that can be controversial and cumbersome because it is so subjective, leading to disputes between the IRS and businesses. Even if misclassification is unintentional the ramifications can be dramatic to both the worker and business owner in the form of back taxes, interest, applicable penalties, and even the possible disqualification of retirement plans.

Adding further confusion is that in addition to the IRS methodology for determining status a business owner may confront other methodologies for differing purposes.[2] For example, the Common Law "Right to Control" test which is often used by courts to determine employee status in various types of cases, including employment discrimination and benefit cases, tax cases, and tort liability cases. And, the Department of Labor uses a model of analysis known as the "economic realities test" to determine coverage under, and compliance with, the minimum wage and overtime requirements of the Fair Labor Standards Act. Further many states have similar but not identical methods for state purposes.

Independent Contractors are Integral to the Construction Industry

Independent contractors are often the perfect answer to a pressing need for special skills and experience needed on short-term projects. The flexibility an independent contractor provides to a small, fledging operation as well as larger enterprises creates numerous advantages for all parties involved. The independent contractor has freedom to choose his or her work schedule, while the small business owner maintains the flexibility to adjust work demands with current business activity, and the consumer enjoys the benefit of a reasonably priced, quality product. Lawful utilization of independent contractors provides a good source of labor for projects where the contractor does not need to exercise the type of control that would necessitate the hiring of an employee.[3]

Potential Resolutions

Four resolutions are commonly discussed:

1. Increase Reporting Requirements—Within the context of "The Federal Tax Gap" it has been proposed to Congress that increased information reporting may provide part of the solution.[4] IRS statistics indicate that when reporting requirements such as Forms 1099 are required, compliance increases from approximately 57% to 96%.[5] Eliminating the exemption from 1099 reporting for corporations would facilitate elevated reporting for independent contractors. By approaching the issue this way, less emphasis is placed on unclear classification rules while emphasis is shifted to the relatively clear laws of filing annual information returns.
2. Elevate Enforcement—IRS indicates that for every dollar invested in enforcement four dollars in increased revenue to Treasury is returned. Further, the Commissioner of the IRS has stated, "This 4:1 return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in non-compliant behavior."[6] De-

[2] There are many non-Federal income factors that may be relevant to independent contractor vs. employee status: Workers compensation benefits; Federal and state civil rights laws; Fair Labor Standards Act; National Labor Relations Act; Occupational Safety and Health Act; Americans with Disabilities Act; and State income/unemployment taxes.

[3] Many ABC members started their own businesses by initially working as an independent contractor. It is not unusual for these individuals to work as employees during regular hours and as independent contractors during off-hours and weekends. There is no better way to become established as a small business than to begin as an independent contractor. Because of the cyclical nature of the industry, many businesses cannot afford to keep certain specialized trade craftspeople as employees. Sometimes, skilled craftspeople are needed several times throughout the year, but not enough to warrant full-time or even part-time employment. Having to place two or three extra employees on the payroll just to finish a short-term project places a significant and unnecessary burden on companies.

[4] *The Causes and Solutions to the Federal Tax Gap: Hearing Before the Senate Committee on the Budget, 109th Cong.* (2006) written statement of Nina E. Olson, National Taxpayer Advocate available at: *http://budget.senate.gov/republican/hearingarchive/testimonies/2006/NinaOlsenTestimony.pdf.*

[5] *IRS Updates Tax Gap Estimates,* IR–2006–28 (Feb. 14, 2006).

[6] Written testimony of Commissioner of Internal Revenue Service, Mark Everson, before The Senate Committee on the Budget (Feb. 14, 2007)

partments of Labor—both Federal and the States—can also elevate enforcement on this issue.

3. Clarify and simplify the 20-factor subjective test and educate businesses and workers.[7]
4. Eliminate availability of independent contractor status.

ABC supports the three initial listed with the understanding that we remain concerned that any action taken by Congress should be measured against the impact on good-honest hard working businesses and their workers to ensure they are not overrun with increased and costly regulatory requirements.

However, the mechanics of eliminating independent contractors from our economy is wrought with technical problems that are not clearly explained by constituencies who have concerns with the legal availability of independent contractors. These technical issues may be the reason you don't hear the IRS constructively discussing the option of eliminating independent contractor status.

Further, this would not be a viable alternative in the construction industry. Consider one fundamental concern for the contractor who is properly functioning as an independent contractor: Cash flow would be impaired for the independent contractor who exceeds FICA limits since each "employer" would withhold up to the limit.[8] For significant technical and practical reasons, ABC cannot advocate that independent contractor status is eliminated and no credible consideration can be given to such option.

Again, thank you for allowing ABC to submit this letter to the official record and we look forward to working with the House Ways and Means Committee on this important issue.

Statement of Contractor Management Services

Thank you for granting this opportunity to submit comments on the Subcommittees' joint hearing on the effects of misclassifying workers as independent contractors.

The issue of independent contractors is complex and not one that can be resolved in one session. There are many interests, some conflicting, which need to be considered and weighed. Not the least of these is the extent to which individuals and businesses should have the freedom to enter into contractual arrangements without governmental interference. The problems with the use of independent contractors today fall into one of two categories: The lack of clear and consistent standards that businesses can rely upon when using the services of independent contractors and the increasing attempt by some government agencies and courts to classify all workers as employees, regardless of the wishes of the parties.

Admittedly, there have been businesses and employers who have classified workers as independent contractors when those workers are clearly employees. These employers have attempted to change the workers' classification from employee to independent contractor without changing the relationship between the workers and the employers or the manner is which they deal and interact with the workers. However, many businesses using independent contractors do not fall into this category. These businesses want to give the workers the freedom that independent contractors should have, while still maintaining the ability of the business to operate. Unfortunately, those who have intentionally misclassified employees as independent contractors have caused unwarranted suspicion and accusations against the many businesses that are making a good faith attempt to use the services of independent contractors in order to survive in today's competitive environment.

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[7] ABC previously testified on July 26, 1995 before the House Small Business Committee in support of increased education and clarification of the 20-factor independent contractor test.

[8] The end result will be increased construction costs. Also consider: a) It would force the independent contractor to adopt a massive record keeping structure that they may not be equipped to handle. At times the independent contractor may be the employer when performing small projects, then switch to an "employee" status when working as a sub. The resulting tax payment requirements would be difficult to monitor; b) Monitoring the unemployment rates in some states would be very difficult and rules would have to be established to help determine which "employer" would be responsible for the unemployed worker; c) Companies in some states may be forced to take on additional exposure in the area of workers compensation for which they may not be familiar and for which duplicative or exorbitant safety program costs may be the result; d) The new "employer" would have to take on all of the financial risks of a project rather than mitigating some of that risk by using the independent contractor for a lump sum job. Bidding jobs would thereby become more complex.

Many businesses attempting to use the services of independent contractors find themselves accused of misconduct, not because the business is attempting to subvert the law, but because the laws are not clear or consistently applied. A recent example of this involves a ruling by the Illinois Supreme Court that a truck driver was an employee of a motor carrier that was subject to the regulations of the U.S. Department of Transportation. In order to protect the public, Congress and the Department of Transportation established certain standards and regulations when a motor carrier contracts to use a truck owned by a driver and the services of the driver. The regulations require the carrier to have "exclusive possession, control, and use of the equipment for the duration of the lease." Recognizing this exclusive control and other requirements of the regulations may impact the ability of the carrier and driver to establish an independent contractor relationship, the regulations at 49 C.F.R. § 376.12(c)(4) state:

"Nothing in the provisions required by paragraph (c)(1) of this section is intended to affect whether the Lessor or driver provided by the Lessor is an independent contractor or an employee of the authorized carrier lessee. An independent contractor relationship may exist when a carrier complies with 49 U.S.C. 14102 and the attendant administrative requirements."

Despite clear language in the federal regulations that compliance with these regulations was not intended to impact the ability of a carrier and driver to enter into an independent contractor relationship, the Illinois Supreme Court determined that the carrier, by ensuring compliance with the federal regulations, exercised control over the driver and compliance with the federal regulations was a permissible factor in finding the driver was an employee of the carrier.

This ruling is contrary to the rulings of many federal and state courts finding compliance with government imposed regulations does not constitute control by the entity using the workers services. In National Labor Relations Board v. Associated Diamond Cabs, Inc., 702 F.2d 912 (11th Cir., 1983) the 11th Circuit Court of Appeals in ruling that drivers of taxi cabs were not employees said:

Consistently the courts have held that regulation imposed by governmental authorities does not evidence control by the employer. *Air Transit v. N.L.R.B.,* 679 F.2d at 1100; *Local 777, Seafarers,* 603 F.2d at 875–76; *SIDA of Hawaii, Inc. v. N.L.R.B.,* 512 F.2d at 359. Indeed, employer imposed regulations that incorporate governmental regulations do not evidence an employee-employer relationship, *Air Transit v. N.L.R.B.,* 679 F.2d at 1100; *Local 777, Seafarers,* 603 F.2d 875–76; *SIDA of Hawaii, Inc. v. N.L.R.B.,* 512 F.2d at 359; *see also N.L.R.B. v. Deaton, Inc.,* 502 F.2d at 1226–28; *Portage Transfer Co., Inc.,* 204 N.L.R.B. No. 117 (1973); *Reisch Trucking and Transportation Co., Inc.,* 143 N.L.R.B. 953 (1963); unless pervasive control by the employer exceeds to a significant degree the scope of the government imposed control. *Local 814, I.B.T. (Santini Brothers),* 223 NLRB 752, 753, enforcement ordered, 546 F.2d 989 (D.C.Cir.1976); *N.L.R.B. v. Cement Transport, Inc.,* 490 F.2d 1024, 1027 (6th Cir.), *cert. denied,* 419 U.S. 828, 95 S.Ct. 47, 42 L.Ed.2d 52 (1974).

And recently, the Florida Court of Appeals in Miami-Dade County v. Florida Dept. of Labor and Employment Security, 749 So. 2d 574 (App., 2000) stated: [G]overnmental regulations constitute supervision not by the employer but by the state. *See Global Home Care, Inc. v. State, Dept. of Labor and Employ. Sec.,* 521 So.2d 220 (Fla. 2d DCA 1988); *La Grande v. B & L Servs., Inc.,* 432 So.2d 1364 (Fla. 1st DCA 1983).

Businesses, especially those involved in interstate commerce, faced with conflicting rulings such as these find it difficult to use the services of independent contractors without risking being accused of misclassifying those who are providing services to the business. Further, a ruling like that of the Illinois Supreme Court that is clearly contrary to the intent of the federal regulations, makes suspect statistics reported by Illinois and other states that the misclassification of workers as independent contractors has increased.

Businesses need a clear definition of what constitutes a legitimate use of independent contractor services regardless of whether the business is conducting operations in New York, California, Florida or Pennsylvania. In addition, businesses need straight forward guidelines they can rely on and know that compliance with these guidelines will result in a legitimate utilization of independent contractors. Further, individuals who have been provided full and complete information regarding the benefits and consequences of working as an independent contractor as opposed to as an employee should have the right to enter into an independent contractual arrangement without a paternalistic government claiming it knows what is better for that person.

The social issues that are frequently raised in discussions about the use of independent contractors—i.e., collection of taxes, protection of workers in the event of

injury, short term protection in the event of loss of a job—can all be addressed through means other than the death of the independent contractor model. Entities using the services of independent contractors on an ongoing basis could be required to withhold a set percentage and remit to the taxing authority unless the independent contractor provides proof of filing and remitting quarterly taxes. Independent contractors could be required to show proof of coverage under either self-employed workers' compensation or occupational accident insurance in the event they are injured while providing services as an independent contractor. And, independent contractors can be given the opportunity to voluntarily participate in some level of unemployment insurance program if their business losses a significant portion of its work.

Some states have recently moved to provide more clarity to businesses utilizing the services of independent contractors. These states recognize the right of individuals to contract provided the person is provided full and completed disclosure of the consequences of providing services as an independent contractor. The states of Colorado and Georgia provide two examples. In these states, the contract between the independent contractor and company using the services of the independent contractor must clearly state in conspicuous language, in one case in larger type and bold faced, that the independent contractor will not be covered by workers' compensation and unemployment insurance providing services as an independent contractor. Georgia further requires the contract advise the independent contractor that he/she is required to pay social security taxes that may be higher than if the person were working as an employee. The obvious purpose of these statutes requiring full disclosure and notice is so a person can make an informed decision whether or not to provide services as an independent contractor. If the person agrees, he/she knows the consequences and ramifications of his/her decision.

The independent contractor issue does not need further regulations designed to limit the ability of businesses to use the services of independent contractors. What is needed are clearer guidelines that are exercised on a more consistent basis and that allow persons who are provided full and complete information as to the benefits, risks and consequences of working as independent contractors to knowingly and voluntarily agree to enter into an independent contractor relationship. The problem is not an increase in the misclassification of workers as independent contractor; the problem is the increasing view by many agencies and courts that the American worker is not capable of protecting himself and of making a decision based on his own.

Statement of the Direct Selling Association

The Direct Selling Association (DSA) appreciates the opportunity to submit comments to the Committee regarding its May 8, 2007 hearing on the effects of misclassifying workers as independent contractors.

The Direct Selling Association (DSA) is the national trade association representing over 200 companies that sell their products and services by personal presentation and demonstration, primarily in the home. The home party and person-to-person sales methods used by our companies and their independent contractor sales forces have become an integral part of the American economy. Our industry represents over $30 billion in domestic sales and over $89 billion in worldwide sales each year. The 14.6 million individual direct sellers who sell for direct selling companies in the U.S. are independent contractors; they typically sell on a part-time basis to their neighbors, relatives, and friends to supplement their family income. These direct selling companies include some of the nation's best known commercial names, such as Alticor (parent of Quixtar), Avon Products, Inc., Mary Kay Inc., The Pampered Chef and Tupperware. The direct selling industry attracts individuals seeking job flexibility, with low start-up costs and often-minimal work experience. Their direct selling activities are generally neither extensive nor elaborate. Government officials have suggested that other entities covered by information reporting requirements, direct sellers have a high tax compliance rate.

The Independent Contractor Status of Direct Sellers is Well-Established

We believe that you can find no better example of the proper classification of a worker as an independent contractor than individual direct sellers. They are truly the quintessential and classic example of an independent contractor. The independent contractor status of direct sellers has long been recognized for Federal tax purposes. Almost 30 years ago direct sellers' status as independent contractors was confirmed for tax purposes under common law. (Aparacor. Inc. v. United States, 556

F. 2d 1004 (Ct. CI. 1977)). In 1982, Congress adopted I.R.C. § 3508 to "provide a statutory scheme for assuring the status of . . . direct sellers and real estate salespersons as independent contractors." (Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (1982), 382)

Internal Revenue Code Section 3508 establishes three conditions in order for a person to qualify as a "direct seller" treated as an independent contractor by statute. First, the person must be engaged in the business of selling consumer products to any buyer on a buy-sell, deposit-commission, or similar basis, in the home or otherwise than a permanent retail establishment. Second, substantially all of the remuneration paid must be directly related to sales or output, rather than to the number of hours worked. Third, the direct selling must be performed pursuant to a written contract between the direct salesperson and the direct selling company, and the contract must provide that the direct salesperson will not be treated as an employee of the company for federal tax purposes.

As part of this statutory classification of direct sellers as independent contractors for tax purposes, Congress also adopted a special tax information reporting requirement for direct salespersons. See I.R.C. § 604 lA(b). Under this special direct seller information reporting system, each direct selling company that sells $5,000 or more of consumer products to a direct salesperson must indicate so on a special direct seller box on the IRS Form 1099–MISC, which is then filed with the Internal Revenue Service and sent to the direct salesperson. This information filing requirement also applies to a distributor in a multi-level direct selling arrangement who is wholesaling to direct salespeople in his or her sales organization. In addition, the Form 1099–MISC is used to report the payment of commissions, bonuses, and awards to direct salespeople in excess of $600. The direct salesperson is required to provide his or her proper taxpayer identification number to the direct selling company as part of this process.

This statutory treatment of direct sellers as independent contractors and the special direct seller tax information reporting procedure constitute a clear and well-established system that has worked effectively for Federal tax purposes for almost 25 years and has achieved an extremely high rate of tax compliance for the direct selling industry. Our own compliance estimates are in the 97% range.

Independent Contractor Status Generally

DSA believes it important to the nation that legitimate use of independent contractors, in all industries, not be threatened. Based on our own studies, people want to be independent contractors because they like being their own bosses, working their own hours, building their own businesses and directly relating effort to reward. Tax benefits generally do not enter the picture for them. From the viewpoint of the users of independent contractors, while there are some tax benefits created by this status, there are also productivity, recruiting, retention and tax *disincentives* as well. Businesses and individuals should be able to choose within structures they wish to operate.

The current frame work, while not perfect, was developed over many years and with input from divergent groups. The reason the 20 factors test was developed was because of the recognition that a "one size fits all" approach does not work for the diversity of industries that properly utilize independent contractors. While, as noted before, we believe that direct sellers are the best example of an independent contractor, we also believe there are many other appropriate and necessary uses for this status of workers. Anything that discourages, prevents, or makes more difficult the appropriate use of independent contractors would have a negative impact on business, workers, and the broader U.S. economy.

Section 530 of the Revenue Act of 1978 was originally enacted by Congress (and then indefinitely extended in 1982) to give a degree of protection and certainty to those who reasonably classify workers as independent contractors. And while we do not doubt there are abuses of the status that is no reason to eliminate Section 530 when simple refinements may be appropriate.

Improving Compliance

Over the years and recently, a few have advocated withholding on independent contractors. Withholding would be counterproductive and an unnecessary burden to the direct selling industry. As noted above, direct selling already has a reporting requirement. Recent testimony by the IRS on the Hill, confirms that where there is reporting there is a high level of compliance with the tax laws. This might be an area to consider as an alternative to withholding.

Conclusion

Industries seeking to protect the independent contractor status have traditionally received bipartisan support in Congress. Members of Congress have long understood the complexity of this "classification" issue and the need to protect this micro-entrepreneurial form of doing business. We are concerned, however, that any attempts to address with the issues raised by this hearing might do inadvertent harm. Until now, Section 530 has proven to be the most inclusive, pro-independent contractor safe harbor test that Congress could enact. Any changes to this section of the law, whether they be designed to curb IRS abuses or to deal with the problem of misclassifications of employees in some industries resulting in competitive disadvantages for some firms, should be carefully handled.

Inadvertent, unforeseen consequences handful to industries legitimately using independent contractors must be carefully avoided. It is a very complex, economically significant area to both corporations and individual entrepreneurs. Experience has shown that there are many landmines in this area, and we urge that extreme caution be used in making any changes.

DSA appreciates the attention that both subcommittees have devoted to this important and challenging issue. We trust that, as your deliberations continue, the legitimate use of independent contractors will be protected and preserved. We also respectfully urge that, should any changes in the law take place, nothing be done to endanger the statutory independent contractor status of direct sellers. Having been active in these discussions for over 30 years, DSA would welcome the opportunity to discuss compliance alternatives to withholding such increased information reporting and the effects such alternatives would have on our industry.

Thank you for your consideration of our views. We are at your service to expand on this statement, to answer any questions you might have or to provide additional information.

Respectfully submitted,

John Webb
Associate Legal Counsel

International Union of Bricklayers
May 17, 2007

Chairman James McDermott
Subcommittee on Income Security and Family Support
U.S. House of Representatives Committee on Ways and Means
B317 Rayburn House Office Building
Washington, DC 20515

Chairman Richard Neal
Subcommittee on Select Revenue Measures
U.S. House of Representative Committee on Ways and Means
1135 Longworth House Office Building
Washington, DC 20515

Dear Chairman McDermott and Chairman Neal:

On behalf of the nearly 100,000 members of the International Union of Bricklayers and Allied Craftworkers (BAC), I want to deeply thank Chairman McDermott, Ranking Member Weller, and the Subcommittee on Income Security and Family Support as well as Chairman Neal, Ranking Member English and the Subcommittee on Select Revenue Measures for their decision to hold a joint hearing on the employee misclassification crisis. As the testimony that the Subcommittee heard on May 8, 2007 made clear, the rampant misclassification of working Americans as independent contractors is wreaking severe and far-reaching havoc on working families and the broader economy. Congressional leadership is plainly necessary to effectively combat this crisis, and we applaud the Subcommittee for taking a place in the vanguard of those seeking to bring justice back to the American workplace.

At the conclusion of the May 8 hearing, you solicited further comments for consideration by the Subcommittee. In light of the fact that the members of the Subcommittee seemed to be searching for ways that Congress could proactively work to reduce the incidence of employee misclassification, BAC is suggesting four key initiatives that Congress might consider as it continues to address this critical issue.

1) Congress should immediately commission a comprehensive study to determine the economic impact of the misclassification crisis on federal tax revenue, the Social

Security system, and Medicare and Medicaid. In recent years, respected economists have analyzed the effect of misclassification on the state tax revenues, workers' compensation systems, and unemployment insurance systems in a number of states; for example, Cornell University recently produced a study of the cost of misclassification in New York, and a University of Missouri-Kansas City analysis demonstrated the disastrous consequences of misclassification in Illinois. But, remarkably, a comprehensive study of the national cost of misclassification has not been conducted in well over 10 years. We simply have no real idea of how big the tax gap, Social Security gap, and Medicare/Medicaid gap caused by misclassification of employees has become. It is almost certainly a number of times greater than the $3.3 billion found by the last national study, in 1995—but we need hard numbers, not guesses. We need to ascertain the true scope of the misclassification crisis before we can determine the best way to attack it. Moreover, understanding the real magnitude of the misclassification crisis will allow the nation to make better informed decisions about the future of Social Security and Medicare. How much of the supposed Social Security crisis is really attributable to employee/independent contractor misclassification? We just don't know—and we ought not to be making major decisions about the future of Social Security until we do. Congress should therefore act swiftly to commission a comprehensive study; similar to the New York and Illinois analyses, to evaluate the degree to which misclassification is defunding the Federal Government, the Social Security system, Medicare, and Medicaid.

2) Congress should budget significantly more money for Department of Labor and Internal Revenue Service enforcement of the existing laws governing employment status, and should allow those agencies to better share information regarding misclassification of employees. One of the most obvious causes of the misclassification crisis is the chronic lack of funding for enforcement of the laws that are intended to prohibit misclassification. The Department of Labor's Wage and Hour Division is, along with the Internal Revenue Service, one of the primary federal bodies charged with preventing misclassification. Yet the decade-old $3.3 billion estimate of the tax gap created by misclassification is nearly 20 times greater than the 2006 budget for Wage and Hour. The agency most responsible for enforcing proper classification of employees simply does not have the resources necessary to police the profligate misclassification that is plaguing the United States. And the budget priorities of recent years have not helped Wage and Hour accomplish its mission; over the past five fiscal years, the Department of Labor's Office of Labor-Management Standards (which is primarily responsible for oversight of labor union finances and activities) has received an appropriations increase three times greater than that received by Wage and Hour.

All the best-intentioned, best-crafted legislation in Washington won't really begin to address the misclassification crisis unless there are a sufficient number of properly funded, hard-working federal agents available to enforce the legislation. A significant increase in funding for the Wage and Hour Division, in conjunction with earmarks for increased targeted auditing of dubious employers, will lead to better enforcement of the laws prohibiting misclassification. And that is an investment which will pay for itself. There are few appropriations that Congress can make that are almost guaranteed to result in far more money being returned to the Treasury—but increased funding for Wage and Hour and for IRS misclassification enforcement efforts will have just that result.

Another way that Congress could improve enforcement of the laws governing employment status would be to remove any impediments barring federal agencies from sharing information regarding the misclassification of employees. Unless the IRS and Department of Labor—in addition to any other agencies that might uncover evidence of misclassification—are allowed to share that information with each other, the government will never be able to bring the full force of its enforcement power against those employers who have willfully chosen to injure their workers and defraud the American people.

3) Congress should seriously consider federal legislation, similar to that in Massachusetts and New Mexico, adopting a presumption that workers are employees until proven otherwise. Over time, different agencies have embraced different tests for "independent contractor" status, and different laws have defined "employees" in different ways. Despite the fact that these multiple definitions generally vary only in minor detail, some observers have argued that the variations have sown confusion among employers. Although we believe that the distinction between employees and independent contractors is usually intuitive and simple, and although we have found that vast numbers of misclassified workers are "employees" under any test and are clear victims of misclassification, it is true that the present regulatory framework may make the employee/independent contractor determination more complex than it needs to be.

One approach to ameliorating this problem would be to consider legislation—like that already adopted in Massachusetts, New Mexico, and a number of other states—which would create a presumption under at least some federal laws that workers are "employees" unless affirmatively shown to be independent contractors. Any such legislation, however, would need to be carefully tailored to avoid unintended disruption of existing regulation. For that reason, BAC suggests that Congress carefully evaluate which areas of federal regulation would best benefit from imposition of a presumption of employee status, and only then move forward with legislation. But we do believe that, carefully implemented, legislation creating a presumption of employee status would go a long way toward eliminating a great deal of existing employee misclassification of workers as independent contractors.

4) Congress should strongly consider amending, or even eliminating, the "safe harbor" provisions of the Internal Revenue Code. Although originally enacted in 1978 to protect the unwitting wrongful misclassification of workers as independent contractors by an employer, this provision has actually emboldened the underground community of misclassifying employers and their enablers in the accounting and legal fields. Recent changes to the law have further complicated and protected unscrupulous employers by placing the burden on the IRS to demonstrate deliberate misclassification. This additional burden placed on the IRS has rendered an already underfunded enforcement effort even less effective.

This unfortunate situation was all too clearly brought to light by recent efforts of BAC's Chicago local leadership to involve the IRS in the near-criminal exploitation of the safe-harbor loophole by a residential masonry contractor. This contractor had misclassified his entire bricklayer workforce, even though industry standards (and the practical realities of masonry construction) require the existence of an employer/employee relationship between a mason contractor and its bricklayers. The IRS consistently ignored this situation until BAC's local officers petitioned Senator Durbin for an investigation. The Senator's investigation of the situation eventually resulted in a serious IRS inquest into the situation—but it is unlikely the framers of the original legislation (or the most recent revisions to the safe harbor provision) anticipated that it would be necessary to prod the IRS into intervention. Unfortunately, as this example indicates, the need for prodding has become the norm rather than the exception.

In conclusion, I would once again like to commend the Committee for its willingness to take a leadership position in combating this hidden crisis—a crisis that so insidiously threatens the American workplace. Your future efforts, and those of your colleagues throughout Congress, will hopefully lead to an effective solution to the misclassification crisis. As you proceed, BAC stands ready to assist you in any way that we can.

Sincerely,

John J. Flynn
President

Statement of Kathy Roman, Sequim, Washington

My husband and I entered in to a contract agreement with FedEx Home Delivery in January 2004. We were interested in starting with two routes and growing the 'business' to operate all Home Delivery routes on the North Olympic Peninsula in Washington. The two routes covered all of the territory we hoped to maintain receiving additional routes within the territory as the area grew in density.

It was obvious within the first month that two trucks could not effectively deliver the area. We were told to add another truck and driver at OUR cost. We added this truck and driver operating at a loss until eight months later we received a third route. There is no language in the contract as to when or if new routes are added.

With the third route it became obvious that the current methodology of have one truck shuttle up the packages for the other two routes was hurting productivity. What originally took 30 minutes to hand off packages was taking 90 minutes. Also, the shuttle truck was delivering packages before meeting the other two trucks making the other two routes wait longer for packages. I came up with different feasibility options to solve the methodology issues and was told "No" to every option I came up with. FedEx was not interested in allowing me to solve my problems in a cost effective manner. The only solution they would entertain was us adding another truck and driver at my expense with no guarantee of receiving new routes. Actually, they said the odds of getting a new route were pretty slim.

After one year of attempting to run my business in collaboration with FedEx it became obvious that I had absolutely no control over my business, my routes, my drivers, or my expenses. The contract states that a driver must delivery a minimum of 7.5 hours each day but it does not have a maximum delivery day. Our average work day is 12 hours and there is not an option of taking less packages to deliver less hours. The only option is to add another truck and driver at my expense. But be certain the truck passes their scrutiny. It took three months to get a bigger truck approved for an existing route. It can take a month to get a new driver approved. Only half of the drivers I find pass FedEx approval. The driver that bought one of my routes was not approved at first. It took six months to get him approved to take over the route. I can not accept single parents as drivers because daycare centers are not open enough hours for the parent to complete the day's work.

This is not self employment, this is slave labor. This is the worst of both. If I can not make decisions, then I am an employee. If I am an employee, then I have protections on my work day.

We have been in this three years and we still can not make decisions regarding the routes. We have tried to sell the routes but those that qualify financially do not meet FedEx approval. I have too much financially invested to just dump the routes and if FedEx ever decides to just take them away, as they threaten all the time, I will have to file bankruptcy.

Statement of National Association of Home Builders

Introduction

The 235,000 members of the National Association of Home Builders (NAHB) appreciate the opportunity to submit this statement for the House Ways and Means Committee, Subcommittee on Select Revenue Measures and Subcommittee on Income Security and Family Support regarding the effects of misclassifying workers as independent contractors. This issue is of great importance to the home building industry, which thrives on the efficiency and entrepreneurship that comes from both home builders and their workers being able to freely choose the form of their business relationship. At the same time, entrepreneurship only succeeds when all participants in the market play by the same rules and one entity cannot have an unfair advantage over others. NAHB supports enforcement of the current rules on the classification of workers, but would also support clarification of those rules to improve compliance across all industries.

This statement focuses on the economics surrounding the decision by home builders to contract with independent contractors as well as the motivations for employees to act as independent contractors. Further, it examines present law rules for the classification of workers and how they ensure a fair and equal marketplace for business. Finally, the statement identifies some potential enhancements to the current law that could improve compliance.

Economics of Independent Contracting

There are important business-related reasons why a home builder would want to use an independent contractor as part of a home construction project. Economic theory dictates that firms employ labor in-house only when the costs of doing so are less than the cost of contracting with another firm. In general, labor costs are lower for businesses that specialize in a particular activity compared to a business that attempts to do all tasks in-house. Consequently, it may be more efficient to contract with a business consisting of dedicated specialists than housing a single or few employees within the firm. This effect is also known as economies of scale and is likely to occur in industries associated with large fixed costs, low marginal costs and learning-by-doing, such as residential construction or the technology sector.

In addition to certain professional duties, such as management and administration, home building requires a large number of specialized tasks. The Census identifies some of these roles, including but by no means limited to: construction supervisor, brick mason, carpenter, flooring contractor, cement worker, general laborer, pile driver, engineer, drywaller, electrician, glazier, insulation contractor, painter, paperhanger, pipe plumber, plaster contractor, rebar worker, roofer, metalworker, quality inspector, fencer, hazmat removal contractor, and septic and sewer specialist.

For a small home builder, who may only construct a few homes a year, there is not sufficient internal demand to justify hiring an employee for each of these specialized roles. For example, the total internal demand for an electrician may only

be for one-half of a position per year. Consequently, it makes more economic sense to contract with an electrician who acts as an independent contractor. This contractor will likely own his own equipment, provide for his own training, and contract with other businesses. He may also employ his own staff. Therefore, working with an independent contractor has the potential for significant efficiency gains. Proposals that would artificially alter the decision between hiring an employee and working with an independent contractor would increase overall construction costs and therefore result in higher prices for home buyers.

Furthermore, there are advantages for specialty trade workers to adopt independent contractor status. Data from the Census Bureau's Survey of Population demonstrates that independent contractors in the construction industry tend to be higher skilled than their employed counterparts. Not surprisingly given the demand issue discussed above, self-employed construction trades workers are more common in rural areas and smaller cities, where home building occurs at a smaller scale. Finally, independent contractor status affords the opportunity of growth and expansion, whereby a successful contractor hires his own staff to meet the increasing needs of his business. Indeed, many contracting business begin operation as a self-employed independent trade worker.[1]

The result of the economic setting described above is a vibrant subcontractor market within the residential construction industry. NAHB survey data indicate that 80% of home builders subcontract at least three-quarters of their total work. The average home builder uses 24 subcontractors for the construction of a single-family home. For example, 53% of home builders subcontract their sales operations.[2]

Present Law Rules

The prevailing tax and regulatory system reflects the economic importance of allowing businesses to determine how services are provided. Under present law, the determination of whether a specialist is an independent contractor or an employee is made by a facts and circumstances evaluation. This evaluation examines the nature of the work completed, the means and control of the work, and the circumstances under which the work is performed, among other factors. Internal Revenue Service Ruling 87–41 provides 20 such factors that may be considered in performing this evaluation. These factors include training, payment by job/time status, tool/material provision, and whether the specialist works for more than one business. Further, Section 530 of the Revenue Act of 1978 allows a business to treat a worker as an independent contractor if the IRS or past industry practice has accorded such status to similar workers in the past. Section 530 is an important policy tool for ensuring that inappropriate tax policy considerations do not interfere with efficient market operation and established business practice.

NAHB supports enforcement of these present law rules. Businesses or individuals that are in violation of these rules, either through wrongful misclassification of workers or through failure to pay taxes in full, can achieve an unfair competitive advantage in the marketplace. This hurts law abiding businesses and individuals in the industry.

Policy Recommendations

Nonetheless, the present law system is complex and potentially confusing. In some cases, misclassification of employees can occur due to unfamiliarity with the rules. This is due in part to the nature of the facts and circumstances test that is available to businesses.

Section 530 is useful because it establishes a safe harbor, thereby providing certainty to potential employers. NAHB recommends that compliance in this area could be improved by establishing additional safe harbors for common scenarios involving subcontractors that provide specialized services to businesses. Further, additional education efforts by the appropriate tax authorities concerning the benefits and responsibilities of being an independent contractor would be helpful. This would be useful for individuals who are new to the experience of being a subcontractor, and thus would prevent surprises concerning tax treatment at the end of the year.

However, NAHB opposes any attempt to legislate the particular circumstances under which professionals must be defined as employees or independent contractors. Such efforts would be damaging to the marketplace, particularly as they would be driven by tax policy considerations and not the economics of the marketplace. Furthermore, such policies would be complex and administratively difficult to enforce.

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[1] For more information, consult "Construction Workers: Settling In." Michael Carliner. Housing Economics, October 2003; and "Self Employment in Construction." Elliot Eisenberg. Housing Economics, January, 2001.

[2] Builders' Economics Council Survey: Special Analysis. May 2005.

Consider the example of a specialist who theoretically would be required by statute to be classified as an employee, despite the fact that the specialist may work for several employers in a given year. Each employer would be required to withhold payroll taxes for FICA purposes, but no accounting could be made for withholding made by other employers. This would create an administratively difficult task to resolve for both the IRS and the employers, which would result in higher business costs and cash flow challenges. Indeed, this example illustrates one of the merits of the existing system.

As a general principle, NAHB opposes tax proposals and policies that impose increased administrative burdens on businesses that play by the rules. For example, increasing information reporting requirements beyond present law rules would increase paperwork burdens on business, and small business in particular. Indeed, such small businesses are those firms that, due to the economics of utilizing specialists, rely on independent contractors the most and thus would shoulder the largest burden from increased paperwork requirements.

Conclusion

The classification of workers as either employees or independent contractors is important for all small businesses, but it is especially so for home builders. NAHB supports maintaining the efficiency and flexibility of the marketplace by continuing to allow employers to classify their workers as independent contractors, as merited. At the same time, we support enforcement of present law to ensure a level playing field for all small businesses. NAHB looks forward to working with the Committee and the Congress to achieve both of these goals.

Statement of Richard A. Samp

The "independent contractor" model of conducting business affairs is coming under increasing assault from government regulators, labor activists, and plaintiffs' attorneys, who often view the model as an impediment to maximization of tax revenues and to increased unionization of workforces. Such objections are generally wrong-headed and overlook the key role that independent contractors play in driving economic growth and business innovation.

But the free enterprise community is often its own worst enemy in the battle to preserve the independent contractor model. All too often, businesses are tempted to skirt the law by classifying individuals as "independent contractors" who quite clearly are employees. By doing so, businesses do not merely gain an unfair cost advantage over rivals. They also strengthen the hand of those who, if given the chance, would do away with the independent contractor model completely.

Why Independent Contractors?

When most of a person's time is devoted to providing services to a single entity or another individual, that person arguably is an "employee" and thus subject to numerous federal and state laws—*e.g.,* mandatory income tax withholding, minimum wage and overtime laws, employee and employer FICA, workers' compensation, and unemployment insurance. But there are many reasons why such individuals, if they genuinely operate independently, ought to be treated not as employees but as self-employed independent contractors.

Chief among those reasons is the entrepreneurial spirit that comes with being one's own boss. Those who operate their own businesses and whose incomes are dependent on how successfully they perform have much more incentive than do employees both to work hard and to find innovative ways to perform more efficiently. Allowing companies to farm out work to independent contractors rather than hire additional employees allows those companies to operate more efficiently as well. Companies that employ independent contractors can avoid being required to develop in-house expertise in performing specialized tasks and can instead concentrate on undertaking the core functions they do best. Companies can also use independent contractors to increase their flexibility in varying production output in response to fluctuating market demand.

How Much Independence Is Enough?

In general, the law permits an individual to be classified as an independent contractor if he or she controls most of the details regarding how and where work is to be performed. There will always be cases that are fairly close to the line that separates employees and independent contractors. In close cases, the analysis can get rather complicated, with administrative agencies applying variants of the infamous "twenty factor test." One can easily have sympathy for companies involved in

those close cases; huge amounts of money are often riding on the outcome, yet they often lack clear guidance regarding how those providing services must be classified.

Nonetheless, in most instances the analysis is relatively straightforward, and it should be fairly obvious to a company whether it is controlling how and where the service provider performs his work, and thus whether he must be classified as an employee. An insurance or real estate agent who establishes her own working hours and meets with customers of her choosing on her own schedule quite obviously can be classified as an independent contractor, notwithstanding that all of her work is performed for a single insurance or real estate company. Conversely, individuals hired by Attorney General-designate Zöe Baird and Supreme Court Justice Stephen Breyer to perform assigned domestic chores within their households during assigned time periods quite obviously should have been classified as employees. Many of the classification controversies have arisen not because the outcome was debatable, but because one side or the other was over-reaching.

Over-Reaching Employers

Companies that should know better have succumbed to financial temptation and have classified as independent contractors many individuals who, based on extensive control over how and when they work, should properly be deemed employees. By so doing, companies are threatening the viability of the entire independent contractor model by providing regulators with the ammunition they need to justify efforts to expand the definition of "employee."

Perhaps the area most rife with employer abuse is the construction industry. Sometimes, it seems that virtually everyone present on a construction site is designated an independent contractor, even though the construction foreman is telling workers precisely what tasks are to be performed in what order and in what time frames. A recent study by the Construction Policy Research Center, affiliated with Harvard University, found that as many as 1 in 4 construction companies in Massachusetts have misclassified employees as independent contractors, and the prevalence of misclassification is on the rise. *See* Francoise Carre and Randall Wilson, *The Social and Economic Costs of Employee Misclassification in Construction* (Dec. 2004). Such worker misclassification can relieve employers of considerable employment tax responsibilities. It can also work to the advantage of workers, who realize that the absence of tax withholding on their wages can facilitate under-reporting of income[1] as well as employment of undocumented aliens. But worker misclassification significantly disadvantages other law-abiding employers, who pay their taxes yet must compete with the scofflaws. It also impacts the public at large, which endures underfunding of such programs as workers' compensation funds designed to compensate workers injured on the job.

Other industries with serious misclassification problems include limousine companies and delivery services. When the service that an individual provides to a company consists of driving a vehicle to benefit the company's customers, that individual should almost surely be deemed an employee when the company (as is often the case) retains significant control over when and how the individual performs his services. For example, if a limousine driver wears a company uniform; must service customers designated by the company within a time frame set forth by the company; drives a vehicle meeting detailed company specifications; performs virtually all of his services for that company; and must abide by a detailed set of operating procedures, there is virtually no basis for classifying the driver as an independent contractor. Yet numerous limousine companies that have adopted such working conditions nonetheless misclassify their employees in that manner.

One package delivery company that finds itself facing adverse administrative and court judgments regarding misclassification of employees is Federal Express, which classifies drivers in its Ground and Home Delivery divisions as independent contractors. FedEx faces at least 36 class-action lawsuits filed by drivers who claim they really are employees; those suits have been consolidated before a Federal court multi-district litigation panel in Indiana. In December 2005, a Los Angeles County Superior Court judge ruled, following a nine-week trial, that FedEx had violated California law by improperly classifying a group of drivers. The court ruled that the drivers were employees and ordered FedEx to pay them $5.3 million, given FedEx's substantial control over the drivers' work activities—including requiring drivers to comply with detailed work procedures, wear uniforms and drive trucks displaying company logos, work a minimum number of hours, deliver all packages assigned to them, and perform virtually all of their work for FedEx. The California court judg-

[1] The Internal Revenue Service estimates that taxpayers pay tax on less than one-half of the income for which the IRS receives little or no reporting information, such as payments made to independent contractors.

ment is echoed by rulings from the National Labor Relations Board Region 22 (November 2004), Region 4 (June 2005), and Region 1 (January 2006) that FedEx drivers were misclassified as independent contractors and should be deemed employees.

In general, a company that engages large numbers of individuals to provide services for the company on a full-time basis should seriously consider whether those individuals should be classified as employees, particularly when they provide a service that is a core component of the company's operations. In such situations, the company very often out of necessity will prescribe large segments of the individuals' day-to-day activities—in which case the individuals almost surely should be classified as employees. Unless the individual brings some special "skill set" to the table (*e.g.,* a licensed insurance or real estate agent or an IT professional) such that the individual could easily transfer his services to another company at a moment's notice, a company that classifies such an individual as an independent contractor has little good-faith grounds for doing so. Such individuals cannot legitimately be deemed "entrepreneurs" if they are not building up a business that provides, or even realistically could provide, services to those other than the company's customers.

There are, of course, numerous reasons other than increased taxes why companies would want to keep to a minimum the number of "employees" on their books. For example, while governments impose regulations on the business community that in some cases can legitimately be categorized as onerous, statutes often waive those regulations for companies with fewer than a specified number of employees. But if a regulation is overly burdensome, the response of the business community ought to be to unite to seek a change in the regulation, not to adopt questionable worker classification policies to reduce a company's claimed employee roll as a means of evading the regulation.

Over-Reaching Regulators

But over-reaching is hardly limited to the business community. Government regulators have considerable financial and bureaucratic incentives to expand the definition of "employees" as far as courts and legislators will permit them. If regulators succeed in having those formerly classified as "independent contractors" reclassified as "employees," revenues derived from a variety of taxes and fees (income tax, FICA, unemployment) will rise sharply. Tax collectors are well aware that non-reporting of income is far higher among independent contractors, who generally are not subject to nearly as many reporting and withholding requirements as are employees. Regulators' natural inclination to expand the definition of "employees" is egged on by labor unions (who understand that employees are easier to organize than are independent contractors) and by lawyers (who view litigation regarding alleged misclassification of employees as a growth opportunity for the trial bar).

All too frequently, such over-reaching leads to truly unfortunate enforcement actions and litigation, such as *Fleece on Earth v. Vermont Department of Labor*, a case pending before the Vermont Supreme Court. The case involves a small country store in Vermont (Fleece on Earth, or "Fleece") that sells home-made sweaters. The sweaters are knitted by (usually elderly) women working in their own homes on their own schedules and at their own pace. The only store to whom the women sell is Fleece; the store pays the women on a per-sweater basis. Given the considerable control the women exercise over their own work schedules, Fleece quite understandably has classified them as independent contractors. The Vermont Department of Labor, apparently seeking to position itself as the champion of elderly workers being "exploited" by the business community, sees things differently. It claims that the knitters should be deemed "employees" and has assessed Fleece for unpaid taxes, unemployment, and workers' compensation. Fleece has appealed that assessment to the Vermont Supreme Court.

In seeking to expand what constitutes an "employee," the Vermont Department of Labor appears to be oblivious to the needs of the business community or the economic value of encouraging entrepreneurial activity. It apparently did not occur to regulators that knitters might well decide not to engage in their craft if deprived of the flexibility to decide when and how often to work. Moreover, if the assessment is upheld, it is difficult to see how any individual performing services for a single company in Vermont could ever be deemed an independent contractor.

Conclusion

The existence of employer abuses has provided ammunition to those who are pushing state regulators and legislatures to crack down on use of the independent contractor model. Unless the free enterprise community can get its own house in order, we can expect to see more businesses like Fleece on Earth being threatened with financial ruin by over-reaching regulators. Given the tremendous entrepreneurial contribution that truly independent contractors make to the American econ-

omy, the business community needs to do all it can to ensure that the independent contractor model survives.