Fact Sheet 2012

The Misclassification of Employees as Independent Contractors

The distinction between genuine independent contractors and employees misclassified as independent contractors is a complicated but crucial matter. Misclassification is often the result of cost-cutting measures instituted by employers at the expense of their employees. While misclassification can be understood through a complex set of definitions set forth by several government agencies, the impact it has on employees is clear. Misclassified employees lose workplace protections, including the right to join a union; face an increased tax burden; receive no overtime pay; and may have no recourse for workplace injury violations and disability-related disputes. Misclassification also causes federal, state, and local governments to suffer revenue losses as employers circumvent their tax obligations.

This fact sheet will cover a range of issues surrounding the misclassification of employees as independent contractors, including legal definitions of independent contractors; the reasons why an employer would misclassify an employee as an independent contractor; the extent of misclassification; the costs and consequences of employee misclassification; and what states and the federal government are doing to combat misclassification.

Defining Independent Contractor

An independent contractor provides a good or service to another individual or business under the terms of a contract.[1] The independent contractor is not subject to the employer's control or guidance except as designated in a mutually binding agreement. The contract for a specific job usually describes its expected outcome.[2] Essentially, independent contractors treat their employers more like customers or clients, often have multiple clients and are self-employed.

A broad range of workers who pursue an independent trade, business, or profession are generally not legally considered employees. For many professionals, however, the line is often blurred, and workers can be classified as either employees or self-employed independent contractors. There are several different standards used to determine if an individual is legally an independent contractor. While the intricacies of contracting are too numerous for a comprehensive treatment and the applicability of the test depends on the specific workplace situation, generally, the independent contractor tests employed by the Internal Revenue Service (IRS) and the Department of Labor (DOL) offer useful guidelines as to who is and who is not an independent contractor.

Internal Revenue Service Test:

Because misclassification often results in lost tax revenue, the IRS has a vested interest in determining when it occurs. For the IRS, there is no set number of factors that determines "employee" or "independent contractor" status. The IRS looks at factors that help it determine whether or not an employer has the right to control the details of how services are performed. A worker is generally not an independent contractor if he or she performs services that can be controlled by an employer.[3]

Based on this general rule, the facts that provide evidence of the degree of control and independence fall into three categories:

1. Behavioral: Does the company control or have the right to control the worker as well as how the worker does her job? For example, if a company provides training for the worker, this signals an expectation to follow company guidelines and thus employment status.
2. Financial: Are the business aspects of the worker's job controlled by the payor? (These include things like how a worker is paid, whether expenses are reimbursed, who provides tools, supplies, etc.) Only an independent contractor can realize a profit or incur a financial loss from his or her work.
3. Type of Relationship: Are there written contracts or employee-type benefits (i.e. pension plan, insurance, vacation pay, etc.?) Will the relationship continue, and is the work a key aspect of the business? [4]

The issue of who has the right to control is often not clear-cut and the tax code does not define "employee." Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor.[5]

The DOL Economic Reality Test:

The DOL has an interest in ensuring accurate classification because only employees receive Fair Labor Standards Act (FLSA) benefits (Federal minimum wage, overtime pay, etc.). The DOL uses an "economic reality test" to determine who is an employee and, thus, eligible for FLSA benefits, by trying to establish whether the worker is economically dependent on the supposed employer. According to the DOL, "an employee, as distinguished from a person who is engaged in a business of his or her own, is one who, as a matter of economic reality, follows the usual path of an employee and is dependent on the business which he or she serves."[6]

The DOL derives its position from judicial precedent. As the U.S. Supreme Court has not established a single rule or test for determining whether an individual is an independent contractor or an employee, the DOL stresses the factors the Court has considered significant:

1. The extent to which the services rendered are an integral part of the principal's business.
2. The permanency of the relationship.
3. The amount of the alleged contractor's investment in facilities and equipment.
4. The nature and degree of control by the principal.
5. The alleged contractor's opportunities for profit and loss.

6. The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor.
7. The degree of independent business organization and operation.[7]

Determining economic reality demands only common sense judgments. An employee who only invests time in an enterprise and who sells his or her services to only one "customer," the employer, is economically dependent upon that work. An independent contractor is in business for him or herself, invests in his or her own equipment and supplies, and has a broad customer base.[8]

Reasons for Misclassifying an Employee as an Independent Contractor

The largest incentive for misclassifying workers is that employers are not required to pay Social Security and unemployment insurance (UI) taxes for independent contractors. These tax savings, as well as savings from income, Social Security, and Medicare taxes results in employers saving between 20 to 40 percent in costs.[9] However, there are a number of other dishonest advantages an employer may derive from misclassifying an employee.

- Because employment and labor laws are based on traditional employee-employer relationships, misclassifying employees as independent contractors can free employers from responsibility under key laws designed to protect the workforce, including minimum wage and hour laws.[10]
- Employers may misclassify workers as a way to circumvent laws overseen by the Equal Employment Opportunity Commission that protect the workplace civil rights of employees, including prohibitions of employment discrimination based on factors such as age, race, gender, or disability.[11]
- Employers can thwart union organizing or dilute bargaining units by misclassifying workers. Independent contractors are not covered by the National Labor Relations Act.
- Independent contractors are usually not permitted to enroll in employer-based health and pension plans, allowing employers to save money on benefits.[12]
- Employers may misclassify their employees to avoid having to verify that workers are U.S. citizens or covered by a work visa. By doing so, employers can ignore labor laws with impunity and exploit low-wage immigrant workers with few legal repercussions.

Misclassification in the FedEx Business Model—a Case Study: It is estimated that FedEx cuts its labor costs by as much as 40 percent by misclassifying drivers as independent contractors. Although drivers have little control over the way in which they perform their job or run their routes, FedEx has long denied that FedEx Ground and FedEx Home drivers are employees entitled to benefits and the right to unionize. By classifying drivers as independent contractors, FedEx is able to transfer operation costs onto its drivers. FedEx is exempted from paying UI and Social Security taxes for the workers, and they are not included in FedEx's health and pension plans.[13]

The Extent of Misclassification

Due to the nature of employer misclassification, accurate data on the extent of the practice is difficult to find. One must examine both state and federal estimates to get an idea of the widespread nature of misclassification. As state audits generally only target two percent of employers and many cases of misclassification occur in the "underground" economy, estimates likely undercount the actual number of misclassified workers.[14]

- According to a 2011 list of state audits compiled by the National Employment Law Project, by extrapolating from audit data of misclassified workers to account for employers in the entire state there are an estimated 368,680 misclassified workers in Illinois, between 125,720 and 248,200 in Massachusetts, 704,780 in New York, between 54,000 and 459,000 in Ohio, and 580,000 in Pennsylvania.[15]
- The DOL commissioned a study in 2000 to determine the extent of misclassification in the unemployment insurance system. The study found that up to 30 percent of audited firms misclassified their employees as independent contractors.[16]
- Misclassification occurs in nearly all major industries, including delivery services, building maintenance and janitorial services companies, agricultural firms, home health care, and child care. Misclassification rates are especially high in construction. In 2007, the Fiscal Policy Institute released a study on misclassified construction workers in New York City, estimating that 50,000 (one in four) workers were misclassified as independent contractors or employed by construction companies completely off the books.[17]
- The IRS Form SS-8, "Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding," provides employers and workers with an opportunity to receive IRS guidance or an internal audit of the business. The IRS estimates as many as 85 percent of all Form SS-8 filers submit the form because they want to contest their treatment as independent contractors.[18]

The Costs and Consequences of Employee Misclassification

Employee misclassification robs individual workers of their rights and benefits, adversely impacts the effective administration of many federal and state programs, and creates unfair competition for law-abiding employers.

- Based on a 1984 estimate by the IRS, the U.S. Government Accountability Office estimates that employer misclassification cost the federal government $2.72 billion in 2006.[19] Nearly 60 percent of lost revenue was attributable to the misclassified individuals failing to pay income taxes on compensation. The remaining losses stemmed from the failure of employers and misclassified workers to pay taxes for Social Security and Medicare and the failure of employers to pay federal unemployment taxes.[20]
- A 2000 study commissioned by the DOL found nearly $200 million in lost UI tax revenue per year through the 1990s due to misclassification. Carrying this number forward to 2005, estimated UI losses would be on the order of $343 million per year.

The study also found that misclassifying employees as independent contractors resulted in lost UI benefits for 80,000 workers annually.[21]

- A federal loophole exists, known as the "Safe Harbor Provision" (Section 530 of the Revenue Act of 1978), which precludes the IRS from collecting income taxes from employers who "reasonably" misclassify their workers as independent contractors. The loophole was intended to be temporary until more workable rules were created but the provision was extended indefinitely in 1982. Thus, any employer with a reasonable explanation is relieved from having to pay back taxes and the IRS cannot correct the misclassification in future tax years.[22] About 40 percent of unpaid taxes and penalties cannot be assessed because of the Section 530 restrictions, while the Congressional Research Service estimated that a modification to the "Safe Harbor" rules would yield $8.71 billion from 2012 to 2021.[23]
- States also suffer losses in UI tax revenue due to misclassification. New York estimated a loss to the state UI fund of $176 million annually. In Illinois and Massachusetts, the annual UI revenue loss was estimated to be $39.2 million and $12.6-$35 million, respectively.[24]
- For 2010, Virginia estimated there were about 40,000 employers misclassifying their employees, potentially shorting the state about $28 million in general fund revenue.[25]
- Because companies that misclassify their workers can unfairly lower their labor costs by as much as 40 percent, they gain an advantage over law-abiding competitors. This uneven playing field means that lawful employers are underbid and lose business, wages and labor standards are depressed across the board, and ultimately lawful employers subsidize the freeloaders in the form of increased workers' compensation and health insurance premiums.[26]

State and Federal Government Action to Combat Misclassification

In today's strained fiscal environment both federal and state governments are taking enhanced steps to combat employer misclassification. On the federal level, the IRS audits employers for unreported federal taxes stemming from misclassification. States, meanwhile, are passing initiatives and laws to protect employees and crack down on unlawful employers.

- While the IRS is responsible for auditing employers, the DOL, during the Obama Administration, has taken steps to increase employer accountability. In September 2011, Secretary of Labor Hilda Solis announced the signing of a Memorandum of Understanding (MOU) between the DOL and IRS. Under the agreement, the agencies will work together and share information to reduce the incidence of misclassification of employees, to help reduce the tax gap, and to improve compliance with federal labor laws.[27]
- The DOL, with the encouragement of Vice President Joe Biden's Middle Class Task Force, launched the "Misclassification Initiative," which seeks to combat misclassification and FLSA violations through the DOL's Wage and Hour Division.[28]
- In 2011, the DOL collected more than $5 million in back wages on behalf of about 7,800 employees who had been misclassified—a 500 percent increase over the amount

collected in 2008. They have also hired 300 additional investigators to probe complaints.[29]

- The administration's 2010 budget assumed that a federal crackdown on misclassification would yield at least $7 billion over 10 years.[30]
- Labor commissioners and other agency leaders representing 13 states have signed MOUs with the DOL. These MOUs will enable the DOL to share information and to coordinate enforcement efforts with participating states to ensure that employees receive the protections to which they are entitled under federal and state law.[31]
- Many states have also taken the initiative to combat employee misclassification. States like New York, Massachusetts, Michigan, New Jersey, and Iowa have created inter-agency task forces to study the magnitude of the problem and coordinate and strengthen enforcement mechanisms.[32]
- The efficacy of these task forces is apparent. In 2010, the Massachusetts Joint Task Force on the Underground Economy and Employee Misclassification recovered nearly $6.5 million through its enforcement efforts. That same year, New York's Joint Enforcement Task Force on Employee Misclassification identified over 18,500 instances of misclassification, discovered over $314 million in unreported wages, and assessed over $10.5 million in unemployment taxes, over $2 million in unpaid wages, and over $800,000 in workers' compensation fines and penalties.[33]
- In terms of legislation, states are beginning to pass laws creating a "presumptive employee status." Often focused on employment sectors with a high number of violations, these laws require employers to overcome this presumption by proving a degree of worker independence. Such laws have been passed in Pennsylvania, Delaware, Colorado, Minnesota, New York, and Maine and are being introduced in other states.[34]

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For more information on professional and technical workers, check DPE's website: www.dpeaflcio.org.

The Department for Professional Employees, AFL-CIO (DPE) comprises 21 AFL-CIO unions representing over four million people working in professional and technical occupations. DPE-affiliated unions represent: teachers, college professors, and school administrators; library workers; nurses, doctors, and other health care professionals; engineers, scientists, and IT workers; journalists and writers, broadcast technicians and communications specialists; performing and visual artists; professional athletes; professional firefighters; psychologists, social workers, and many others. DPE was chartered by the AFL-CIO in 1977 in recognition of the rapidly growing professional and technical occupations.

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