AMERICAN RIGHTS AT WORK

Billions in Revenue Lost Due to Misclassification and Payroll Fraud

Misclassification of employees as independent contractors costs us all: federal and state governments, businesses, workers, and taxpayers. Our laws grant workers vital workplace benefits and protections, as long as the worker is a direct *employee* of the employer. Consequently, workers who are independent contractors in name only are cheated out of important benefits and legal protections.

Furthermore, government and academic studies estimate that the federal government loses *at least* $3-4 billon annually due to misclassification, and billions more due to off-the-books cash payments. State studies indicate that that figure could be much higher. At a time when the federal and state governments are facing such difficult budget choices and making cuts to programs that Americans depend upon, there is no excuse for allowing so many businesses to cheat the system.

The federal government loses *billions* of dollars in tax revenues each year due to misclassification

More than 25 years ago, the IRS estimated that about 15% of employers misclassified their employees as independent contractors, costing the federal government nearly $3 billion each year in income, payroll, and federal unemployment taxes.[1] Since that time, the prevalence of misclassification and employers paying their workers in unreported cash has skyrocketed.

- The U.S. Treasury Department estimates that a provision to prevent misclassification in the Obama Administration's 2013 budget would bring in $8.32 billion in federal revenue over 10 years.[2]

- $3–4 billion each year in federal income and employment tax revenue is lost due to misclassification.[3]

- Census data analyzed by the Fiscal Policy Institute shows a disproportionate growth in the non-employer sector compared to payroll employees. Non-employers are businesses without paid employees and are mostly self-employed individuals. Between 2000-2005, U.S. payroll employment grew by 2.4%. However, non-employer growth was 23.6%, nearly a 50% increase in annual absolute growth. This disparity in growth rates likely reflects increasing misclassification.[4]

- Ten to 30% of all employers misclassify their employees, according to a conservative estimate by the U.S. Department of Labor. [5]

- A total of approximately 1.8 million workers were found to have been misclassified in four states that have recently conducted studies – Illinois, Maine, Massachusetts, and New York.[6] National figures on the total number of misclassified employees are not available.

Misclassification and unreported cash pay are significant parts of the 'tax gap'

The 'tax gap' is money that is owed but not paid. It is composed of under-reporting of tax liabilities on tax returns, underpaying taxes reported on filed returns, and late-filing or non-filing of tax returns.

- The IRS estimated that $68 billion of the annual $345 billion gross tax gap for 2001 was due to sole proprietors, business owners who alone own all of a company's assets, under-reporting their net income by 57%.[7]

- If even a fraction of that sole proprietor tax gap was the result of misclassification and/or unreported cash, the federal tax gap due to misclassification would be closer to $10 billion dollars a year.

State and local governments are also losing hundreds of millions, and often billions, in state revenue

- Illinois alone loses an estimated $300-400 million a year in income taxes, unemployment insurance taxes, and workers' compensation premiums due to misclassification,[8] while Massachusetts loses $195-278 million a year.[9]

- On average, 30% of Michigan employers misclassify employees as self-employed workers or under-report employee payroll.[10] Annually, this results in an estimated underpayment of state income tax of $20 to $33 million, and an estimated loss to the federal government of between $57 and $96 million.[11]

- From 1997 to 2002, as workers compensation premium levels rose, under-reporting in California increased from between 6-10% of private industry payroll to 19-23 percent. This translates to as much as $100 billion in under-reported payroll in 2002, and could amount to a loss in federal employment tax revenue of as much as $15 billion. *That's $15 billion in one year, from one state*.

- In New York from 2002 to 2005, data for a range of industries shows that, on average, more than $4 billion in unemployment insurance taxable wages were under-reported due to misclassification each year.[12] For the same period, the under-reported unemployment insurance taxes totaled $175.7 million.

- Ohio loses an estimated $890 million annually in state unemployment taxes, workers' compensation premiums, and state and local income taxes. This translates to an estimated loss in federal Social Security and Medicare taxes of $500-600 million and in federal income taxes of $500 million.[13]

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[1] U.S. Government Accountability Office, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification* (2006) 2. "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." Adjusted to 2006 dollars.

[2] U.S. Department of the Treasury. "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals," February 2012. Explanation on page 148: http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf, figures in table: http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013-Tables.pdf.

[3] *See* Ibid; *The Dunlop Commission on the Future of Worker-Management Relations: Final Report* (1994) 62 ($3.3 billion projected loss in 1996 would be equivalent to $4.3 billion in 2007 dollars).

[4] Fiscal Policy Institute, *State of Working New York* (2007).

[5] Lalith de Silva et al., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, prepared by Planmatics, Inc., for U.S. Department of Labor, Employment and Training Division (2000) iii.

[6] *See* Michael Kelsay, et al., *The Economic Costs of Employee Misclassification in the State of Illinois* (2006) [Illinois Study]; Françoise Carré, *et al*., *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry* (2005) 13; Françoise Carré, et al., *The Social and Economic Costs of Employee Misclassification in Construction* (2004) 2 [Massachusetts Study]; Linda H. Donahue et al., *The Cost of Worker Misclassification in New York State* (2007). All of the above studies are available via United Brotherhood of Carpenters.

[7] *See* GAO, Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification (2007).

[8] *See* Illinois Study, *supra* note 2, at pp. 6-7.

[9] *See* Massachusetts Study, *supra* note 2, at p. 2.

[10] Dale L. Belman and Richard Block, School of Labor and Industrial Relations, Michigan State University, *The Social and Economic Costs of Employee Misclassification in the Michigan Construction Industry* (2008).

[11] Using the average tax rate of 12.9% of adjusted gross income found in the Statistics of Income for 2005, see Ibid p. 14.

[11] See Donahue, *The Cost of Worker Misclassification in New York State* (2007) at 15, n. 40. Audited industries included construction; manufacturing; wholesale and retail trade; transportation and warehousing; information; finance and insurance; real estate; professional, scientific, and technical services; administrative and support and waste management and remediation services; health care and social assistance; arts, entertainment, and recreation; other industries.

[13] *Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio* (Feb. 18, 2009).