

SECOND REPORT
of the
TASK FORCE ON
EMPLOYEE MISCLASSIFICATION
OCTOBER 1, 2009

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MISSION STATEMENT

The Task Force was formed to study employee misclassification throughout the state of New Hampshire, focusing on what is meant by misclassification, the extent of misclassification, relative levels of misclassification in different industries and different regions of the state, and the impacts of misclassification on worker protections, revenue and funding. Further, the Task Force will report its findings and, if necessary, develop a comprehensive and statewide strategy to begin to address the issues identified, including its recommendations and if appropriate, proposed legislation.

Introduction

The 2008 session of the New Hampshire General Court passed Senate Bill 500, which along with strengthening penalties for employers purposely avoiding workers' compensation insurance to their employees, also established a New Hampshire Task Force to Study Employee Misclassification.

Worker classification in the broader sense refers to the designation of a worker as an employee or independent contractor. Under New Hampshire law, every worker is considered to be an employee until proven otherwise. Working as an independent contractor is a legitimate and well-accepted business model here in NH, and using independent contractors is a legal means of doing business. However, in New Hampshire and nationally, there has been growing concern about the number of workers who are, in fact, employees but are being treated as independent contractors.

Correct classification of workers has important implications. Incorrect classification as either an employee or an independent contractor may affect many public and private issues, including but not limited to labor standards such as minimum wage and overtime requirements, unemployment insurance, federal and state payroll taxes, business profit taxes, compliance with workplace safety and health requirements and workers compensation insurance.

Neither employers nor workers can voluntarily choose one status over another. Rather, various conditions and criteria for determining worker status are contained in federal and state laws and rules, and these factors are applied to the facts and circumstances of a specific relationship between a worker and an employer. In some cases, a worker may be an independent contractor for certain purposes and an employee for others.

Employers that misclassify employees as independent contractors may not pay their fair share of business taxes, withhold income taxes or pay the employer's share of FICA and unemployment insurance. Other taxpayers are then required to pay relatively more in taxes to make up for those who avoid their obligations.

Many studies have been done or are ongoing around this issue, with one of the fundamental concerns being that employers that correctly classify their workforce as employees are likely to be at a competitive disadvantage to those employers that misclassify workers and thus avoid some of the costs of doing business we discussed above. Estimates of the cost savings to non-compliant employers, while they vary, can be significant. In a competitive industry, especially one where competing organizations bid for contracts or jobs, this may mean lost business opportunities for those employers who 'play by the rules' and thus incur higher overhead costs.

While misclassified workers are still eligible to receive unemployment compensation and workers' compensation for workplace injuries, the payment of such benefits may be delayed for an extended period of time while a determination is made as to whether they were misclassified. Typically, this determination process must be initiated by the worker, despite the fact that under New Hampshire law there is a rebuttable presumption that workers are employees. Many workers are unaware of their rights, and thus may not even seek benefit determinations. Such benefits are ultimately funded by other employers who have been properly paying their share of unemployment compensation and workers' compensation. However, when a misclassified worker's employer carries no workers' compensation insurance, the cost for treatment for any workplace injury will ultimately be passed along to health insurers and state free care pools. This places an additional burden on taxpayers/consumers and employers who do provide health insurance. Finally, they may not be able to seek protections that employees are entitled to under the Fair Labor Standards Act or various employment discrimination laws.

The second meaning of misclassification is within the workers' compensation arena. Workers are classified by the type of work they do, and the premiums are developed based on those classifications. Since different types of work result in different levels of risk of employee injuries or illnesses, the rates vary by classification. Thus, if employees are misclassified into the wrong employment types the premiums will not adequately reflect the risk of the work they do. The result is that honest employers may pay more than their fair share of premiums.

The Mission Statement (shown above) will continue to focus and direct the activities of the Task Force, and allow us to look at employee misclassification from both these perspectives. The Task Force has spent the last year in working toward an understanding of the effects of Employee Misclassification on our government agencies, the economic situation and business, and the consumers of the state. In addition, the Task Force has collected information on how the issue of Employee Misclassification is being viewed and handled in other states, and even at the national level. While we continue to seek information through presentations and publications, we are also moving into the next phase of our work, which is to develop tangible and realistic strategies for addressing the issues.

Meeting of January 13, 2009

Commissioner George Copadis (DOL) spoke about a website that the Labor Department is implementing, to be active before the end of January. The website allows members of the public to verify whether an employer has workers' compensation insurance coverage.

Also, the Task Force heard from Tom Jones (MA DOL) and Ray Marchand (MA Department of Industrial Accidents, or DIA.) Both are members of the Massachusetts Joint Task Force on the Underground Economy and Employee Misclassification. They explained the background leading to the formation of the Massachusetts Task Force – by executive order - approximately one year prior and how it now has a full-time Executive Director. The goals of the Task Force are compliance and education; punitive measures are used as a tool to achieve compliance. Since the formation of the Task Force, compliance with workers' compensation coverage laws has increased.

They explained how they defined the underground economy, with a focus on violations of the labor, licensing and tax laws. The MA Task Force helps ensure that employers that don't carry workers' compensation insurance are unable to obtain licenses and permits, such as building permits. The MA DIA has the authority to issue stop work orders when an employer does not have workers' compensation insurance; the Department does not require court action to issue these orders as in NH. The statute has a three year debarment period from government contracts for companies that are found operating without workers' compensation insurance. The MA Task Force has observed both the lack of workers' compensation coverage and the misclassification of employees.

However, the Task Force's enforcement powers are limited and generally do not include misclassification issues. Such cases are typically referred to the Massachusetts Insurance Fraud Bureau.

The MA Task Force has a tip-line that is answered by a MA DIA Chief Investigator. Some calls are anonymous; some are not. They receive about 50 tips per month on average. Each tip is then passed along to the other member agencies and the agencies then report back as to whether or not they will be participating in a joint investigation. They have handled approximately 12 major criminal prosecutions through this procedure.

In response to a question from a member of our NH Task Force, they confirmed that there are difficulties with the fact that some of the participating agencies are prohibited by law from exchanging certain information with other agencies; this is a significant issue in NH both for inter-agency sharing of information and what information can be released publicly.

Meeting of March 9, 2009

At the request of the House Labor Committee, the Task Force provided a forum for discussion of HB 108, (AN ACT: establishing an employers' private right of action to enforce the payment of workers' compensation coverage) and how it impacted the issues before the Task Force.

Rep. Long, as the prime sponsor, provided a history of the bill to the committee and then deferred to Attorney Mickey Long, who he stated could speak to the subject more informatively than he. Attorney Long stated that he was there representing not only Unions but that he also represents business in MA. He believes that the system has been allowing an unfair advantage to some businesses, based on them not including some or all of the cost of workers' compensation in the cost of their bids – i.e. cheating, or circumventing the law. HB108 was developed to try to stop this practice by allowing a private right of action by other employers disadvantaged by the unscrupulous employer.

Questions by the Task Force members focused on two major themes: the potential for abuse by larger employers and the need for better communication between state agencies. Some of the questions raised included:

1. What happens to innocent employers? Is there intimidation by larger employers?
2. What about potential abuse (i.e. tying up an employer in a frivolous lawsuit?)
What will prevent frivolous lawsuits?
3. How many cases might be expected to go to suit under this private right of action?
4. Why would this be necessary at all; wouldn't insurance companies go after the appropriate premiums once it becomes known that they were due? The insurance company has first claim.

In response to this group of questions, Attorney Long reiterated that under the bill, any penalties actually resulting from one of these suits go to the state and not to the employer (no direct financial incentive), that the court might award attorney fees and expenses to discourage and act as a deterrent to frivolous lawsuits or those designed to intimidate, and that for the most part attorneys are ethical and would not encourage frivolous or unjustified lawsuits. Further, Attorney Long indicated that his best estimate of the number of cases we might see is a couple of cases per year on average because of required resources, the complexity of the issue and the ramifications of bringing a suit like this. As to the question of premiums collected by the insurer, Attorney Long indicated that he believed there were cases where the insurers did not go after these premiums; Task Force members in the insurance industry indicated that their view is that an insurer who finds out about fraud, misunderstanding or misrepresentation leading to under-paying of WC premiums would (after the audit) try to collect any uncollected premium of any significance.

1. Will the private right of action actually make a difference, given the time lag before it would be adjudicated and the fact that the behavior would be months or years in the past?
2. There is a major issue with follow-up by the DOL; would the sponsors of the bill support language to facilitate this follow-up?
3. Is there any way under existing law to have various state agencies work together to leverage their various powers to help ensure compliance with the letter and intent of laws affected by employee misclassification and lack of workers' compensation coverage?

This group of questions was mostly somewhat rhetorical, as it is difficult to answer them with any definitiveness at this time, but the Task Force agreed that it would further explore the options for greater inter-agency communication as well as for communication between regulatory agencies and industry.

A motion was made and seconded to send a letter to the HB 108 sub-committee chairman with the Task Force's recommendations. There was discussion of whether this was really within the purview of the Task Force, after which the motion was put to a vote and failed (5 affirmative and 6 negative.)

Meeting of April 15, 2009

The primary issue of the April 15th meeting was the information sharing between DOL and WC insurers; this issue was first raised in the February Task Force meeting.

Insurance companies perform audits on workers' comp policies after the policy expiration dates, but may also perform interim audits if they want. The goal of interim audits would be to confirm that correct employee classifications were being used and that payrolls were correctly estimated, and thus to increase the accuracy of premiums being charged. Audits may be physical (the insurer actually going out to the company) but many are done remotely, especially for smaller businesses. Questions were raised as to whether it would be reasonable, or even possible, to mandate interim audits and whether physical audits should be required over a certain dollar threshold (e.g. \$25,000 of premium.) After discussion, the Task Force agreed that these are business practices that should not be put into statute or regulation, but that should be left up to the insurer and should be voluntary. Also, it was noted that premium audits are less likely to turn up misclassification issues than loss control audits may be, since premium audits typically take place in corporate or other office sites but loss control audits are on job-sites themselves.

However, the Task Force also agreed that there is information known to individual state agencies that, if it were allowed to be shared, would facilitate investigation by into issues related to employee misclassification and possible action to address these issues. The MA Task Force was discussed again, and their ability to share information between various agencies so that, for example, a restaurant that didn't carry workers' compensation could have their liquor license pulled, or a contractor without workers' compensation insurance may not be able to get a building permit.

The questions raised were: Can DOL or NHID share information they collect about possible misclassification by an employer with the insurer holding that account? Can DOL and NHID even share this type of information between the two agencies?

The Task Force will work with representatives of the agencies as well as the Attorney General's office to determine what is possible under existing law. The Chair further

reminded members that there is now in place a website (through the DOL) where people can go to determine whether an employer has workers' compensation coverage. In addition, the Chair informed the Task Force that another website is under development; it will allow 'tips' to be submitted regarding possible employee misclassification and will forward that information to various state agencies so that they can each see if action may be warranted. While this is a start, the information available is limited and the sharing is one-way only.

Meeting of May 12, 2009

This meeting further addressed information sharing and communication issues, both between state agencies and between state agencies and the insurance industry.

First, there was discussion about information held by the DOL. Hearings with regard to workers' compensation claims or possible employee classification discovered during audit are held by the DOL. In general, information (including medical information) held by the DOL pursuant to these complaints and hearings is confidential and may only be shared as the result of an approved Right-to-Know petition under state law. Thus, there is no direct way for the DOL to inform insurers that they may have written a policy where there are misclassification issues to be investigated and addressed. The question was raised as to whether DOL could share the results of completed hearings with NHID and then NHID (who communicates regularly with insurers) could share any or all of that information with the appropriate insurers when there was a determination that misclassification existed. In some cases, there is only an 'informal hearing' at DOL which may make it more difficult to share information, as there is no actual finding.

Next the Task Force looked at information sharing possibilities between state agencies. Ellery Hathorn gave examples of situations where information sharing would be to the financial advantage of the state; e.g. in a case where fines by the DOL are pending, the employer would be more likely to actually pay them promptly be paid if another state agency could refuse to issue a license of some kind to that company until they were paid in full. Some members of the Task Force were concerned about bureaucratic delays in this process causing undo hardship and adversely affecting the business community; an idea to address this was for an agency to issue a provisional license only until fines to all agencies were paid in full. There is some precedent in NH for this type of arrangement (DMV.)

A motion was made and seconded to establish a subcommittee charged with investigating what is currently possible with regard to interagency cooperation between DOL, NHID, NHES and DRA, which motion was approved. Ron Ciotti asked that it be put on record that he felt that the motion exceeded the scope of the Task Force. The sub-committee includes Deb Stone, Ellery Hathorn, Jeff Goley, John Lighthall, Ron Ciotti and Lon Siel.

Finally, the Task Force discussed penalties available in each state agency regarding workers' compensation or employee misclassification. The Department of Revenue

Administration stated that they had no specific penalties for workers' compensation infractions. The Insurance Department stated that they had no established penalties for infractions. Both the Department of Labor and the Department of Employment Security do have penalties for infractions.

No meetings were held from June to August because of the difficulties of coordinating speakers, meeting places and achieving a quorum of Task Force members during summer months.

Meeting of September 22, 2009

The Task Force heard from Mark Hounsell of Conway, NH. He reported to the Task Force that there is confusion in the northern part of the state as to the rules for employee classification, whether someone is truly an independent contractor, how the rules are enforced and how they work in an area where there are many small contractors engaged in small jobs where there may not be a written contract at all. There has been discussion between Mr. Hounsell and DOL and there will be one or more training sessions offered by DOL in that area.

A second major item addressed at this meeting was a preliminary discussion of the goals of the Task Force over the next months. The consensus is that we have done enough fact-finding and that now it is time to take action. Our next meeting will focus on developing strategic and tactical plans for the next twelve months. In the meantime, we have two action areas currently being worked on. The first, as described in the May 12, 2009 section of this document, concerns what information sharing and inter-agency cooperation is possible under existing state law and regulations.

The second issue is based on an issue concerned with NH RSA 281-A:2.VI(c), which reads:

(c) Prima facie evidence that the criteria prescribed in subparagraphs (b)(1)(A)-(L) have been met may be established by a written agreement signed by the employer and the person providing services, on or about the date such person was engaged, which describes the services to be performed and affirms that such services are to be performed in accordance with each of the criteria. Nothing in this subparagraph shall require such an agreement to establish that the criteria have been met. If the commissioner finds that the employer's use of such written agreement was intended to misrepresent the relationship between the employer and the person providing services, the commissioner may assess a civil penalty of up to \$2,500; in addition, such employer shall be assessed a civil penalty of \$100 per employee for each day of noncompliance. The fines shall be assessed from the first day of the infraction but not to exceed one year. Notwithstanding any provision of law to the contrary, any person with control or responsibility over decisions to disburse funds and salaries and who knowingly violates the

provisions of this subparagraph shall be held personally liable for payments of fines. All funds collected under this subparagraph shall be continually appropriated and deposited into a nonlapsing workers' compensation fraud fund dedicated to the investigation and compliance activities required by this section and related sections pertaining to labor and insurance law. The commissioner of labor shall appoint as many individuals as necessary to carry out the department's responsibilities under this section.

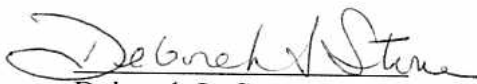
Based on this statutory language, DOL believes that they can not penalize an employer unless (1) there is a contract and (2) they intended to misrepresent the relationship as part of the contract. This does not allow them to penalize an employer at all when there is no written contract of this type, which may often be the case. The majority of the Task Force believes this is a loophole that should be addressed. A sub-committee was formed to develop language to address this perceived loophole in existing law and will be submitting legislation for the upcoming legislative session.

Conclusion

Over the last year, the Task Force has invited speakers from various state agencies, businesses and other states to help us explore and understand the issues before us. We are still planning to bring in a few more speakers, including a large contractor/sub-contractor and a small contractor/sub-contractor in the construction industry as well as a representative of a business outside of construction that uses contractors. The Task Force wants to make sure that we really understand the business challenges out there and the reasons that make purposefully misclassifying employees something some businesses are willing to do. In addition, the Task Force is actively engaged in looking for tactics and solutions that will help address the issues that have been raised, in a way that is clear, achievable and will promote a successful business environment while maintaining the protections due to the workers in NH.

Employee misclassification is not just a NH problem; there are task forces looking at the issue in many other states as well as at the national level. We will be doing everything we can to leverage the expertise here in the state and across the country and to take advantage of any tools or solutions we can identify.

Respectfully submitted,



Deborah L. Stone
Chairperson

APPENDIX A

Meeting of September 3, 2008

The Committee met for the first time on September 3, 2008. At that meeting Ms. Deborah Stone representing the New Hampshire Insurance Department was elected chairperson of the Task Force and Representative Randolph Holden was elected clerk.

The first order of business was developing the mission statement (see page 5).

As the issue of employee misclassification is not unique to New Hampshire it was decided the Task Force should explore what other states have done in this area or are in the process of doing. Several sources of information were identified and requests for the information were sent out.

It was also determined that representatives from the Department of Insurance, Department of Labor, and Department of Revenue Administration should make presentations on any information that would be helpful to the Task Force. In addition, it was suggested the Task Force should hear from workers' compensation insurance auditors in order to know what is really happening in the marketplace.

Meeting of September 17, 2008

Cynthia Flynn of the New Hampshire Department of Labor explained the various steps the Department takes in making sure all employers are complying with the wage and hour and workers' compensation laws. When the Department receives a complaint, an inspector will go to the worksite and do an inspection. It is during these inspections that the Department of Labor determines if workers are employees or independent contractors and if the employer is carrying compensation insurance. Some employers try to bypass the compensation law by treating employees as independent contractors. In the State of New Hampshire, a person is presumed to be an employee unless the employer can prove they are independent contractors. SB 92, which was effective January 1, 2008, defines the twelve requirements that must be met in order to qualify as an independent contractor. Ms. Flynn testified that in her view it was premature to evaluate the effectiveness of the requirements under SB 92 in reducing the number of misclassified employees. However, as of the date of her testimony, while she was aware of cases pending before the Department, she was aware of only one case where there had been a determination of a repeated offense by an employer.

Christos Lianos from the New Hampshire Department of Employment Security spoke on how the Department differentiates between independent contractors and employees. There is a three-part test the Department uses for unemployment compensation claims which is called the ABC test and is used by 46 states. This test is different from the statutory test used by the Department of Labor. There are approximately 40,000 registered employers in NH; the Department audits 2% of these employers every year.

John Lighthall from the New Hampshire Department of Revenue spoke on the number of 1099s (non-employee compensation) issued in New Hampshire in 2006. It is not known how many of these 1099s may have been incorrectly issued to misclassified workers, but the Committee intends to further investigate this issue.

Meeting of October 1, 2008

The Committee heard from Daniel Montembeau, auditing manager at MEMIC Indemnity. In 2007, MEMIC Indemnity was the sixth largest workers' compensation insurer in New Hampshire. Mr. Montembeau stated 80% of MEMIC's insured contractors are using uninsured subcontractors, who may or may not be legitimately independent contractors. When doing an audit, MEMIC uses the 12 step test in SB 92 to help identify independent contractors. In addition, their auditors check payroll records (940's), certificates of insurance, 1099's, and contracts if possible. Mr. Montembeau pointed out that misclassified workers have been seen in the construction, taxicab, drywall installation, floor covering installation and building operation industries.

Thad Dougherty, New Hampshire senior auditor for Acadia Insurance also spoke to the Committee. In 2007 Acadia Insurance was the fifth largest workers' compensation insurer in New Hampshire. Mr. Dougherty stated he also goes through the same procedures MEMIC does in trying to identify independent contractors who are really employees. Mr. Dougherty explained some areas where he has been successful in separating independent contractors from employees, such as business cards with the employers 24 hour access number, painted signs on trucks and advertising. Mr. Dougherty also mentioned it is sometimes difficult to obtain all the necessary information to do the audit as he may be dealing with a bookkeeper, or an accountant off of the premises as opposed to the owner of the business. Bookkeepers and accountants generally don't know all the employees and who should be classified in which job. Mr. Dougherty stated that misclassified workers have been observed in the construction, property maintenance, newspaper delivery, trucking and shipping industries.

Meeting of October 15, 2008

Ellery Hathorn from the Department of Labor described four hearings recently held by the Department regarding alleged employee misclassification. In two of these cases; the workers were found to be properly classified as independent contractors; in the other two cases, the workers were found to be improperly classified as such. Mr. Hathorn chose these four cases for discussion purposes.

Chairperson Deborah Stone informed the committee the New Hampshire Department of Insurance does not hold hearings on employee misclassifications, but the Department works with the parties when possible to help them reach an agreement on the appropriate premium after an audit. Misclassification cases are heard at the Department of Labor if

they have been triggered by a claim or potential claim. A recently enacted law directs misclassification cases stemming from the underwriting/premium side to the Department of Labor as well; however, second tier cases (i.e. subcontractor of a subcontractor working for a general contractor) are not within the scope of that law, and in those cases, disputes might be heard at the Department of Insurance. Some members of the Task Force have suggested that the Task force consider whether to make a recommendation that all cases be heard by one agency. Information on independent contractors from the following states was given to the committee for review: CT, ME, RI, MI, MT, CA, CO, DL, IL, NJ, NY, SC, TN, VT, WA, FL, IA, LA, MA, MN, MS and UT. The Task Force also reviewed versions of independent contractor registration/certification processes in IN, MN, MT and RI.

Meeting of October 29, 2008

George Rioux, District Director of the U. S. Department of Labor, made a presentation to the Committee on what his department is doing to identify employers who are not complying with federal labor laws. Mr. Rioux is in charge of northern New England and has 16 inspectors covering ME, NH, VT and MA. These inspectors visit businesses to make sure they are in compliance with federal labor laws. Most of the inspections are the result of complaints. Mr. Rioux explained that for the most part his inspectors have been focused on wage & hour complaints. He also said that the U. S. DOL has recognized that the issue of misclassifying employees as independent contractors is a rapidly growing problem and the U. S. DOL will be placing a special focus in that area beginning in 2009. Mr. Rioux roughly estimated that 60% of the complaints come from the construction industry with the manufacturing industry receiving the next highest number of complaints.

APPENDIX B

Statement from the Commissioner of the Department of Labor

“The NH Department of Labor has the mission to serve and protect the New Hampshire workforce. We can perform that task best when workers are properly classified as employees or independent contractors. Too often workers are taken advantage of by employers who seek to misclassify works, and deny them the protection of wage laws, safety controls, workers’ compensation and financial benefits such as tax payments and unemployment benefits.

Because of a recent state statutory change, which re-defined the word “employee” as used in our labor laws, we are now able to assure that employees are not unfairly treated by employers who seek to avoid providing proper legal benefits to workers, while still permitting person to enter into independent contractor relationships when they wish to do so. By making the presumption that work relationships are usually employment, the law assures that most workers gain the benefits of the laws designed to uphold the physical and financial well-being of those who must earn their living by providing labor for pay.

Our Department will continue to enforce these laws with thorough investigations and vigorous enforcement.”

Statement on Employee Misclassification
by the New Hampshire Department of Revenue Administration

The mission of the Department of Revenue Administration is to collect the proper amount of taxes due, incurring the least cost to the taxpayers, and in a manner that merits the highest degree of public confidence in our integrity, efficiency and fairness.

If employers misclassify their workers as independent contractors instead of employees, this would be one of many areas to consider in the performance of our audits. Treating a worker as an independent contractor may increase an employer's adjusted gross business profits but reduces their wage component for the Business Profits Tax apportionment formula. At the same time, the amount of Business Enterprise Tax an employer should pay would be decreased.

When conducting audits, the Department is often reviewing the pertinent issues months and sometimes years after the close of the tax year. The area of misclassification is problematic at that later date. The issue really needs to be addressed during the year in which the employment occurs. A more timely determination by other New Hampshire Departments such as the Departments of Labor and Employment Security would directly impact the employer's federal tax return. This return is the basis for the New Hampshire audits we perform. Therefore, early intervention and departmental cooperation are necessary to alleviate the issue of employee misclassification.

The Department of Revenue Administration has a long history of working very well with other New Hampshire agencies. On this issue and many others, we endeavor to further our cooperation and will continue to do so in order to collect the proper amount of taxes and live up to our motto of "Equity for All".

Margaret J. Fulton
Assistant Commissioner

Statement from the New Hampshire Insurance Department
Commissioner Roger Sevigny

The New Hampshire Insurance Department's main goal is to protect the consumers of the state of New Hampshire. The Department accomplishes this through many actions, paramount among them regulating the way insurance companies do business in the state and also monitoring and protecting the solvency of insurance companies so that they are able to pay claims.

The issue of employee misclassification affects the work of the Insurance Department and the Department of Labor in multiple ways having to do with Workers' Compensation insurance. Workers' Compensation law is actually a law through the Department of Labor and the basic issues of whether entities have workers' compensation insurance when required, whether workers are correctly classified as either independent contractors or employees, and whether an insurance company has to pay a claim for an injured worker when the correct classification is in dispute are all handled by them.

The Insurance Department gets involved in other aspects of the situation. Since workers' compensation is a type of insurance policy, the Department is responsible for regulating the forms, rates and rules the workers' compensation insurance companies' use. Workers' compensation rates vary by work-type classifications; for example, the rate per \$100 of payroll for a clerical worker is a small fraction of the rate per \$100 of payroll for a carpenter. There are approximately 600 of these workers' compensation classification codes.

When workers are misclassified within these classification codes, the premiums collected do not appropriately reflect the risk borne by the insurance company. Also, if workers are incorrectly classified as independent contractors (when they should be classified as employees) there may be no premium collected for them at all if they choose to be excluded from workers' compensation. As a result, the total of all premiums collected within the system may not be adequate to pay the associated claims, resulting in higher rates, and thus premiums, for everyone in the system.

There has been an obvious need for the Insurance Department and the Department of Labor to work together to help ensure that the workers' compensation laws are applied appropriately and fairly, and that the workers' compensation market is working in such a way that there is availability and affordability of workers' compensation insurance. The two Departments have a long history of collaborative efforts and will continue to cooperate as we move forward. We also wish to facilitate better communication between all agencies of the state in order to continue to address the issues we face, with employee misclassification being a high priority.

Statement from New Hampshire Employment Security
Commissioner Richard Brothers

A central component of the mission of New Hampshire Employment Security (NHES) is the payment of unemployment compensation benefits to eligible claimants and the collection from employers of the tax which funds these payments.

The misclassification of workers as independent contractors improperly decreases the amount of taxes an employer pays, decreasing the amount of money in the Unemployment Trust Fund and thus the funds available for the payment of unemployment benefits. It also unfairly increases the tax burden on employers who are paying their fair share since an employer's tax rate is determined, in part, by the amount of money in the Trust Fund. Finally, if a worker is incorrectly led to believe that he or she is an independent contractor, the worker may mistakenly believe that he or she is not eligible for benefits and fail to apply.

If a misclassified worker does file for unemployment compensation, a "blocked claim" results, triggering an investigation by NHES' Contributions Section. If NHES determines that the individual is indeed an employee, benefits are paid, and the employer is required to pay taxes, including back taxes for the period during which the individual was an employee of the company plus interest. However, the investigation and determination of benefit eligibility delay the worker's receipt of benefits, potentially causing great hardship to the worker.

The only other means of identifying misclassifications traditionally available to NHES has been the random audit of employers.

More recently, NHES has gained access to information from the Internal Revenue Service which will enable the department to identify cases of misclassification in a more proactive manner. Also, since July 1, 2006, New Hampshire law has allowed NHES to impose upon an employer a penalty of up to \$25 for each misclassified worker for each calendar day such violation occurs.

NHES looks forward to greater communication and coordination among New Hampshire state agencies in identifying instances of worker misclassification and addressing this important issue.

APPENDIX C

Under New Hampshire law, every worker is considered to be an employee until proven otherwise (RSA 281-A:2.VI.b.1)

Any person, other than a direct seller or qualified real estate broker or agent or real estate appraiser, or person providing services as part of a residential placement for individuals with developmental, acquired, or emotional disabilities, who performs services for pay for an employer, is presumed to be an employee. This presumption may be rebutted by proof that an individual meets all of the following criteria:

(A) The person possesses or has applied for a federal employer identification number or social security number, or in the alternative, has agreed in writing to carry out the responsibilities imposed on employers under this chapter.

(B) The person has control and discretion over the means and manner of performance of the work, in that the result of the work, rather than the means or manner by which the work is performed, is the primary element bargained for by the employer.

(C) The person has control over the time when the work is performed, and the time of performance is not dictated by the employer. However, this shall not prohibit the employer from reaching an agreement with the person as to completion schedule, range of work hours, and maximum number of work hours to be provided by the person, and in the case of entertainment, the time such entertainment is to be presented.

(D) The person hires and pays the person's assistants, if any, and to the extent such assistants are employees, supervises the details of the assistants' work.

(E) The person holds himself or herself out to be in business for himself or herself.

(F) The person has continuing or recurring business liabilities or obligations.

(G) The success or failure of the person's business depends on the relationship of business receipts to expenditures.

(H) The person receives compensation for work or services performed and remuneration is not determined unilaterally by the hiring party.

(I) The person is responsible in the first instance for the main expenses related to the service or work performed. However, this shall not prohibit the employer or person offering work from providing the supplies or materials necessary to perform the work.

(J) The person is responsible for satisfactory completion of work and may be held contractually responsible for failure to complete the work.

(K) The person supplies the principal tools and instrumentalities used in the work, except that the employer may furnish tools or instrumentalities that are unique to the employer's special requirements or are located on the employer's premises.

(L) The person is not required to work exclusively for the employer.

August 2009

EMPLOYEE MISCLASSIFICATION

Improved
Coordination,
Outreach, and
Targeting Could Better
Ensure Detection and
Prevention



GAO

Accountability * Integrity * Reliability



Highlights of [GAO-09-717](#), a report to congressional requesters

Why GAO Did This Study

When employers improperly classify workers as independent contractors instead of employees, those workers do not receive protections and benefits to which they are entitled, and the employers may fail to pay some taxes they would otherwise be required to pay. The Department of Labor (DOL) and Internal Revenue Service (IRS) are to ensure that employers comply with several labor and tax laws related to worker classification. GAO was asked to examine the extent of misclassification; actions DOL and IRS have taken to address misclassification, including the extent to which they collaborate with each other, states, and other agencies; and options that could help address misclassification. To meet its objectives, GAO reviewed DOL, IRS, and other studies on misclassification and DOL and IRS policies and activities related to classification; interviewed officials from these agencies as well as other stakeholders; analyzed data from DOL investigations involving misclassification; and surveyed states.

What GAO Recommends

This report includes various recommendations to DOL and IRS to enhance enforcement of proper worker classification, improve outreach to workers about classification, and improve interagency coordination in addressing misclassification. In commenting on a draft of this report, DOL and IRS generally agreed with our recommendations.

View [GAO-09-717](#) or key components. For more information, contact Andrew Sherrill at (202) 512-7215 or sherrilla@gao.gov.

EMPLOYEE MISCLASSIFICATION

Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention

What GAO Found

The national extent of employee misclassification is unknown; however, earlier and more recent, though not as comprehensive, studies suggest that it could be a significant problem with adverse consequences. For example, for tax year 1984, IRS estimated that U.S. employers misclassified a total of 3.4 million employees, resulting in an estimated revenue loss of \$1.6 billion (in 1984 dollars). DOL commissioned a study in 2000 that found that 10 percent to 30 percent of firms audited in 9 states misclassified at least some employees.

Although employee misclassification itself is not a violation of law, it is often associated with labor and tax law violations. DOL's detection of misclassification generally results from its investigations of alleged violations of federal labor law, particularly complaints involving nonpayment of overtime or minimum wages. Although outreach to workers could help reduce the incidence of misclassification, DOL's work in this area is limited, and the agency rarely uses penalties in cases of misclassification.

IRS enforces worker classification compliance primarily through examinations of employers but also offers settlements through which eligible employers under examination can reduce taxes they might owe if they maintain proper classification of their workers in the future. IRS provides general information on classification through its publications and fact sheets available on its Web site and targets outreach efforts to tax and payroll professionals, but generally not to workers. IRS faces challenges with these compliance efforts because of resource constraints and limits that the tax law places on IRS's classification enforcement and education activities.

DOL and IRS typically do not exchange the information they collect on misclassification, in part because of certain restrictions in the tax code on IRS's ability to share tax information with federal agencies. Also, DOL agencies do not share information internally on misclassification. Few states collaborate with DOL to address misclassification, however, IRS and 34 states share information on misclassification-related audits, as permitted under the tax code. Generally, IRS and states have found collaboration to be helpful, although some states believe information sharing practices could be improved. Some states have reported successful collaboration among their own agencies, including through task forces or joint interagency initiatives to detect misclassification. Although these initiatives are relatively recent, state officials told us that they have been effective in uncovering misclassification.

GAO identified various options that could help address the misclassification of employees as independent contractors. Stakeholders GAO surveyed, including labor and employer groups, did not unanimously support or oppose any of these options. However, some options received more support, including enhancing coordination between federal and state agencies, expanding outreach to workers on classification, and allowing employers to voluntarily enter IRS's settlement program.

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Abbreviations

CSP	Classification Settlement Program
DOL	Department of Labor
ETA	Employment and Training Administration
ETEP	Employment Tax Examination Program
FLSA	Fair Labor Standards Act
IRS	Internal Revenue Service
OSHA	Occupational Safety and Health Administration
QETP	Questionable Employment Tax Practices
SB/SE	Small Business/Self Employed Division
TIN	taxpayer identification number
WHD	Wage and Hour Division

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United States Government Accountability Office
Washington, DC 20548

August 10, 2009

The Honorable Edward M. Kennedy
Chairman
Committee on Health, Education,
Labor, and Pensions
United States Senate

The Honorable Richard J. Durbin
Chairman
Subcommittee on Financial Services
and General Government
Committee on Appropriations
United States Senate

The Honorable Rob Andrews
Chairman
Subcommittee on Health, Employment,
Labor, and Pensions
Committee on Education and Labor
House of Representatives

The Honorable Lynn Woolsey
Chairwoman
Subcommittee on Workforce Protections
Committee on Education and Labor
House of Representatives

In fiscal year 2007, states uncovered at least 150,000 workers who may not have received protections and benefits to which they were entitled because their employers misclassified them as independent contractors when they should have been classified as employees. According to the Bureau of Labor Statistics, approximately 10.3 million workers, or 7.4 percent of the employed workforce, were classified as independent contractors in the United States in 2005, although it is not clear how many of these workers were misclassified. Misclassification can precipitate violations of labor and tax laws. Independent contractors are not covered by many of the labor laws that protect employees and are not eligible for many benefits to which employees are entitled. Misclassified employees may not know that they are improperly classified and may not be aware that they are being denied the protections and benefits to which they are entitled under federal and state laws. In addition, when employers

misclassify workers as independent contractors, they may fail to pay and withhold payroll taxes they would otherwise be required to pay and withhold, and the workers may not be aware of their tax obligations.

No single agency is directly responsible for ensuring proper worker classification. Several federal agencies have responsibility, however, for ensuring that workers receive the benefits and protections to which they are entitled as employees. The Department of Labor (DOL) is responsible for ensuring employer compliance with several labor laws, including the Fair Labor Standards Act of 1938 (FLSA). Other federal agencies responsible for enforcing laws that provide employees—but not independent contractors—with benefits and protections include the Equal Employment Opportunity Commission and the National Labor Relations Board. The Internal Revenue Service (IRS) is not responsible for ensuring that employee protections are provided, but is responsible for ensuring that employers and employees pay proper payroll tax amounts and that employers properly withhold taxes from workers' pay. IRS also seeks to provide general information to employers about worker classification.

In response to your request, this report provides information on the misclassification of employees as independent contractors, including (1) what is known about the extent of the misclassification of employees as independent contractors and its associated tax and labor implications; (2) what actions DOL has taken to address misclassification, if any; (3) what actions IRS has taken to address misclassification, if any; (4) the extent to which DOL and IRS collaborate with each other, states, and other relevant agencies to prevent and address cases of employee misclassification; and (5) options that could help address challenges in preventing and responding to misclassification.

To determine what is known about the extent of misclassification, we reviewed IRS's past estimates and its plans to update its estimates of the revenue losses associated with misclassification; analyzed the information from audits that states report to DOL on the number of employers they determined to have misclassified employees; and reviewed misclassification studies conducted by states, universities, and research institutes. To describe actions DOL has taken to address employee misclassification, we examined laws, regulations, and agency policies and documentation; examined summary data from DOL's Wage and Hour Division (WHD) on cases involving misclassification concluded during fiscal year 2008; reviewed select WHD misclassification case files; interviewed agency officials and investigators as well as employer and labor advocates; and surveyed states to obtain their perspectives on DOL's

education and outreach efforts. To describe actions IRS has taken to address employee misclassification, we reviewed IRS's strategy for enforcing rules and regulations related to employee misclassification, analyzed data from IRS's enforcement programs related to employee misclassification, reviewed IRS's education and outreach activities, and interviewed independent contractor and labor advocates. To understand how DOL and IRS cooperate with each other and with states and other relevant agencies, we examined agency policies and procedures for referring cases involving misclassification, interviewed agency and state officials, conducted a Web-based survey of states to determine how they coordinate with DOL and IRS, and reviewed information from IRS's Questionable Employment Tax Practices (QETP) initiative, a collaboration between IRS and states aimed at increasing tax compliance by employers. To describe options to help address misclassification, we reviewed GAO and other federal agency reports and recommendations and other organizations' studies on misclassification of employees. We also surveyed relevant stakeholders to help identify such options and summarize any related trade-offs.

We conducted this performance audit from August 2008 through August 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. For more information on our scope and methodology, see appendix I.

Background

In general, employee misclassification occurs when an employer improperly classifies a worker as an independent contractor instead of an employee.¹ As we reported in 2006, the tests used to determine whether a worker is an independent contractor or an employee are complex and differ from law to law.² While laws vary in their definitions of the

¹In this report, we define the term employer as an entity that compensates employees, independent contractors, or both for services received in the course of a trade or business. Thus, the term does not include consumers or individuals who contract for services. While independent contractors may also be classified improperly as employees, this report focuses on the misclassification of employees as independent contractors.

²GAO, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, [GAO-06-656](#) (Washington, D.C.: July 11, 2006).

conditions that make a worker an employee, in general, a person is considered an employee if he or she is subject to another's right to control the manner and means of performing the work. In contrast, independent contractors are individuals who obtain customers on their own to provide services (and who may have other employees working for them) and who are not subject to control over the manner by which they perform their services.

Many independent contractors are classified properly, and the independent contractor relationship can offer advantages to both businesses and workers. Businesses may choose to hire independent contractors for reasons such as being able to easily expand or contract their workforces to accommodate workload fluctuations or fill temporary absences. Workers may choose to become independent contractors to have greater control over their work schedules or when they pay taxes, rather than have employers withhold taxes from their paychecks.

However, employers have financial incentives to misclassify employees as independent contractors. While employers are generally responsible for matching the Social Security and Medicare tax payments their employees make and paying all federal unemployment taxes and a portion of or all state unemployment taxes, independent contractors are generally responsible for paying their own Social Security and Medicare tax liabilities and do not pay unemployment taxes because they are not eligible to receive unemployment insurance benefits.³ In addition, businesses generally are not required to withhold the income, Social Security, or Medicare taxes from payments made to independent contractors that they are required to withhold for their employees. Independent contractors may also be responsible for making their own workers' compensation payments, depending on their state program. The differences, in general terms, between the tax responsibilities of employees and independent contractors are summarized in table 1.

³The Federal Unemployment Tax Act (26 U.S.C. §§ 3301–3311), in combination with 53 state-administered programs, provides for payments of unemployment compensation to workers who have lost their jobs. State-administered programs are subject to broad federal guidelines and oversight. States determine key elements of their programs, including who is eligible to receive state unemployment benefits and how much they receive. State unemployment tax revenues are held in trust by the U.S. Treasury and are used by the states to pay for regular, weekly unemployment benefits. Federal unemployment tax is used to administer the state and federal unemployment insurance programs, to administer the loan fund for state advances, to fund extended benefits when authorized by Congress, and to provide labor exchange services under the Wagner-Peyser Act.

Table 1: Differences between General Tax Responsibilities of Employees and Independent Contractors

Type of tax	Individuals classified as employees		Individuals classified as independent contractors	
	Businesses' general responsibilities	Workers' general responsibilities	Businesses' general responsibilities	Workers' general responsibilities
Federal income tax ^a	Withhold tax from employees' pay	Pay full amounts owed, generally through withholding	Generally, none ^b	Pay full amounts owed, generally through estimated tax payments ^c
Social Security and Medicare taxes ^d	Withhold one half of taxes from employees' pay and pay other half	Pay half of total amounts owed, generally through withholding	None	Pay full amounts owed, generally through estimated tax payments ^c
Federal unemployment tax ^e	Pay full amount	None	None	None
State unemployment tax	Pay full amount, except in certain states ^f	None, except pay partial amount in certain states ^f	None	None

Source: GAO analysis.

Note: There are various exceptions to the general responsibilities included in this table.

^aMost states also require payment of state income taxes.

^bEmployers are generally required to withhold taxes at a rate of 28 percent from independent contractors who do not provide, or provide incorrect, taxpayer identification numbers (this practice is known as backup withholding).

^cFor estimated tax purposes, the year is divided into four payment periods.

^dThe overall tax rates for Social Security and Medicare for 2009 are 12.4 percent and 2.9 percent of income, respectively. Social Security taxes are to be paid for earnings up to the established wage base limit (\$106,800 for 2009).

^eEmployers generally are required to pay federal unemployment insurance on the first \$7,000 of employee pay at a rate of 6.2 percent, which can be offset by a credit of up to 5.4 percent for timely payment of state unemployment insurance taxes, resulting in an effective rate as low as 0.8 percent. The rate is set to decrease to 6.0 percent in 2010. 26 U.S.C. §§ 3301, 3302.

^fAccording to DOL, these states are Alaska, New Jersey, and Pennsylvania.

While businesses may be confused about how to properly classify workers, some employers may misclassify employees to circumvent laws that restrict employers' hiring, retention, and other labor practices, and to avoid providing numerous rights and privileges provided to employees by federal workforce protection laws. These laws include

- FLSA, which establishes minimum wage, overtime, and child labor standards for employees;
- the Americans with Disabilities Act of 1990 and the Age Discrimination in Employment Act of 1967, which protect employees from discrimination based on disability or age;

-
- the Family and Medical Leave Act of 1993, which provides various protections for employees who need time off from their jobs because of medical problems or the birth or adoption of a child; and
 - the National Labor Relations Act, which guarantees the right of employees to organize and bargain collectively.

Employers may also choose to misclassify their employees in order to avoid having to obtain proof that workers are U.S. citizens or obtain work visas for them. In addition, independent contractors generally do not qualify to participate in health and pension plans that employers may offer to employees. Finally, when employers misclassify employees, they may be able to undercut competitors because their costs are reduced.

While some workers may agree to be misclassified as independent contractors in order to be paid in cash, avoid withholding of taxes, or prevent having to provide proof of their immigration status, other workers may not realize that they have been misclassified. In addition, they may not realize that as independent contractors, they are not protected under many laws designed to protect employees, and that they have obligations for which employees are not responsible, such as payment of their own taxes over the course of the year.

Responsibility for enforcing laws that afford employee protections and administering programs that can be affected by employee misclassification issues is dispersed among a number of federal and state agencies, as shown in table 2.

Table 2: Key Federal and State Agencies Affected by Employee Misclassification

Agency	Areas potentially affected by employee misclassification
DOL	<ul style="list-style-type: none">• Minimum wage, overtime, and child labor provisions• Job-protection and unpaid leave• Safety and health protections
IRS	<ul style="list-style-type: none">• Federal income and employment (payroll) taxes
Department of Health and Human Services	<ul style="list-style-type: none">• Medicare benefit payments
DOL, IRS, and the Pension Benefit Guaranty Corporation	<ul style="list-style-type: none">• Pension, health, and other employee benefit plans
Equal Employment Opportunity Commission	<ul style="list-style-type: none">• Prohibitions of employment discrimination based on factors such as race, gender, disability, or age
National Labor Relations Board	<ul style="list-style-type: none">• The right to organize and bargain collectively
Social Security Administration	<ul style="list-style-type: none">• Retirement and disability coverage and payments
State agencies	<ul style="list-style-type: none">• Unemployment insurance benefit payments• State income and employment taxes• Workers' compensation benefit payments

Source: GAO analysis.

Misclassification itself is not a violation of any federal labor law, but it can result in violations of federal and state laws. For example, DOL's Wage and Hour Division (WHD) may cite employers that have misclassified their employees as independent contractors for violations of FLSA relating to recordkeeping (not keeping required records for these employees), nonpayment of the federal minimum wage, and nonpayment of overtime. It also assesses back wages owed to workers in cases where misclassification leads to nonpayment of overtime or minimum wage. IRS can also assess taxes and penalties on employers that it finds have misclassified employees.

However, some workers who would otherwise be considered employees are deemed not to be employees for tax purposes. With increased IRS enforcement of the employment tax laws beginning in the late 1960s, controversies developed over whether employers had correctly classified certain workers as independent contractors rather than as employees. In some instances when IRS prevailed in reclassifying workers as employees, the employers became liable for portions of employees' Social Security and income tax liabilities (that the employers had failed to withhold and remit), although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, Congress enacted section 530 of the Revenue Act of 1978.⁴ That provision generally allows employers to treat workers as not being employees for employment tax purposes regardless of the workers' actual status if the employers meet three tests.⁵ The employers must have filed all federal tax returns in a manner consistent with not treating the workers as employees, consistently treated similarly situated workers as independent contractors, and had a reasonable basis for treating the workers as independent contractors. Under section 530, a reasonable basis exists if the employer reasonably relied on (1) past IRS examination practice with respect to the employer,⁶ (2) published rulings or judicial precedent, (3) long-standing recognized practices in the industry of which the employer is a member, or (4) any other reasonable basis for treating a worker as an independent contractor. Section 530 also prohibits IRS from issuing regulations or Revenue Rulings with respect to the classification of any individual for the purposes of employment taxes. Congress intended that this moratorium to be temporary until more workable rules were established, but the moratorium continues to this day. The provision was extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982.⁷

Federal agencies use different tests to determine whether a worker is an independent contractor or an employee. IRS uses the concepts of behavioral control and financial control and the relationship between the employer and the worker to determine whether a worker is an employee,⁸

⁴Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978).

⁵Section 530 does not apply in the case of certain technical workers (engineers, designers, drafters, computer programmers, systems analysts, or other similar skilled workers engaged in a similar line of work) who provide services for third parties pursuant to arrangements between the business for whom the technical worker works and the third party. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1706 (Oct. 22, 1986).

⁶In 1989, we stated that Congress may want to consider repealing the limitation on IRS prospectively reclassifying employees who may have been misclassified. See GAO, *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers*, GAO/GGD-89-107 (Washington, D.C.: Sept. 25, 1989). Based in part on this report, Congress modified section 530 through the Small Business Job Protection Act of 1996 (Pub. L. No. 104-188, August 20, 1996) to limit the past examination practice reasonable basis to examinations for employment tax purposes of whether a worker should be treated as an employee.

⁷Pub. L. No. 97-248, 96 § 269(c)(1)(C)(2), 96 Stat. 324 (Sept. 3, 1982).

⁸See IRS Publication 1779, *Independent Contractor or Employee*, and Publication 15-A, *Employer's Supplemental Tax Guide*.

while WHD uses six factors identified by the United States Supreme Court to determine employee status during investigations of FLSA violations. The complexity and variety of worker classification tests may also complicate agencies' enforcement efforts. In addition, states use varying definitions of employee. For example, according to a report commissioned by DOL, at least 4 states follow IRS's test, and at least 10 states use their own definitions. The remaining states use various definitions that rely at least in part on whether the employer has the right to control the worker.

Decisions regarding employee status are sometimes determined through the courts. For example, in a recent decision, the United States Court of Appeals for the District of Columbia Circuit ruled that drivers for FedEx's small package delivery unit are independent contractors, and not employees, and therefore do not have the right to bargain collectively. FedEx had sought review of the determination by the National Labor Relations Board that the FedEx drivers were employees and that FedEx had committed an unfair labor practice by refusing to bargain with the union certified as the collective bargaining representative of its Wilmington, Massachusetts drivers. In ruling that the drivers are independent contractors, the court noted that because FedEx Ground drivers can operate multiple routes, hire extra drivers, and sell their routes without company permission, they were not like employees of traditional trucking companies.⁹

Legislation aimed at preventing employee misclassification has been introduced in previous sessions of Congress. At least four bills relating to employee misclassification were introduced in the 110th Congress. Two of the bills, both titled the Employee Misclassification Prevention Act (H.R. 6111 and S. 3648), were introduced in the House of Representatives and the Senate, respectively, to amend FLSA to require employers to keep records of independent contractors and to provide a special penalty for misclassification. Two other bills were aimed, in part, at amending the Internal Revenue Code to aid in proper classification. The Independent Contractor Proper Classification Act of 2007 (S. 2044) was introduced in the Senate to provide procedures for the proper classification of employees and independent contractors, including amending the tax code and requiring DOL and IRS to exchange information regarding cases involving employee misclassification. In the House of Representatives, the Taxpayer Responsibility, Accountability, and Consistency Act of 2008

⁹*FedEx Home Delivery v. National Labor Relations Board*, 563 F.3d 492 (D.C. Cir. 2009).

(H.R. 5804) sought to amend the Internal Revenue Code to modify the rules relating to the treatment of individuals as independent contractors or employees, including requiring IRS to inform DOL of cases involving employee misclassification. However, these bills were not enacted into law.

The Current Extent of Misclassification Is Unknown, but Misclassification Can Be a Significant Problem with Adverse Consequences

Although the national extent of employee misclassification is unknown, earlier national studies and more recent, though not comprehensive, studies suggest that employee misclassification could be a significant problem with adverse consequences.

In its last comprehensive estimate of misclassification, for tax year 1984, IRS estimated that nationally about 15 percent of employers misclassified a total of 3.4 million employees as independent contractors, resulting in an estimated revenue loss of \$1.6 billion (in 1984 dollars).¹⁰ Nearly 60 percent of the revenue loss was attributable to the misclassified individuals failing to report and pay income taxes on compensation they received as misclassified independent contractors. The remaining revenue loss stemmed from the failure of (1) employers and misclassified independent contractors to pay taxes for Social Security and Medicare and (2) employers to pay federal unemployment taxes.

For 84 percent of the workers misclassified as independent contractors in tax year 1984, employers reported the workers' compensation to IRS and the workers, as required, on the IRS Form 1099-MISC information return.¹¹ These workers subsequently reported most of their compensation (77 percent) on their tax returns. In contrast, workers misclassified as independent contractors for whom employers did not report

¹⁰The study did not include an estimate of the percentage of all independent contractors who were misclassified by their employers (that is, of all independent contractors, the percentage that should have been classified as employees).

¹¹Employers are generally required to report payments of \$600 or more in any given year made to independent contractors on Form 1099-MISC, unless the independent contractors are incorporated.

compensation on Form 1099-MISC reported only 29 percent of their compensation on their tax returns.¹²

Although IRS has not updated the information from its 1984 report, it plans to review the national extent of employee misclassification as part of a broader study of employment tax compliance.¹³ However, IRS officials anticipate that the results of this study will not be available until 2013, at the earliest. As part of its National Research Program, IRS plans to examine a randomly selected sample of employers' tax returns for tax years 2008 to 2010. IRS employment tax officials told us they may need to extend the study if they have not collected sufficient data to provide reliable estimates. For the misclassification part of the employment tax compliance study, they said they hope to estimate the number of employers that misclassify employees, the number of employees who are misclassified, and the resulting loss of tax revenue. The officials also said they are uncertain whether IRS will be able to collect sufficient data to estimate the extent of misclassification within particular industries or geographic regions.

A study commissioned by DOL in 2000 found that from 10 percent to 30 percent of firms audited in nine selected states had misclassified employees as independent contractors.¹⁴ The study also estimated that if

¹²In past reports, we identified various options to improve tax compliance among independent contractors and sole proprietors, who are included in a category of self-employed taxpayers along with independent contractors. In 1996, we identified two approaches to increase tax compliance of independent contractors: (1) require businesses to withhold taxes from payments to independent contractors and (2) improve information reporting on payments made to independent contractors. See GAO, *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors*, [GAO/T-GGD-96-130](#) (Washington, D.C.: June 20, 1996). In 2007, we analyzed various options to address tax noncompliance among sole proprietors. See GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, [GAO-07-1014](#) (Washington, D.C.: July 13, 2007). In 2009, we made various recommendations to improve compliance with filing Forms 1099-MISC. See GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, [GAO-09-238](#) (Washington, D.C.: Jan. 28, 2009).

¹³We previously attempted to estimate the extent of misclassification and the extent of income tax losses using compliance data that existed in 1994, but these data were not sufficient to produce reliable estimates. See GAO, *Tax Administration: Estimates of the Tax Gap for Service Providers*, [GAO/GGD-95-59](#) (Washington, D.C.: Dec. 28, 1994).

¹⁴Planmatics, Inc., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Program* (Rockville, Md: U.S. Department of Labor, February 2000).

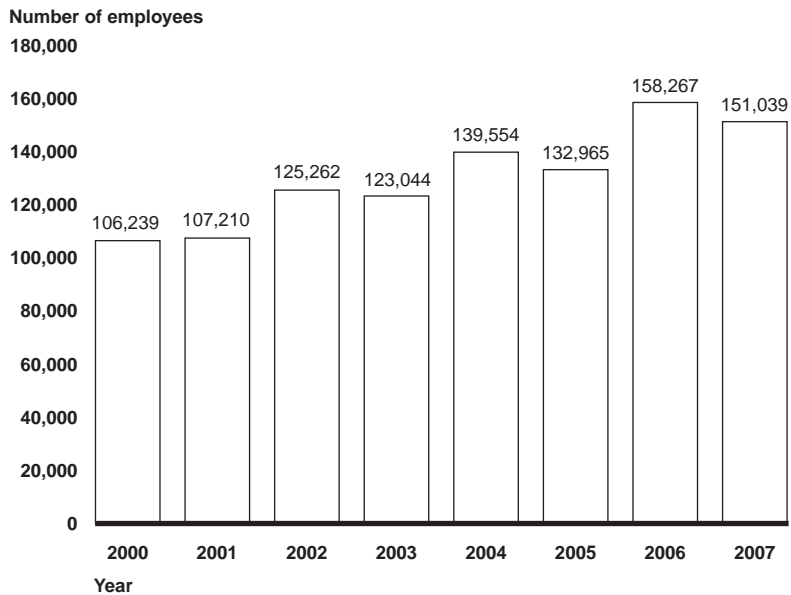
only 1 percent of all employees were misclassified nationally, the loss in overall unemployment insurance revenue because of employers' underreporting of unemployment taxes across all states would be nearly \$200 million annually. In addition, the Bureau of Labor Statistics periodically conducts a survey of contingent workers (defined as workers holding jobs that are expected to last only a limited period of time), including independent contractors.¹⁵ The most recent survey, conducted in 2005, revealed that 10.3 million U.S. workers were classified as independent contractors—approximately 7.4 percent of all workers. However, the survey did not indicate how many of these workers were misclassified.

State officials we interviewed told us that in their opinion, misclassification has generally increased over recent years. State activity in this area may support this view. For example, officials from New Hampshire's Department of Labor said the agency recently hired four new investigators to focus exclusively on investigations of employee misclassification. Summary data states reported to DOL's Employment and Training Administration, which oversees state administration of the unemployment insurance program, showed that from 2000 to 2007 the number of misclassified workers uncovered by state audits had increased from approximately 106,000 workers to over 150,000 workers, as shown in figure 1.¹⁶ While these counts reveal an upward trend, they likely undercount the overall number of misclassified employees, since states generally audit less than 2 percent of employers each year.

¹⁵This survey, a supplement to the Current Population Survey, is a household survey in which workers are asked to self-report information about their jobs. It was conducted in February 1995, 1997, 1999, 2001, and 2005.

¹⁶States may uncover misclassification during their audits of employers' unemployment insurance tax payments. DOL requires states to report summary information related to misclassification from these audits on a quarterly basis, including the overall number of misclassified employees identified. We did not evaluate whether states changed their audit criteria over this period of time, which may explain the increase in some or all of the numbers of misclassified workers identified by the states. In addition, we note that during this period, the total number of employers audited by states increased from approximately 114,000 to about 117,000.

Figure 1: Number of Misclassified Employees Identified by State Audits of Employers, 2000 to 2007



Source: GAO analysis of DOL data.

State officials, however, told us that summary data they reported to DOL's Employment and Training Administration (ETA) did not include all misclassification identified by their investigations. For example, officials from one state said they did not report cases to DOL that did not meet ETA's prescriptive audit criteria that mandate, among other things, extensive testing of an employer's payroll records. Furthermore, the official pointed out that the data ETA collects do not include cases involving workers in the underground economy, where workers are paid in cash and income is not reported to states or IRS.

Studies conducted by states, universities, and research institutes have been generally limited in scope—for example, confined to one state or a specific industry within a state. However, some of these studies have noted that misclassification is especially prevalent in certain industries, such as construction. For example, a study conducted by Harvard University on the extent of misclassification in the construction industry in Maine estimated that approximately 14 percent of construction firms misclassified at least some of their employees each year from 1999 to

2002.¹⁷ Maine state officials told us that following the study, they began targeting construction firms for their unemployment insurance audits and found higher levels of misclassification—up to 45 percent of the firms audited misclassified at least some of their employees.

Misclassification may undermine workers' access to protections, such as unemployment insurance and workers' compensation. For example, one group that advocates for workers cited an instance of a construction worker who fell three stories, was severely injured, and incurred hospital expenses of over \$10,000 related to the injury. Because the worker was misclassified as an independent contractor, his employer did not provide workers' compensation coverage for the employee. Several union officials told us that misclassification of workers is especially prevalent in the construction industry where workers are often paid entirely in cash and, as a result, are not noted on the employers' records at all, either as employees or independent contractors. These officials told us they believe that some employers have been emboldened to begin operating on a cash basis by the ease with which they are able to misclassify their workers.

The WHD investigation case files we reviewed provided detail on several instances where misclassified employees did not receive minimum wages or overtime pay. For example, one case involved a medical transcription service that hired workers—whom WHD determined had been misclassified as independent contractors under FLSA—to work out of their homes transcribing medical files they downloaded from the company's computer system. When the system was not accessible, workers were not paid—although they were required to remain available until the system became operational—and, as a result, they were not paid the minimum wage required by FLSA.

¹⁷Construction Policy Research Center, Harvard University, *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry* (Cambridge, Mass.: Apr. 25, 2005). This study was based on unemployment insurance audits conducted by the state of Maine. We did not assess the study to determine whether the methodology used was reliable.

DOL Has Taken Limited Steps to Detect and Address Misclassification

DOL's detection of employee misclassification is generally the indirect result of its investigations of alleged FLSA violations, particularly complaints involving nonpayment of overtime or minimum wages. WHD officials have stated to Congress that the misclassification of an employee as an independent contractor is not itself a violation of FLSA or other laws WHD enforces. Misclassification, however, is often associated with FLSA violations—in particular, recordkeeping violations and the failure to pay overtime or minimum wages. When WHD finds FLSA violations resulting from misclassification, it assesses back wages owed to workers as appropriate. In addition, although there is no penalty for recordkeeping violations, WHD requires businesses to place any workers the employer reclassifies as employees on the company payroll records, as per FLSA rules.

Our review of the case files also showed that WHD investigators, in the course of their investigations, did not consistently review documents that could indicate that employees had been misclassified. Specifically, investigators may ask employers about independent contractors or uncover misclassification through worker interviews, according to the information contained in the case files. However, they did not, as a matter of course, review employer records such as IRS Forms 1099-MISC that show payments made to independent contractors. Reviewing these records could aid WHD investigators in identifying workers who have been misclassified. Although one district director told us it is standard practice for investigators in his office to ask for this type of information during an investigation, it is not WHD policy to do so.

Many of the experts we interviewed said that targeted investigations of employers or industries could increase the detection of misclassification. Approximately 80 percent of the investigations WHD concluded in 2008 involving misclassification were initiated because of complaints from workers about possible labor violations. However, several experts we spoke with pointed out that some workers, such as immigrants or those in low-wage industries, are often less likely to file complaints with WHD.¹⁸ Thus, a lack of targeted investigations coupled with the reluctance of misclassified workers to complain may result in less effective enforcement of proper classification. WHD officials told us that their ability to conduct

¹⁸Experts we spoke with explained that this reluctance sometimes stems from the fear of losing one's job, employer coercion, or, in the case of immigrant workers, apprehension about interacting with the federal government.

targeted investigations in recent years has been limited by reductions in agency resources combined with consistently high levels of worker complaints about possible labor law violations.¹⁹ According to WHD policy, the first priority of the agency's enforcement is to respond to these complaints.²⁰

WHD conducts few investigations targeted at misclassification, though it has begun to place a greater focus on misclassification within existing agency initiatives. WHD concluded over 24,500 FLSA cases in fiscal year 2008, and misclassification was the primary reason for the violation identified in 131 investigations. Most of these investigations (80 percent) were initiated by complaints from workers rather than being targeted by WHD. In the 26 investigations that were targeted by WHD,²¹ the agency identified 341 misclassified employees who were owed back wages of over \$88,000. In the 1990s, WHD implemented initiatives to conduct targeted investigations within low-wage industries with a history of FLSA violations, such as restaurants, hotels, and nursing homes. These initiatives enabled WHD to detect employee misclassification to the extent it was prevalent in those industries. WHD officials told us that in fiscal year 2007, in part because of heightened congressional interest in misclassification, they instructed their district directors to place a special emphasis on those low-wage industries within their districts with a history of misclassifying employees. During fiscal year 2009, for example, the New Orleans district office planned to conduct targeted investigations of the

¹⁹On March 25, 2009, the Secretary of Labor announced plans to hire 150 new investigators. WHD officials said they did not know whether this would enable them to target more employers for investigation.

²⁰GAO has recently conducted evaluations of WHD's enforcement efforts and made recommendations for improvement. See GAO, *Fair Labor Standards Act: Better Use of Available Resources and Consistent Reporting Could Improve Compliance*, [GAO-08-962T](#) (Washington, D.C.: July 15, 2008); *Department of Labor: Wage and Hour Division's Complaint Intake and Investigative Processes Leave Low Wage Workers Vulnerable to Wage Theft*, [GAO-09-458T](#) (Washington, D.C.: Mar. 25, 2009); and *Department of Labor: Wage and Hour Division Needs Improved Investigative Processes and Ability to Suspend Statute of Limitations to Better Protect Workers Against Wage Theft*, [GAO-09-629](#) (Washington, D.C.: July 23, 2009).

²¹Although WHD categorized nine of these cases as targeted investigations, they actually stemmed from investigations based on complaints from workers. In addition, targeted investigations that do not result in violations are not flagged as involving employee misclassification in WHD's database. Therefore, we were unable to determine the effectiveness of the agency's targeting strategy.

staffing and janitorial industries in its region, although it limited this effort to three investigations.

Examples of state efforts support the potential effect of targeted investigations aimed at detecting misclassification. New York's Department of Labor has created a task force that conducts investigations and audits aimed specifically at detecting misclassification. Among other activities, the task force conducts sweeps, or targeted investigations of businesses located within a certain area or within industries where misclassification is prevalent. In conducting investigations during 2007 and 2008 that targeted approximately 300 businesses in the retail and commercial industries, the task force found that 67 percent of the businesses were in violation of unemployment laws, labor standards, or workers' compensation laws. In addition, at the request of investigators, the task force scheduled follow-up audits of about half of these employers. As of December 2008, it had completed 54 of these audits and found in approximately 70 percent of them that employers had continued to misclassify at least some employees as independent contractors.

In addition, the task force conducted targeted investigations of over 600 businesses, primarily in the construction industry. It found labor violations in nearly half of these businesses and ordered follow-up investigations. Just over half of these investigations have been completed, resulting in nearly 7,800 employees being identified as misclassified. The state determined that the misclassification led to \$2.2 million in unpaid wages, over \$3.5 million in unpaid unemployment taxes and associated penalties, and over \$1 million in penalties related to workers' compensation. As a result of all investigations conducted during a 16-month period ending December 31, 2008, the task force detected 12,300 instances of misclassification, with approximately \$12 million in associated unpaid wages. In contrast, in fiscal year 2008, WHD identified 1,619 instances of misclassification nationwide during its investigations and assessed about \$1 million in unpaid wages.

DOL has begun to track cases of misclassification in its WHD investigations database. However, although DOL's Occupational Safety and Health Administration (OSHA) may identify misclassification during its safety and health inspections, it does not record this information in its inspections database. In addition, in their responses to our survey, a majority of state workforce agencies noted that their states collect data on the occurrences of misclassification, but most of those states do not send this information to DOL. For example, an official in one state agency told us that in 2008 his state conducted investigations that led to the detection

of approximately 46,000 instances of misclassification, but that DOL collected no information associated with those cases. Since this information would likely include the names of employers that misclassified their employees, and the industries involved, collecting it could enable DOL to focus its investigations more effectively on certain employers or industries with a known history of misclassification.

DOL Makes Only Limited Use of Education or Penalties to Deter Misclassification

Although education and outreach to workers could help reduce the incidence of misclassification, DOL's work in this area is limited. The DOL Web site contains publications on the employment relationship under FLSA, some of which mention the use of independent contractors.²² However, the Web site does not provide material that focuses specifically on the subject of employee misclassification. In addition to publications, the DOL Web site provides printable workplace posters, some of which employers are required to display in their workplaces. However, none of WHD's posters contain information on employment relationships or misclassification.

DOL employees sometimes hand out to workers pamphlets that contain general information on workers' rights. Also, DOL staff provides information materials at seminars and training sessions for employers. While these materials address what constitutes an employment relationship, they do not specifically mention misclassification. Similarly, WHD district directors we interviewed told us that their staffs do not conduct employer and worker outreach activities specifically on misclassification. However, some said their staffs may provide information about misclassification when answering questions from employers or workers. Finally, an OSHA official told us that the agency does not conduct any outreach or education directly related to misclassification, although officials in one region told us that workers were misclassified as independent contractors at over 80 percent of the construction sites they inspected.

²² Department of Labor, Wage and Hour Division, *Employment Relationship Under the Fair Labor Standards Act*, WH Publication 1297 (Washington, D.C., August 1985); "Fact Sheet #13: Employment Relationship Under the Fair Labor Standards Act," <http://www.dol.gov/esa/whd/fact-sheets-index.htm> (accessed June 1, 2009); and "Fact Sheet #35: Joint Employment and Independent Contractors Under the Migrant and Seasonal Agricultural Worker Protection Act," <http://www.dol.gov/esa/whd/fact-sheets-index.htm> (accessed June 1, 2009).

According to our survey, few states regard DOL's efforts to educate workers and employers on employee misclassification to be effective. In fact, 16 states had no awareness of DOL education or outreach on the subject. Of the states that were aware of DOL's outreach activities, only 5 reported that they thought outreach for workers was effective, and only 6 stated that it was effective for employers. Further, some experts we interviewed also expressed the view that DOL's education and outreach efforts on misclassification are inadequate and that improvement is needed, especially for vulnerable populations. For example, some noted that immigrants are less likely to know their rights and are more likely to be misclassified than other types of workers.

WHD district directors we interviewed noted that there are challenges associated with reaching vulnerable populations, such as immigrant workers. Some noted that many noncitizens, whether documented or not, are wary of government and therefore reluctant to approach DOL officials or attend DOL-sponsored events. Despite this challenge, the directors told us that their offices coordinate with immigrant population communities in order to educate workers on labor issues. For instance, staff from the Boston and New Orleans district offices told us they participate in presentations, information sessions, and forums with the Hispanic communities in their districts in coordination with the Mexican consulates. These activities are generally broad in scope but may include specific information on misclassification.

When WHD identifies misclassification, the division does not use all available remedies—such as assessing financial penalties, pursuing back wages owed to workers who have been misclassified, and conducting follow-up investigations of employers that have misclassified workers—to penalize employers who have violated FLSA and help ensure future compliance. WHD levied penalties in less than 2 percent of the cases involving misclassification it completed in fiscal year 2008—2 of 131 investigations. In contrast, the division levied penalties in 6 percent of the cases involving FLSA violations from 2000 to 2007. WHD can only levy penalties for violations of the minimum wage or overtime pay provisions of FLSA when the violations are willful or repeated, though a WHD district director noted that it can be difficult to prove that employers are willfully misclassifying employees. In addition, although WHD determined that there were back wages to be paid in most of these cases, we found that investigators did not always follow up to ensure that employees were paid the back wages assessed. For example, in one case we reviewed, the employer did not provide documented proof that she paid back wages of over \$5,000 owed to her employees, but WHD closed the case and

recorded the back wages as paid. Further, WHD officials told us that if the division uncovers violations caused by misclassification, it does not generally conduct follow-up investigations to ensure that the employees are properly classified.

IRS Has Several Enforcement and Education Efforts That Focus on Misclassification but Faces Challenges in Undertaking These Efforts

IRS's misclassification enforcement strategy relies on identifying and examining employers that have potentially misclassified employees. IRS primarily identifies employers to examine for potential misclassification through four sources:

- The Determination of Worker Status (Form SS-8) Program, in which workers or employers request that IRS determine whether a specific worker is an employee or an independent contractor for purposes of federal employment tax and income tax withholding through the submission of Form SS-8.²³ IRS examines some of the employers it determines to have misclassified workers through the SS-8 program.
- The Employment Tax Examination Program (ETEP), in which IRS uses specific criteria to identify for examination employers that have a high likelihood of having misclassified employees.
- General employment tax examinations, meaning examinations of tax returns that are started because of separate employment tax issue that lead to examinations of classification issues.
- The Questionable Employment Tax Practices (QETP) program, through which IRS and states share information on worker classification-related examinations and other questionable employment tax issues. IRS examines some employers that states have determined to have misclassified employees.

IRS's Small Business/Self Employed Division (SB/SE) conducts the majority of IRS's misclassification-related examinations. It made applicable assessments (taxes and penalties) in 71 percent of such examinations that it closed during fiscal year 2008, resulting in a total of almost \$64 million in assessments, as shown in table 3. A description of the four programs through which IRS primarily generates misclassification-related examinations follows table 3. Also following table 3 is a description of IRS's Classification Settlement Program (CSP), which

²³IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

enables qualifying employers under examination for misclassification-related issues to lower their misclassification-related tax liabilities if they agree to properly classify their workers in the future.

Table 3: SB/SE Misclassification Examination Results by Examination Source, Fiscal Year 2008

	Examination source				
	SS-8	ETEP	General examinations	QETP	All programs
Number of closed examinations ^a	38	221	690	232	1,181
Percentage of all closed examinations by referral source	3	19	58	20	100
Number of closed examinations with assessments	30	127	522	165	844
Percentage of closed examinations with assessments ^b	79	57	76	71	71
Total assessments (dollars in millions) ^c	\$1.1	\$11.8	\$40.9	\$9.8	\$63.5
Average assessment per examination	\$28,191	\$53,378	\$59,225	\$42,314	\$53,810

Source: GAO analysis of IRS data.

Notes: We could not isolate the assessments made for taxpayers with CSP agreements because before fiscal year 2009, IRS did not separately track the outcomes of such examinations. For a qualifying taxpayer who enters into a CSP agreement, IRS records the dollar amount of the settlement as the assessment amount, not the dollar amount that would otherwise have been assessed for the taxpayer. IRS conducts examinations of taxpayers who do not comply with the terms of their CSP agreements, and assessments from such cases are included in table 3.

^aIn fiscal year 2008, SB/SE conducted all of IRS's examinations based on ETEP and QETP, all but one of IRS's examinations based on SS-8 referrals, and the majority of IRS's misclassification-related examinations based on general examinations. Examinations completed in fiscal year 2008 cover tax returns from previous tax years.

^bA portion of the examinations that resulted in no assessments were closed because the taxpayers in question qualified for protection under section 530 of the Revenue Act of 1978, but IRS does not track the number of cases that are closed for this reason.

^cTotal assessments for each examination source do not sum to the total assessments for all programs because of rounding. Assessment amounts may include tax liabilities related to other employment tax issues that were assessed to the same taxpayer concurrently, as well as any penalties. Total assessments reflect the amounts that examiners recommended rather than the amounts collected by IRS. Taxpayers may challenge IRS's recommended assessments.

Through its SS-8 program, IRS provides workers or employers that file Forms SS-8 with its determination on the correct classification of the workers in question. IRS also uses the program to identify employers that may have misclassified employees and therefore would be fruitful to examine. In fiscal year 2008, 72 percent of all Form SS-8 requests filed resulted in IRS determinations that the workers in question were employees, 25 percent were closed without any advice given, and 3 percent resulted in determinations that the workers in question were

independent contractors or had other results.²⁴ IRS's SS-8 unit makes these determinations, in part, using information workers or employers provide on Forms SS-8.²⁵ After making classification determinations, IRS sends letters to employers to provide them with guidance on how to voluntarily amend their tax returns to comply with the determinations. IRS's SS-8 unit then uses specific criteria to determine which cases it should refer for examination, including the amount of compensation the worker in question earned, the number of similar workers hired by the employer, and whether the case likely involves fraud. The majority of employers the SS-8 unit determined to have misclassified employees are very small businesses, which generally are not referred because examining such businesses is generally not cost effective. As a result, IRS officials estimated that for recent tax years, only an average of 2 percent to 3 percent of employers it identified to have misclassified employees through SS-8 determinations were referred for examination, and an even smaller percentage resulted in examinations.²⁶

For ETEP, IRS uses a computer matching program to identify annually employers that potentially misclassified employees. The match criteria include employers that reported paying compensation to workers (on Form 1099-MISC), the amount of compensation the workers reported on their tax returns, and the portion of the workers' total income that was

²⁴ According to IRS employment tax officials, the SS-8 unit closes about 20 percent of cases it receives each year without a determination for various reasons. For example, IRS may need to contact employers in order to make a determination for Form SS-8 requests filed by workers, and some workers withdraw their SS-8 requests because of fear of retaliation from their employers. To avoid duplication, the SS-8 unit does not make a determination in cases where IRS is examining the employer. In addition, a case is closed if the associated Form SS-8 is incomplete and IRS is unable to contact the applicant.

²⁵ About 90 percent of Form SS-8 requests are filed by workers.

²⁶ IRS examines an even smaller percentage of all Forms SS-8 filed. For example, IRS closed 39 examinations of employers that it identified through SS-8 determinations in fiscal year 2008 out of the almost 12,000 such requests filed. This amount was an increase from the average of 6,000 Form SS-8 requests that were filed annually for fiscal years 2005 through 2007. This increase was prompted, in part, by a new IRS form (Form 8919) that informs workers who think they may have been misclassified that they can file a Form SS-8 to obtain a determination from IRS.

paid by the employers.²⁷ IRS uses these criteria to identify employers to examine with the greatest potential for tax assessments. IRS officials told us that generally IRS examines about 1 percent to 3 percent of the employers it identifies annually through ETEP to have potentially misclassified employees. IRS does not examine some employers that it determines based on the ETEP match to have potentially misclassified employees, such as those that no longer appear to be in business; appear to have legitimate reasons for meeting the ETEP selection criteria, such as employers who compensate real estate agents, who are statutorily defined as independent contractors; or are protected by section 530. For tax year 2006, IRS identified over 33,000 employers through ETEP.²⁸ In fiscal year 2008, IRS examined 221 employers it identified through ETEP, as reflected in table 3.

Over half (58 percent) of the misclassification-related examinations of employers that SB/SE conducted in fiscal year 2008 arose through the course of IRS examining employers for other types of employment tax noncompliance. IRS examiners in all divisions are trained about misclassification issues, but the depth of training depends upon the division and group in which the examiners work.

According to IRS employment tax officials, QETP, initiated in December 2007, has proven to be a useful source of timely leads on potential misclassification cases. QETP is a collaborative initiative between IRS and, currently, 34 participating states through which IRS and state workforce agencies share information on misclassification examinations. IRS employment tax officials told us that the examination information that states provide through QETP is especially useful to the agency because it

²⁷In a 1989 report, we recommended that IRS match independent contractors' information returns with their tax returns to more systematically identify employers that are misclassifying employees as independent contractors. One scenario we discussed in the report involved identifying independent contractors with incomes of more than \$10,000 to identify contractors who received all of their income from one employer. See [GAO/GGD-89-107](#). IRS's use of this matching process during the review led it to assess \$9.9 million in additional taxes and penalties against 67 employers found to have misclassified workers.

²⁸ETEP match data for tax year 2006 were the most recent data available at the time that we did our work.

is timely, making it easier for IRS to contact and collect money from noncompliant employers.²⁹

In addition to its programs that generate misclassification examinations, IRS uses CSP to offer settlements to employers that it is examining for misclassification. Through CSP, which IRS initiated in 1996, employers under examination that meet certain criteria can lower their misclassification-related assessments if they agree to correctly classify their workers in the future and pay proper employment taxes.³⁰ As of November 2008, IRS had entered into about 2,800 settlement agreements, of which about 2,500 involved SB/SE. Employment tax officials in this IRS division estimated that their CSP agreements signed through the end of 2006 have resulted in at least approximately \$76 million in taxes voluntarily reported by participating employers without further IRS intervention.³¹ Of employers that entered into agreements through the end of 2006, IRS determined that 64 percent appear to be in compliance with their agreements. IRS has not been able to determine, through a review of filing histories, whether the remaining 36 percent of employers have complied with their CSP agreements. IRS would need to examine these employers to determine if they are in compliance with their agreements.

IRS Uses Various Methods to Educate Taxpayers about Proper Classification

IRS provides extensive general information on its Web site on worker classification issues for employers and workers, including flyers, IRS forms, fact sheets, a Web cast, and a training manual providing in-depth information on how IRS examiners determine a worker's correct classification. IRS also held a national phone forum on worker classification determinations in May 2009 targeted at tax professionals and small business employers and organizations. IRS officials noted that a key IRS worker classification Web page was recently linked to IRS's main page and was viewed nearly 800,000 times in fiscal year 2008.

²⁹IRS officials reported that some QETP audit referrals it receives contain extraneous information or are provided in a format that is difficult to use. However, IRS officials have worked with at least one state workforce agency to help the state tailor the information it forwards to IRS.

³⁰For example, employers must have filed all required information returns for their workers to be eligible to participate in CSP.

³¹IRS calculated this figure by first noting the dollar amount of each CSP agreement, multiplying the dollar amount for each agreement by the number of tax years since the taxpayer signed the agreement, and summing the values of all CSP agreements that had been signed since CSP was initiated.

IRS's outreach strategies include the use of handouts, e-mail lists, and industry newsletters. In 2008, IRS began conducting worker classification workshops. IRS employment tax officials said that IRS targets these workshops toward persons working as payroll professionals, who are most likely to handle workers' pay paperwork, and paid tax return preparers. IRS does not generally conduct outreach on classification issues for workers.

IRS Faces Challenges in Enforcing Compliance with and Educating Taxpayers about Classification Regulations

IRS's programs aimed at enforcing proper worker classification and educating taxpayers about this issue face three main challenges. First, because misclassification is a complex issue, addressing proper classification can be labor intensive for the IRS officials involved. For example, in determining whether workers are employees or independent contractors, IRS examiners must look to the common law, which can be a complex process.³² The examiners must collect and weigh evidence on the related common law factors to determine what is relevant for classifying each relationship between the respective businesses and the workers in question.

Second, given competing agency priorities, IRS has limited resources to allocate to these programs. With regard to enforcement, it has resources to examine only a small percentage of the potential misclassification cases it detects. As shown in table 3, SB/SE completed examinations of less than 1,200 employers in 2008, a very small number when compared to the millions of small business and self-employed taxpayers in the United States. IRS focuses its examinations on employers with potential for large assessments or cases that likely affect a number of workers. To encourage voluntary compliance, IRS sends SS-8 determination letters to employers, and has also sent "soft notices" to employers it determined had not reclassified their workers after receiving these letters. However, IRS officials told us that SS-8 determination letters and soft notices can be

³²For employment tax purposes, the Internal Revenue Code incorporates the common law definition of an employee. 26 U.S.C. § 3121(d)(2). The Department of the Treasury's regulations state that an employee-employer relationship generally exists when the business has a right to control and direct the worker not only as to the result to be accomplished but also as to the details and means by which that result is accomplished. 26 C.F.R. §§ 31.3121(d)-1(c); 31.3306(i)-1; 31.3401(c)-1. IRS's Revenue Ruling 87-41 contains a list of 20 factors or elements that IRS examiners can use to determine whether a worker is an employee under the common law. IRS examination training materials characterize these 20 factors as being based on three concepts: behavioral control, financial control, and the relationship between the employer and the worker.

ineffective if the letter or the notice signals that IRS will not further pursue the noncompliant employers. For example, according to these officials, only about 20 percent of employers that are sent SS-8 determination letters but that are not selected for examination voluntarily comply with IRS's classification determination. With regard to education, IRS uses indirect methods to reach the millions of businesses across the United States, such as sending correspondence to a large list of contacts in various industries and posting information in industry newsletters. According to IRS employment tax officials, information on misclassification is generally passed down two or three levels in order to reach employers.

Third, according to IRS officials we interviewed, section 530 is both a major reason that it cannot examine many of the suspected cases of misclassification it identifies and an impediment to its ability to educate taxpayers on misclassification issues, as discussed below.

- Before examining each potential misclassification case, IRS examiners must verify whether the employer in question qualifies for section 530 protection.³³ This verification process can be time and labor intensive, because examiners must determine whether the employers in question meet the three tests for section 530 protection.³⁴
- Section 530 also restricts IRS's ability to issue regulations and Revenue Rulings with respect to the classification of any individual for purposes of employment taxes. Because of this limitation, IRS restricts the educational information it issues to informal general guidance and SS-8 determinations and rulings, which provide recommendations on how to classify specific workers. However, as noted previously, applying the classification rules can be complex. IRS employment tax officials told us that businesses regularly request IRS's guidance on how to classify workers. In accordance with section 530, IRS officials do not answer such inquiries but instead recommend that the businesses file Form SS-8 requests, which take time for the businesses to file and for IRS to process. Representatives

³³IRS has interpreted the Small Business Job Protection Act of 1996, which added subsection (e) to section 530, as requiring the first step in examining any case involving employment tax obligations of an employer with respect to workers to be determining whether the business meets the requirements of section 530. Pub. L. No. 104-188, § 1122, 110 Stat. 1755, 1766 (Aug. 20, 1996), *codified at* 26 U.S.C. § 3401 note.

³⁴As previously mentioned, in order to receive section 530 protection, employers must have filed all federal tax returns in a manner consistent with not treating the workers in question as employees, consistently treated similarly situated workers as independent contractors, and had a reasonable basis for treating the workers as independent contractors.

of worker, business, and paid tax return preparer groups pointed to a great deal of confusion about proper worker classification. In an interview, representatives of IRS's Taxpayer Advocate Service told us that IRS should have the ability to issue guidance on the rules it enforces, in the interest of effective tax administration.

Collaboration among Federal Agencies Is Limited, but States Report Successful Collaboration to Address Misclassification among Their Agencies and with IRS

DOL and IRS typically do not exchange the information they collect on misclassification, and DOL does not share information internally. However, when an employee is misclassified there is a potential for violations of both tax and labor laws, and sharing information could enable multiple agencies to address the consequences of misclassification. For example, WHD does not always send information on cases involving misclassification to other federal and state agencies, although WHD's policies and procedures direct it to share such information with other federal and state agencies. WHD officials said they may not provide referrals to states or other federal agencies because the definition of an employee varies by statute and the division does not want its investigators to interpret statutes outside its jurisdiction. WHD officials told us there were no legal limitations on sharing information from an investigation, although they said they were reluctant to share information on open cases because they did not want to compromise their investigations.

Although WHD has a memorandum of understanding stating that it will share information with IRS, WHD officials said they are concerned about referring cases to IRS because they fear that employers would be reluctant to cooperate with the division if they knew that it refers cases to IRS. However, in these cases, WHD could obtain a subpoena to compel the employer to provide WHD with records. Similarly, WHD depends on complaints from workers to drive much of its workload and locate employers that are in violation of the laws under its purview. According to these officials, if workers who were not paying taxes properly knew that WHD shared information with IRS about its investigations, they might be less likely to file complaints or cooperate during investigations.

In cases where WHD refers a case involving misclassification to states or other federal agencies, or to other divisions within DOL, it does not track these referrals centrally. Therefore, officials do not know how often or to whom cases are referred. In addition, officials are not able to ensure that cases are referred consistently across offices. Some district offices, however, keep track of the forms used to make such referrals. The referrals are usually made by the district offices, which maintain records

of the referrals in their files and send the originals to the agencies to which WHD has referred the cases.

OSHA may uncover misclassification during its inspections of potential health and safety violations but generally does not refer these cases to WHD or IRS. OSHA officials told us that although they have a number of memorandums of understanding with other agencies and divisions within DOL, these pertain to issues such as child labor and migrant workers and not to misclassification. However, we found that OSHA has a memorandum of understanding with WHD dating from 1990 that states that, in order to secure the highest level of compliance with labor laws, the agencies will exchange information and referrals where appropriate. This agreement also states that both agencies will report the results of any referrals to the other agency and will establish a system to monitor the progress of actions taken on referrals. However, while OSHA tracks referrals and results in its database, WHD has not established such a system.

ETA, which oversees unemployment insurance, collects only summary data from states on the number of employees they have found to be misclassified during unemployment insurance audits. While DOL funds the administration of state unemployment insurance programs, states are responsible for all tax collection, benefit payment, and investigations and audits. Therefore, officials told us that detailed employer or employee-specific information is available only at the state level, and ETA is unable to refer potential misclassification cases to WHD. Moreover, since state agencies are administrators of their own programs, officials told us that ETA does not investigate instances of misclassification that occur in state unemployment insurance programs.

Other federal agencies with jurisdiction over laws affected by misclassification told us that they do not work with DOL or track cases involving misclassification. Officials from the National Labor Relations Board, which enforces the right of employees to bargain collectively, told us that the agency does not work with DOL. Equal Employment Opportunity Commission officials said that they have not worked with DOL in any substantial way, although they do have a memorandum of understanding with DOL.

According to officials, IRS does not share misclassification-related information with DOL and shares only limited information with other federal agencies. In general, IRS is prohibited from sharing taxpayer information with other agencies per section 6103 of the Internal Revenue

Code.³⁵ IRS and the Social Security Administration have memorandums of understanding in place to facilitate information sharing on employment tax cases and issues, but they do not regularly share information on misclassification, according to IRS employment tax officials. However, the officials told us that the two agencies are creating a joint employment tax task team, and noted that the Social Security Administration can use IRS employment tax information to ensure that misclassified workers are given Social Security credit for wages earned. Contracting officers from several federal agencies we interviewed said that they saw relatively high volumes of potential misclassification among workers on federal construction contracts, and that the payroll information they collect could be of value to IRS. However, many of these agencies did not have information sharing relationships with IRS.

DOL Generally Does Not Work with States, but IRS Shares Information with Them

Less than 25 percent of states collaborate with DOL to identify employee misclassification. In responding to our survey, 12 states said that they have some type of collaborative arrangement with DOL in this area. These arrangements may include sending information to DOL, receiving information from DOL, and conducting joint investigations with DOL of cases involving potential misclassification. Approximately 56 percent of states we surveyed said that they collect data on misclassification beyond the summary unemployment insurance audit data they are required to report to DOL's ETA on a quarterly basis. Although this information could be useful to DOL in pursuing potential FLSA violations stemming from misclassification, state officials we interviewed said that they are not required to report it to DOL. For example, officials told us that they do not report information on employees who were misclassified but paid in cash and whose wages were not reported to IRS or state revenue agencies. DOL could use information on these employees to target investigations of possible FLSA violations, such as improper payment of overtime.

IRS and state workforce agencies share information on misclassification as part of QETP. IRS, DOL, and state workforce agencies collaborated to create QETP in September 2005. In its first year, 5 states participated and additional states have been added over time. Currently, IRS and workforce

³⁵26 U.S.C. § 6103. The protection of taxpayer information is commonly thought to be critical to voluntary compliance with the tax code and necessary to protect taxpayer privacy. There are statutory exceptions to the general prohibition, such as those permitting the sharing of certain information with state tax officials and the Social Security Administration. 26 U.S.C. § 6102(d),(l)(1).

agencies from 34 states share information on audits involving misclassification as part of QETP.³⁶ IRS employment tax officials remarked that QETP sends an important message to employers and workers that IRS and states are working together on compliance issues. According to the IRS officials, the state agencies audit employers to determine whether they have classified workers correctly and paid state unemployment taxes as appropriate. We surveyed participating state agencies, and most respondents reported that audit information IRS provided was helpful.

In addition to sharing audit reports for employers that were found to have misclassified their employees, IRS also shares other types of misclassification-related data with some states. Nineteen of the state workforce agencies we surveyed reported that they receive Form 1099-MISC data from IRS.³⁷ The state agencies may use these data to identify potential cases of misclassification. According to IRS employment tax officials, IRS also shares the worker classification determinations it makes through its SS-8 program with some state agencies; IRS issues these determinations following employers' or workers' requests for determinations of employment status. Fourteen of the state workforce agencies we surveyed reported receiving this information from IRS.³⁸

Some state workforce agencies surveyed noted that IRS's QETP information sharing and communication practices could be improved. For example, two states commented that the information they receive from IRS is somewhat dated. Some states that participated in our survey reported frustration over not receiving requested information from IRS or difficulty contacting IRS officials. IRS officials with whom we spoke were aware that some states were not receiving QETP referrals, and stated that IRS was in the process of centralizing its QETP administration in order to rectify the problem. They also said that IRS is in the process of clearing out a backlog of referrals from states. According to IRS employment tax officials, IRS has completed the centralization of QETP administration and taken steps to clear the backlog of referrals from states. Finally, some

³⁶Seven additional state agencies reported that they were working with IRS to become QETP members.

³⁷According to IRS officials, as of April 2009, 22 state workforce agencies were enrolled in the process to receive Form 1099-MISC data extracts.

³⁸According to IRS officials, as of May 2009, 31 states were enrolled in a process to receive information from classification determinations.

states we surveyed also reported several key barriers to effectively using information provided by IRS. These included resource limitations within their own agencies, data system incompatibilities, and difficulties complying with IRS's legal requirements for safeguarding taxpayer data.

Some States Are Identifying Misclassification through Collaborative Initiatives Involving Their Revenue, Labor, and Enforcement Agencies

Some states have made efforts to address misclassification and have reported successful collaboration among their own agencies. States are particularly concerned because of misclassification's impact on workers' compensation programs and unemployment tax revenue, among other programs. In addition, states may incur additional costs, such as the cost of providing health care to uninsured workers, as a result of misclassification. Some states have passed legislation related to misclassification. For example, Massachusetts passed legislation that standardizes the definition of an employee and penalizes employers for misclassification, regardless of whether it was intentional. The statute authorizes the state Attorney General to impose substantial civil and criminal penalties and, in certain circumstances, to ban violators from obtaining state public works contracts.

Several states have recently created interagency initiatives or joint task forces aimed at detecting misclassification, often by executive order of the states' governors. These task forces share information across revenue, labor, and enforcement agencies. For example, the New York State Joint Enforcement Task Force on Employee Misclassification, which was formed in September 2007, is led by the New York Department of Labor and includes revenue agencies, other enforcement agencies, and the Attorney General's office. Since its inception, the task force has engaged in joint enforcement sweeps, coordinated assignments, and systematic referrals and data sharing between state agencies. New York state officials told us that they now consider it customary to use a multiagency approach and cross-agency coordination to deal with misclassification.

However, some of these state task forces have encountered challenges, particularly in coordination among state agencies. The agencies must overcome or ease restrictions on sharing information outside their jurisdictions, which may require state legislative action. State officials we interviewed cited other challenges, such as the fact that the lead agency does not have oversight authority over task force members, which makes it difficult to direct their efforts; the limited resources of many state agencies; and dealing with the added layers of bureaucracy involved in tracking cases and enforcing compliance together.

While these task forces are relatively recent innovations, state officials told us that they have already been effective in uncovering misclassification. New York state officials told us that the state uncovers many more misclassified employees through task force activities than solely through the unemployment insurance audits required by DOL. The state estimated that in just over a year's time, its misclassification task force uncovered 12,300 instances of employee misclassification and, as noted earlier, \$157 million in unreported wages. The task force's enforcement activities also resulted in over \$12 million in workers' back wages being assessed against employers.

Various Options Could Help Address Misclassification Challenges

As far back as 1977, we have analyzed options for addressing tax noncompliance arising from employee misclassification. In 1977, we recommended a specific definition to clarify who should be considered an independent contractor, and in 1979, we concluded that some form of tax withholding could be warranted to reduce tax noncompliance among self-employed workers.³⁹ In 1992, we offered options to improve independent contractor tax compliance, such as ensuring that their taxpayer identification numbers (TIN) are valid, informing them of their classification status and tax obligations, and closing gaps in the payments that are required to be reported on Form 1099-MISC.⁴⁰ For this report, we explored current options to address the challenges raised by employee misclassification, some of which are similar to the options we analyzed in these prior reports.

We identified 19 options to address the challenges raised by employee misclassification by reviewing literature and speaking with various groups, including those representing (1) labor and advocacy, (2) independent contractors and small businesses, and (3) tax professionals.⁴¹ These

³⁹GAO, *Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions*, [GAO/GGD-77-88](#) (Washington, D.C.: Nov. 21, 1977) and *Compliance Problems of Independent Contractors*, Testimony 109909 (Washington, D.C.: July 17, 1979).

⁴⁰GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, [GAO/GGD-92-108](#) (Washington, D.C.: July 23, 1992). Other options dealt with improving information reporting on payments made for services to independent contractors, including incentives to file Form 1099-MISC, and requiring more information to be reported on tax returns about the payments made for services.

⁴¹For a more detailed discussion of our methodology in selecting options to include in this report, see app. I.

options would require either legislative or administrative actions. Table 4 lists the 19 options. The list is not ranked in any order, but rather is grouped in seven broad categories.⁴²

Table 4: Options for Addressing Employee Misclassification

A. Clarify the employee/independent contractor definition and expand worker rights

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1. Clarify the distinction between employees and independent contractors under federal law
 2. Allow workers to challenge a classification determination in U.S. Tax Court
 3. Ensure that workers have adequate legal protection against retaliation from filing a Form SS-8
 4. Define misclassification as a violation under FLSA
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B. Revise section 530 of the Revenue Act of 1978

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5. Narrow the definition of “a long-standing recognized practice of a significant segment of the industry” so that fewer firms qualify for this reasonable basis for the section 530 safe harbor provision
 6. Lift the ban on IRS/Treasury issuing regulations or revenue rulings clarifying the employment status of individuals for purposes of employment taxes
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C. Provide additional education and outreach

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7. Require service recipients^a to provide standardized documents to workers that explain their classification rights and tax obligations
 8. Expand IRS outreach to service recipient, worker, and tax advisor groups to educate them about classification rules and related tax obligations, targeting groups IRS deems to be “at risk”
 9. Create an online classification system, using factors similar to those used in the SS-8 determination process, to guide service recipients and workers on classification determinations
 10. Increase the use of IRS notices to service recipients in industries with a potentially high incidence of misclassification to educate them about classification rules and ask them to review their classification practices
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⁴²The list also does not include options that we have recently analyzed or recommended in prior reports that are indirectly related to worker misclassification, such as information reporting on payments made to independent contractors. For example, in [GAO-09-238](#) we made various recommendations to improve compliance with filing Forms 1099-MISC, and in [GAO-07-1014](#) we analyzed various options to address tax noncompliance among sole proprietors, a group of taxpayers that includes independent contractors.

D. Withhold taxes for independent contractors

11. Require service recipients to withhold taxes for independent contractors whose TINs IRS cannot verify or who IRS has determined are not fully tax compliant
12. Require universal tax withholding for payments made to independent contractors, using tax rates that are relatively low (e.g., 1 percent to 5 percent of payment amounts)
13. Require service recipients to withhold taxes from payments made to independent contractors who request withholding in writing

E. Collect data on misclassification and independent contractors

14. Measure the extent of misclassification and related impacts on tax revenues at the national level
15. Require each independent contractor to apply for a separate business TIN

F. Enhance IRS compliance programs

16. Expand IRS's CSP to include service recipients that voluntarily contact IRS about their misclassified workers
17. Require service recipients to submit Forms SS-8 for all newly retained independent contractors

G. Enhance coordination and information sharing

18. Enhance coordination between IRS, DOL, and other federal agencies to share data and address misclassification
19. Enhance coordination between IRS, states, and selected local governments to share data and address misclassification

Source: GAO analysis of literature reviews and interviews with affected stakeholders.

^aBy "service recipients," we mean businesses and other entities that receive services from independent contractors or employees in the course of a trade or business, not including consumers or individuals who seek services for their homes or personal use.

We asked 11 external stakeholders to provide input on these 19 options, including (1) the extent to which they supported or opposed each option and (2) the benefits and drawbacks of each option (see app. II for a summary of these benefits and drawbacks for each option).⁴³ These stakeholders included 4 groups that represent the views of small businesses, independent contractors, and those who hire them (i.e., independent contractor groups); 4 groups that represent the views of organized labor (i.e., labor groups); 2 groups that represent the tax

⁴³We identified these 11 stakeholder groups from the original 19 that we interviewed early in our study. We selected the 11 based on those that provided specific ideas and comments on the options in our first round of interviews and that expressed willingness to respond to our written data collection instrument.

preparation and advice community; and 1 federal agency that uses contractors. We received responses from 9 of these groups.⁴⁴

No Option Had Unanimous Support or Opposition Stakeholders did not unanimously support or oppose any of the 19 options. Although views were mixed, stakeholders generally expressed support for the options more frequently than they expressed opposition. For example, at least seven of the nine responding stakeholders supported three options (see table 5).

Table 5: Options for Addressing Employee Misclassification with the Greatest Level of Stakeholder Support

Ensure that workers have adequate legal protection against retaliation from filing a Form SS-8 (option 3)
Require service recipients to provide standardized documents to workers that explain their classification rights and tax obligations (option 7)
Increase the use of IRS notices to service recipients in industries with a potentially high incidence of misclassification to educate them about classification rules and ask them to review their classification practices (option 10)

Source: GAO analyses of stakeholder responses to questions about 19 options.
Note: Options included in this table were supported by seven or eight stakeholders out of the nine from which we received input on the 19 options.

In contrast, five of nine stakeholders opposed one option—narrowing the definition of “a long-standing recognized practice of a significant segment of the industry” under section 530 of the Revenue Act (option 5). While all three independent contractor groups opposed this idea on the grounds that the protection was important, two labor groups that opposed the option did so because it only narrowed rather than eliminated this protection.

Labor Groups and Others Were Generally More Supportive of Options Than Independent Contractor Groups In general, labor groups, a group representing tax preparers, and a federal agency that hires contractors tended to be more supportive of the 19 options than independent contractor groups. We analyzed whether the majority of stakeholders in each group—that is, over half of them—stated that they supported, opposed, or were neutral on the 19 options. Table 6 shows that a majority of the labor group respondents (i.e., at least 3 of the 4) supported 9 options and opposed none. Similarly, the tax professional group and the federal

⁴⁴We did not receive responses from one of the paid tax return preparer groups and one of the independent contractor groups.

agency both supported 10 options and opposed none. In contrast, a majority of the independent contractor respondents (i.e., at least 2 of the 3) supported 7 options and opposed 8. A blank cell in the table indicates that the stakeholders for the group lacked a majority view on the option.

Table 6: Options to Address Misclassification by Expressed Support, Opposition, or Neutrality by a Majority of Stakeholder Group

Options	Labor groups	Independent contractor groups	Other groups ^a
1. Clarify the distinction between employees and independent contractors within federal law		Support	Support
2. Allow workers to challenge determinations in Tax Court	Support	Oppose	Support
3. Ensure that workers have protection for filing a Form SS-8	Support	Support	Support
4. Define misclassification as a violation under FLSA	Support	Oppose	
5. Narrow the definition of “a long-standing recognized practice of a significant segment of the industry”		Oppose	Support
6. Lift the ban on IRS clarifying employment status	Support	Oppose	
7. Require service recipients to give workers documents that explain classification	Support	Support	
8. Expand IRS outreach		Support	Support
9. Create an online classification system		Oppose	Support
10. Increase the use of IRS notices	Support	Support	Support
11. Require service recipients to withhold taxes for certain independent contractors	Neutral	Oppose	Support
12. Require universal tax withholding for payments made to independent contractors		Oppose	
13. Require service recipients to withhold taxes at independent contractor request		Neutral	Support
14. Measure the extent of misclassification at the national level	Support	Neutral	
15. Require each independent contractor to apply for a separate business TIN		Support	
16. Expand IRS's CSP		Support	
17. Require service recipients to submit Forms SS-8 for newly retained independent contractors		Oppose	Support
18. Enhance coordination between IRS, DOL, and other federal agencies	Support	Neutral	
19. Enhance coordination between IRS, states, and selected local governments	Support	Neutral	

Source: GAO analyses of stakeholder responses to questions about 19 options.

Note: “Support” indicates that over half of the respondents in the group generally or strongly supported the option. “Oppose” indicates that over half of the respondents in the group generally or strongly opposed the option. “Neutral” indicates that over half the group was neutral on the option or had no opinion. A blank cell indicates that the option lacked a consensus opinion by a majority of stakeholders.

^aOther groups included a group representing tax professionals and a federal agency that hires contractors.

Stakeholders Identified
Various Benefits and
Drawbacks to the Options

We asked stakeholders what they perceived to be the benefits and drawbacks of each option. We did not follow up on these responses to clarify and understand the basis for the stakeholders’ perceptions on benefits and drawbacks. As a result, absent other relevant data, these responses did not allow us to uniformly assess whether the benefits outweighed the drawbacks for each option, or vice versa. Table 7 lists examples of types of benefits and drawbacks identified across all the options.

Table 7: Types of Benefits and Drawbacks Stakeholders Identified across the 19 Options

Examples of types of benefits identified	Examples of types of drawbacks identified
Improved tax compliance	Higher financial costs/burdens for businesses
Greater equity/justice for workers	Inequities among those using independent contractors
More consistency/uniformity in classifying	Economic disruption/upheaval
More education/understanding	More litigation
More attention/visibility	Political opposition
More worker protection	Less freedom of choice
Less misclassification	Deter use of independent contractors
Less manipulation of classification rules	More manipulation of classification rules

Source: GAO analyses of stakeholder responses to questions about 19 options.

We found that some of the stakeholders had different perceptions of whether an outcome for an option would be beneficial. For example, some respondents said that creating an online classification system could help reduce confusion over classification rules and unintentional misclassification. However, other respondents stated that such a system would produce inconsistent determinations and could be manipulated to achieve desired classification determinations. Similarly, some stakeholders said that requiring a separate TIN for independent contractors could increase voluntary tax compliance or help facilitate IRS compliance and enforcement efforts. However, others expressed the opinion that a separate TIN could be conducive to tax fraud or manipulation of the classification system. Finally, some perceived that expanding CSP to include employers that volunteer to disclose their misclassified employees would benefit such employers by reducing their financial exposure while others viewed this same outcome as allowing

them to escape financial sanctions for misclassifying. (See app. II for summaries of the types of benefits and drawbacks for each option.)

We also asked IRS officials to share their insights on the benefits and drawbacks of the options from a tax administration perspective. Some of their insights included the following:

- Expanding CSP to include employers that voluntarily ask to participate could help reduce employee misclassification, although allowing voluntary participation raises issues of equity and may create a safe harbor from examination. For example, this expansion could bring into compliance employers that voluntarily disclose that they have misclassified employees but would reduce the financial sanctions they face for having done so. IRS employment tax officials said that they recently created a team to explore these and other issues related to such an expansion and that they hope to start soliciting comments on a proposal from across IRS starting in summer 2009.
- “Soft” (i.e., non enforcement) notices to educate employers that appear to be misclassifying employees and to encourage them to correct their classifications might not be effective unless IRS is able to follow up with employers that do not change their classification behavior. Notices also are more effective if they are sent strategically rather than using a “shotgun” approach. Furthermore, sending notices to employers in certain industries without sufficient justification for targeting them likely would create a backlash that IRS would have to manage.
- Expanded information sharing with other federal agencies generally can help IRS to be more effective at enforcing proper worker classification. However, section 6103 protections against improper disclosure of tax data generally hamper such sharing and one-way information sharing can create resentment among other agencies.
- Creating standardized documents on worker rights and tax obligations can impose burdens on businesses, although such burdens could be reduced by requiring employers to provide such documents only to newly hired or retained workers rather than to all workers. Also, IRS may not currently have the authority to require employers to provide such documents to workers.
- Requiring a separate TIN for each independent contractor could help compliance but would impose some costs on businesses and IRS to reprogram its computers.

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- Requiring Forms SS-8 for all newly retained independent contractors would create tremendous costs for IRS, and it may not be able to review the forms quickly enough to affect some independent contractors who employers retain on a short-term basis.
 - An online classification system that uses factors like those that IRS uses to make Form SS-8 determinations could provide guidance to those unsure about classifying workers. However, the system should not be used to make classification determinations because those entering the data could manipulate their entries to receive a desired outcome.

Some of the identified options relate to goals, objectives, and strategies in IRS's Strategic Plan for 2009-2013. For example, IRS's plan envisions placing more emphasis on providing more targeted and timely guidance and outreach on how to voluntarily comply and creating opportunities for taxpayers to proactively resolve tax disputes as soon as possible as part of its goal to improve service to make voluntary compliance easier. To enforce the law to ensure that everyone meets their tax obligations, IRS plans to strengthen its partnerships with other government agencies to leverage resources in a way that allows quick identification and pursuit of emerging tax schemes through education as well as enforcement. IRS also seeks to expand its enforcement approaches by allowing for alternative treatment of potential noncompliance. These approaches include expanding the use of soft notices to educate taxpayers and to encourage them to self-correct to avoid traditional enforcement contacts, such as examinations, as well as expanding incentives and opportunities for taxpayers to voluntarily self-correct noncompliant behavior.

Conclusions

Misclassification can have a significant impact on federal and state programs, businesses, and misclassified employees. It can reduce revenue that supports such programs as Social Security, Medicare, unemployment insurance, and workers' compensation. Further, employers with responsible business practices may be undercut by competitors who misclassify employees to reduce their costs, for example, by not paying payroll taxes or providing benefits to workers. Employers may also exploit vulnerable workers, including low-wage workers and immigrants, who are unfamiliar with laws pertaining to employment relationships, including laws designed to protect workers. For example, misclassified workers may not be paid properly for overtime or may not know that their employers are not paying worker's compensation premiums.

Although misclassification is a predictor of labor law violations, and although state examples show that targeting misclassification is an effective way to uncover violations, DOL is not taking advantage of this opportunity by looking for misclassification in its targeted investigations. As a result, employers may continue to misclassify employees without consequences and workers may remain unprotected by labor laws and not receive benefits to which they are entitled. Furthermore, because DOL conducts limited education and outreach on misclassification, many workers have insufficient information on employment relationships and may not understand their employment status and rights. In addition, vulnerable populations, including low-wage workers and immigrants, may not know they are misclassified and, as result, may not receive the protections and benefits to which they are entitled. By not regularly sharing information on cases involving misclassification, federal and state agencies are also losing opportunities to protect workers and to make the most effective use of their resources. Also, because DOL is not working with states active in this area to identify misclassification, it is not using its resources most effectively by establishing a collaborative effort between federal and state agencies to address misclassification.

Many of the IRS-related options we analyzed to address misclassification were generally perceived to have merit as means to address misclassification, but all have some drawbacks, according to those stakeholders we surveyed. Although several options had support from many of those who provided input, we had no reliable measure of the extent of misclassification and did not have sufficient information to weigh the benefits compared to the drawbacks of the options given the scope of our work. Even so, qualitative information provided by the stakeholders can help policymakers and tax administrators judge whether any of the options merit pursuit.

Likewise, some actions have potential to address misclassification in a cost-effective manner while also adhering to IRS's strategic vision for the next few years. For example, IRS and DOL can do more to educate employers and workers. Given that most complaints come from workers, further educating them about the consequences of misclassification may be especially useful. Developing a standard document on classification rights and related tax obligations that all new workers would either be given by employers or referred to on agencies' Web sites would be particularly well targeted. Similarly, IRS could build on its existing state contacts to resolve current concerns with the QETP initiative, which mutually benefits both federal and state parties. Regularly collaborating with participating states can help ensure that issues are addressed by both

IRS and states in a timely manner. Finally, expanding CSP to allow for voluntary self-correction of classification decisions could prompt compliance among employers that IRS is unlikely to pursue through enforcement because of limited resources. Soft notices targeted to employers that appear to be misclassifying would give them a chance to self correct before IRS decides whether to examine them and should be tested to determine their effectiveness.

Recommendations for Executive Action

We are making six recommendations to the Secretary of Labor and the Commissioner of Internal Revenue to assist in preventing and responding to employee misclassification.

- To increase its detection of FLSA and other labor law violations, we recommend that the Secretary of Labor direct the WHD Administrator to increase the division's focus on misclassification of employees as independent contractors during targeted investigations.
- To enhance efforts to protect workers and make the most effective use of their resources, we recommend that the Secretary of Labor direct the WHD Administrator and the Assistant Secretary for OSHA to ensure that information on cases involving the misclassification of employees as independent contractors is shared between the two entities and that cases outside their jurisdiction are referred to states and other relevant agencies, as required.
- To identify promising practices in addressing misclassification and use agency resources most effectively, we recommend that the Secretary of Labor and the Commissioner of Internal Revenue establish a joint interagency effort with other federal and state agencies to address the misclassification of employees as independent contractors. Because tax data may provide useful leads on noncompliance, the task force should determine to what extent tax information would assist other agencies and, if it would be sufficiently helpful, seek a legislative change through the Department of the Treasury to allow for sharing of tax information with appropriate privacy protections.
- To enhance understanding of classification issues by workers—especially those in low-wage industries—we recommend that the Secretary of Labor collaborate with the Commissioner of Internal Revenue to offer education and outreach to workers on classification rules and implications and related tax obligations. Such collaboration should include developing a standardized document on classification that DOL would require employers to provide to new workers.

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- To maximize the effectiveness of the relatively new QETP initiative, we recommend that the Commissioner of Internal Revenue create a forum for regularly collaborating with participating states to identify and address data sharing issues, such as ensuring clear points of contact within IRS for states and expeditious sharing of data.
 - To increase proper worker classification, we recommend that the Commissioner of Internal Revenue extend the CSP to include employers that volunteer to prospectively reclassify their misclassified employees, and as part of this extension test whether sending notices describing the program to potentially noncompliant employers would be cost effective. Employers to which IRS would send notices could include those referred for examination but who may not be examined because of higher priorities, resource limitations, or other reasons.

Agency Comments and Our Evaluation

In their comments on a draft of this report, both DOL and IRS generally agreed with our recommendations, and either agreed to implement or to take steps consistent with our recommendations, such as exploring their implementation. WHD, OSHA, and IRS provided written comments on the draft, which are reprinted in their entirety in appendixes III (DOL comments from WHD and OSHA) and IV (IRS comments). In addition, ETA provided technical comments, which we incorporated.

DOL agreed with our recommendation to increase WHD's focus on misclassification of employees as independent contractors during targeted investigations. WHD commented that it would reexamine its training documents and field guidance to ensure that employee classification was addressed during all stages of an investigation. In addition, WHD agreed to focus on increasing compliance for workers in industries where misclassification is prevalent.

DOL also agreed that there is value in sharing information on cases involving the misclassification of employees as independent contractors between WHD and OSHA and with state agencies. WHD and OSHA stated that they are both committed to working closely together to exchange information and improve protections afforded workers. In addition, WHD said that it would assess its current referral processes to ensure that they adequately provided for referrals to other agencies in cases related to employee misclassification.

In their comments, the agencies expressed support for our recommendation to establish a joint interagency effort to address

misclassification. DOL stated that a joint effort between DOL and IRS may prove useful in WHD's efforts to enforce wage and hour laws, and that WHD would participate in any such interdepartmental effort. Similarly, IRS stated that coordination between departments and agencies at the federal and state levels is an effective way to encourage voluntary compliance and agreed to work with the Secretary of Labor to explore developing a joint effort, subject to disclosure rules under section 6103 of the Internal Revenue Code and other privacy rules.

In addition, DOL and IRS agreed to explore opportunities to collaborate to offer education and outreach to workers on the topic of worker classification, including developing a standardized document that DOL would require employers to provide to new workers. WHD agreed to reach out to IRS to explore opportunities for joint outreach to workers, and IRS agreed to collaborate with the Secretary of Labor, make education and outreach materials available to DOL, and work with the Secretary of Labor to explore developing a standardized document on classification for DOL to provide to new workers.

Finally, IRS agreed to work with state workforce agencies participating in QETP to establish a forum to identify and address data sharing and IRS points of contact issues using its Enterprise Wide Employment Tax Program. IRS also said it would consider expanding the CSP to employers not under examination and commented that if it decides to expand the program, it will consider all options, including issuing notices and soft letters and soliciting volunteers through outreach and education. We appreciate that IRS will consider these actions and continue to believe that extending the CSP to include employers that volunteer to prospectively reclassify their misclassified employees would be an effective way to increase proper worker classification and that it would be useful to test whether sending notices would be a cost-effective feature of an expanded program.

As we agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this letter. At that time, we will send copies of this report to the Secretary of Labor, the Commissioner of Internal Revenue, and relevant congressional committees. The report is also available at no charge on GAO's Web site at <http://www.gao.gov>.

Please contact Andrew Sherrill at (202) 512-7215 or sherrilla@gao.gov or Michael Brostek at (202) 512-9110 or brostekm@gao.gov if you or your staffs have any questions about this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.



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Appendix I: Scope and Methodology

To determine what is known about the extent of the misclassification of employees as independent contractors and its associated tax and labor implications, we reviewed studies on misclassification conducted by the Internal Revenue Service (IRS), the Department of Labor (DOL), and others. We reviewed IRS's estimate on the extent of misclassification and the associated revenue loss for tax year 1984. We also interviewed IRS officials responsible for planning an update to that estimate. From DOL, we reviewed a study it commissioned in 2000 on the extent of misclassification. We also analyzed the information states report to it regarding their findings of misclassification during their audits of employers.¹ We analyzed summary data that the states reported for the years 2000 to 2007. These data included the number of employers in each state, the number of audits completed, and the number of misclassified employees identified during these audits. We also reviewed misclassification studies conducted by states, universities, and research institutes. Finally, we interviewed officials from federal and state agencies to obtain their views on misclassification and its consequences for workers.

To describe actions taken by DOL to address employee misclassification, we examined DOL policies and documentation, including DOL's Wage and Hour Division's (WHD) *Field Operations Handbook* and the Occupational Safety and Health Administration's *Field Operations Manual*. We interviewed agency officials at the national and district levels, as well as several investigators from WHD, and spoke with employer and labor advocates to obtain their perspectives on DOL's efforts. In some cases, we relied on interviews conducted for a previous closely related GAO testimony, issued in July 2008.² We also obtained and analyzed WHD data on cases involving misclassification concluded during fiscal year 2008. We could not obtain data for other time periods because WHD did not flag cases to indicate whether they involved misclassification before fiscal year 2008. We assessed the reliability of the data and determined them to be sufficiently reliable for the purposes of this report. However, because DOL only flagged cases as involving misclassification when it was the primary reason for Fair Labor Standards Act (FLSA) violations, and because WHD officials told us that not all investigators understood how to properly flag these cases, this information may be incomplete.

¹All states, the District of Columbia, and Puerto Rico are required to report information regarding their unemployment insurance audits to DOL on a quarterly basis.

²[GAO-08-962T](#).

In total, we examined data for 131 cases involving 1,619 misclassified employees who were denied payment for overtime or were paid less than minimum wage. Using these data from the WHD database, we judgmentally selected 26 case files to review. We selected cases based on factors such as the number of employees misclassified, the total amount of back wages computed, whether a single employee was owed over \$10,000 in back wages, whether civil money penalties were assessed, and whether the case resulted from a complaint or was directed by the agency. We conducted reviews of 13 case files in the WHD New Orleans and Boston offices and requested copies of the remaining selected case files from WHD. Because we judgmentally selected these files, our findings from the reviews of case files are not projectable to all WHD cases.

To obtain information on state coordination with DOL and IRS, state perspectives on DOL's education and outreach efforts, and whether states collect data on cases involving misclassification, we conducted a Web-based survey of unemployment insurance directors in all states, the District of Columbia, and Puerto Rico. We administered two versions of this survey: one for states participating in the Questionable Employment Tax Practices (QETP) program and one for states that do not participate in the QETP program. After we drafted the questionnaire, we asked for comments from a knowledgeable official at the National Association of State Workforce Agencies as well as from an independent GAO survey professional.

We conducted two pretests of the survey, one with a state participating in the QETP program and one with a state that does not participate in the QETP program, to check that (1) the questions were clear and unambiguous, (2) terminology was used correctly, (3) the questionnaire did not place an undue burden on agency officials, (4) the information could feasibly be obtained, and (5) the survey was comprehensive and unbiased. We received responses from all 32 states on the survey for QETP participants, for a response rate of 100 percent. We did not receive a response from 1 state on the survey for states that do not participate in QETP, for a response rate of 95 percent. We were unable to contact the official in Puerto Rico within the study's time period. Finally, we interviewed officials in 4 states to obtain more information about their efforts to address misclassification and, where applicable, reviewed documentation on these efforts.

To describe actions IRS takes to address employee misclassification, we interviewed officials from the employment tax group within IRS's Small Business/Self Employed Division (SB/SE), which conducts the majority of

IRS misclassification-related examinations. We also obtained data on SB/SE examinations of worker misclassification for tax year 2008 generated from four sources: (1) the Determination of Worker Status (Form SS-8) program, (2) the Employment Tax Examination Program (ETEP), (3) QETP, and (4) general IRS employment tax examinations, including cases referred from other divisions within IRS. SB/SE conducted all IRS misclassification examinations generated by ETEP and QETP, over 97 percent of the examinations generated by the SS-8 program, and the majority of general examinations IRS conducted during fiscal year 2008. We also obtained data from IRS's Classification Settlement Program. We assessed the reliability of these IRS data sources and found them to be sufficiently reliable for the purposes of this report. To obtain information on IRS's education and outreach activities that address misclassification, we interviewed officials from the employment tax group within SB/SE, interviewed independent contractor and labor advocates, and reviewed educational materials on classification IRS makes available on its Web site.

To understand how DOL and IRS cooperate with each other and with states and other relevant agencies, we examined agency policies and procedures for sharing information on misclassification and referring cases involving misclassification, and interviewed agency and state officials. We also reviewed information IRS provided on its arrangements with states through the QETP program.

To describe options that could help address challenges in preventing and responding to misclassification, we reviewed GAO and other federal agency reports and recommendations and other organizations' studies on misclassification of employees. We also interviewed 19 relevant stakeholders representing various groups, including (1) labor and advocacy groups, (2) groups that represent small businesses and independent contractors, (3) groups that represent tax professionals, (4) authors who have published on misclassification issues, and (5) federal agencies, to help identify options and summarize any associated trade-offs. Based on those discussions, we identified 19 options to include in this report. We originally identified over 100 options but reduced the list to 19 options that directly addressed misclassification challenges and issues, were not already being implemented, and were distinct from each other. In addition, we did not include other options that we have recently analyzed or recommended in prior reports on misclassification or that are indirectly related to worker misclassification, such as for information reporting on payments made to independent contractors.

We surveyed 11 stakeholders for their views on the 19 options we identified, asking them to state their level of support or opposition to the options and what they perceived to be the strengths and drawbacks of each option. These stakeholders included 4 groups that represent the views of small businesses, independent contractors, and those who hire them (i.e., independent contractor groups); 4 groups that represent the views of organized labor (i.e., labor groups); 2 groups that represented the tax preparation and advice community; and 1 federal agency that uses contractors. We received responses from 9 of these groups.³ We analyzed the responses we received in order to present summary information in the report.

We conducted this performance audit from August 2008 through July 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

³We did not receive survey responses from one of the groups representing the tax preparation and advice community and one of the independent contractor groups.

Appendix II: Stakeholder Views on Options to Address Misclassification Challenges

We identified 19 options to address challenges involved with preventing and responding to worker misclassification by reviewing related literature and interviewing knowledgeable persons about misclassification. As we identified these options, we asked these stakeholders for their views on the options, including what they considered to be the benefits and drawbacks of each. These stakeholders included IRS officials and representatives of organizations representing workers, independent contractors, tax professionals, and a federal agency that hires contractors.

The following is a summary of the options and their perceived associated benefits and drawbacks. Neither the list of options nor the list of their perceived associated benefits and drawbacks is exhaustive. Some of the options are concepts rather than fully developed proposals with details of how they would be implemented. Additional detail could bring more benefits and drawbacks to light. The benefits and drawbacks are not weighted and are not listed in order of importance or by frequency of mention. Options should not be judged by the number of benefits and drawbacks. Some of the options overlap, covering more than one problem, while other options only deal with specific aspects of a problem.

A. Clarify the employee/independent contractor definition and expand worker rights

1. Clarify the distinction between employees and independent contractors under federal law by unifying multiple definitions, limiting the number of factors used to make determinations, and making the factors more conclusive

Benefits:

- Could reduce manipulation of classification rules
- Could improve equity and efficiency of classification rules
- Could improve worker protection if an expansive definition is adopted
- Could improve objectivity of rules/reduce confusion

Drawbacks:

- Lobbying and political compromises could weaken the definition
- Lobbying and political compromises could lead to a more restrictive definition
- Could lead to increased litigation if a new definition has no history or precedent
- Could create transitional costs and upheavals in working relationships
- Could deter use of independent contractors
- A “one-size-fits-all” approach may cause imbalances and more problems than it solves in certain industries
- IRS and government agencies could incur costs to administer a new definition
- Could sidetrack key anti-abuse reforms
- No need to harmonize definitions since courts work well in doing so
- Could encourage more employers to engage in fraud

2. Allow workers to challenge classification determinations in U.S. Tax Court

Benefits:

- Could increase equity and protections for workers
- Could reduce incentives for misclassification

Drawbacks:

- Could result in more or unnecessary litigation
- Would be unfair to businesses
- Could deter use of independent contractors
- Too narrow to limit challenges to just Tax Court and just workers

-
3. Ensure that workers have adequate legal protection from retaliation for filing a Form SS-8

Benefits:

- Could help reduce misclassification/improve misclassification compliance
- Could help improve worker protection and justice

Drawbacks:

- Could result in more litigation
- Limits ability of employers to end contractual relationships as needed
- Could reduce use of independent contractors
- Not necessary because retaliation is rare and independent contractors can protect themselves through a contract
- Does not include worker protection for other actions to challenge misclassification

-
4. Define misclassification as a violation under FLSA

Benefits:

- Could help increase voluntary compliance
- Would allow federal agencies, including DOL, to take greater enforcement actions

Drawbacks:

- Could increase costly lawsuits for businesses
- Could deter use of independent contractors
- Unfair to penalize businesses and contractors for confusing and subjective regulations

B. Revise section 530 of the Revenue Act of 1978

5. Narrow the definition of “a long-standing recognized practice of a significant segment of the industry” so that fewer firms qualify under this reasonable basis for the section 530 safe harbor

Benefits:

- Could reduce incentive to misclassify and increase voluntary compliance
- Could reduce confusion
- Could help reduce tax gap related to misclassification

Drawbacks:

- Opens the door to eroding the protection of section 530
- Could create inequities among those who use independent contractors
- Could lead to economic disruption or upheaval in some industries
- Ignores unique issues that some industries possess
- Unnecessary because current definition can be hard to meet
- Only narrows rather than eliminates “industry practice”

-
6. Lift the ban on IRS/Treasury regulations or revenue rulings clarifying the employment status of individuals for purposes of employment taxes

Benefits:

- Could reduce requests for individual classification determinations and associated costs
- More consistent application of the rules
- Could increase voluntary compliance
- Could allow IRS to more effectively prevent misclassification and enforce classification
- Could improve understanding and reduce confusion over classification

Drawbacks:

- No need because existing case law is sufficient
- IRS favors employee status
- Could erode section 530 protection
- Could increase litigation and lobbying costs
- IRS cannot fix the classification problem without congressional guidance
- A national standard would not affect state definitions
- Could disrupt working relationships
- Political influences could slant the new guidance

C. Provide additional education and outreach

7. Require service recipients to provide standardized documents to workers that explain their classification rights and tax obligations

Benefits:

- Could increase voluntary compliance
- Could help reduce misclassification by reducing errors
- Could help educate workers about classification

Drawbacks:

- Could discriminate against some independent contractors
- Relies on employers instead of IRS to inform workers
- Could be ineffective if workers cannot understand the documents
- Employers would incur costs and burdens

-
8. Expand IRS outreach to service recipient, worker, and tax advisor groups to educate them about classification rules and related tax obligations, targeting groups IRS deems to be “at risk”

Benefits:

- Could increase voluntary compliance
- Could improve uniformity of classifications
- Could reduce misclassification by reducing errors

Drawbacks:

- Could deter use of independent contractors
- Could divert IRS resources from enforcement
- Does not target tax advisors who facilitate misclassification
- Could lead to unfair targeting of business groups
- Could lead to independent contractors suing their clients

-
9. Create an online classification system, using factors similar to those used in the SS-8 determination process, to guide service recipients and workers on classification determinations

Benefits:

- Uses electronic instead of paper-based processes
- Could minimize the need for SS-8 determinations
- Could provide more information to workers and service recipients
- Could streamline decision making on classifications
- Could reduce confusion and unintentional misclassification

Drawbacks:

- IRS would incur costs to develop system
- Still relies on subjective weighting of evidence and is likely to produce inconsistent determinations
- Not all workers have access to computers
- Could be manipulated by employers to attain desired classification

-
10. Increase the use of IRS notices to service recipients in industries with a potentially high incidence of misclassification to educate them about the classification rules and ask them to review their classification practices

Benefits:

- Could increase voluntary compliance
- Could improve understanding of correct classification

Drawbacks:

- IRS would incur costs to develop and mail notices
- Could be ineffective if not combined with IRS enforcement
- Could expose employers to more litigation
- Could create adversarial relationships between employers and workers
- Could be unfair to targeted industries

D. Withhold taxes for independent contractors

11. Require service recipients to withhold taxes, with rates at an adequate level to induce compliance, for independent contractors whose taxpayer identification numbers (TIN) cannot be verified or if notified by IRS during the TIN verification process that the contractors are not fully tax compliant

Benefits:

- Could identify more misclassification
- Could help improve voluntary filing and tax compliance by having taxes paid up front

Drawbacks:

- Would impose costs and burdens on employers
- Does not hold employers financially accountable for misclassification
- TIN verification is not effective
- Could face political opposition
- Discriminates against independent contractors
- Could result in withholding errors

12. Require universal tax withholding for payments made to independent contractors using tax rates that are relatively low (e.g., 1 percent to 5 percent of payment amounts)

Benefits:

- Would make payments to workers more visible
- Could increase voluntary filing and tax compliance by having taxes paid up front
- Could help identify misclassification
- Such low rates would not be burdensome to independent contractors

Drawbacks:

- Would impose costs and burdens on employers and workers
- Could expose employers to underwithholding penalties
- Does not hold employers financially accountable for misclassification
- Could deter use of independent contractors
- Does not recognize that profit margins vary widely across businesses
- Could be used to intimidate undocumented workers
- Withholding amounts could be too high or withholding rate could be too low
- Could lead to increased “off-the-books” payments for services

13. Require service recipients to withhold taxes from payments made to independent contractors who request withholding in writing

Benefits:

- Could increase voluntary filing and tax compliance by having taxes paid up front
- Would be practical because withholding is voluntary
- Could help independent contractors meet their tax obligations
- Could make misclassification easier to identify and less likely to occur

Drawbacks:

- Could increase employers' costs and exposure to penalties for withholding errors
- Could deter use of independent contractors
- Does not hold employers financially accountable for misclassification
- Would need additional remedies for workers if employer did not remit taxes to IRS

E. Collect data on misclassification and independent contractors

14. Measure the extent of misclassification and related impacts on tax revenues at the national level

Benefits:

- Could raise awareness of misclassification
- Would provide data to support any reform efforts
- Could help IRS more effectively address misclassification
- Could improve understanding of correct classification

Drawbacks:

- Timely estimates could be costly
- May not be successful
- Could take a while and delay needed reforms

-
15. Require each independent contractor to apply for a separate business TIN

Benefits:

- Could increase voluntary compliance
- Reinforces business status and obligations of independent contractors
- Could facilitate IRS compliance and enforcement efforts
- Could prompt workers to think about their desired status

Drawbacks:

- IRS would incur costs
- Would impose burdens on independent contractors to apply
- Could be harmful to some industries
- Employers could use it to force workers into independent contractor status or to justify their independent contractor classifications

F. Enhance IRS compliance programs

16. Expand IRS's Classification Settlement Program (CSP) to allow for CSP treatment for service recipients that voluntarily contact IRS about their misclassified workers before any contact from IRS about potential misclassification

Benefits:

- Would reduce the financial exposure of participating employers
- Could increase voluntary compliance
- Would not unnecessarily burden employers

Drawbacks:

- IRS would incur costs to expand program
- Unfairly rewards intentional misclassification
- Could create section 530 protection or allow other manipulation of classification rules for some employers

-
17. Require service recipients to submit Forms SS-8 for all newly retained independent contractors

Benefits:

- Could increase voluntary compliance/reduce misclassification
- Shifts burden of proof to the independent contractor
- Provides IRS more information about independent contractors for compliance and enforcement

Drawbacks:

- Current SS-8 process does not sufficiently protect workers or investigate employers
- Would impose burdens and costs on employers and independent contractors
- Could severely slow down the contracting process
- Could deter use of independent contractors
- Could allow for more manipulation of classification rules unless the rules are clarified and IRS more vigorously investigates employers
- Does not address IRS's bias for employee status
- IRS's costs would be significant

G. Enhance coordination and information sharing

-
18. Enhance coordination between IRS, DOL, and other federal agencies to share data and address misclassification

Benefits:

- Could increase voluntary compliance
- Could deter intentional misclassification
- Could make federal enforcement more efficient
- Could improve consistency across federal agencies

Drawbacks:

- IRS may not be able to use all the information that it receives
- Could deter some workers from reporting misclassification, especially if it leads to questions about their immigration status
- Could result in loss of privacy for individuals affected by the information sharing
- Could be hampered by differences in agency definitions of employee status

19. Enhance coordination between IRS, states, and selected local governments to share data and address misclassification

Benefits:

- Could help increase voluntary compliance
- Could improve federal agency efficiency and effectiveness

Drawbacks:

- IRS may not be able to use all the information it receives
- Could deter some workers from reporting misclassification
- Could result in loss of privacy for individuals affected by the information sharing
- Could be hampered by different definitions of employee status
- Having too many government agencies involved could hamper action and allow employers to manipulate rules

Appendix III: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employment Standards
Washington, D.C. 20210



JUL 14 2009

Mr. Andrew Sherrill
Director
Education, Workforce, and
Income Security Issues
U. S. Government Accountability Office
Washington, D. C. 20548

Dear Mr. Sherrill:

Thank you for the opportunity to comment on the Government Accountability Office's (GAO) draft report entitled "*Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention*" (GAO-09-717).

The draft report provides four recommendations to the Secretary of Labor, two of which directly cite the Employment Standards Administration's Wage and Hour Division (WHD). Our comments follow the restated recommendations.

Recommendation 1

To increase its detection of FLSA and other labor law violations, we recommend that the Secretary of Labor direct the Wage and Hour Division Administrator to increase the division's focus on misclassification of employees as independent contractors during targeted investigations.

Response

WHD agrees with this recommendation. WHD investigators must establish an employment relationship to pursue remedies on behalf of workers under most of the statutes that the agency enforces, including the Fair Labor Standards Act and the Family and Medical Leave Act. To reinforce this position, the agency will reexamine its training materials and field guidance documents to ensure that all investigative staff is aware of the potential for employer misclassification of workers as independent contractors, that procedures are clearly articulated, and that investigators address employers' classification practices during all stages of an investigation. In addition, WHD's future performance planning priorities will focus on increasing compliance on behalf of workers employed in industries that are characterized by frequent incidences of independent contractor misclassification.

Recommendation 2

To enhance efforts to protect workers and make the most effective use of their resources, we recommend that the Secretary of Labor direct the Wage and Hour Division Administrator and the Assistant Secretary for OSHA to ensure that information on cases involving misclassification of employees as independent contractors is shared between the two divisions and that cases outside their jurisdiction are referred to states and other relevant agencies, as required.

Response

WHD agrees that there is value in sharing information about misclassification with the Occupational Safety and Health Administration (OSHA) and with state agencies, as appropriate. To this end, WHD and OSHA are committed to working together to improve coordination between the two agencies and to institutionalize the exchange of information on this issue. WHD will also assess its current referral processes to ensure that they adequately provide for referrals of potential violations of other laws outside WHD's jurisdiction that may be related to the misclassification of workers as independent contractors.

Recommendation 3

To identify promising practices in addressing misclassification and use agency resources most effectively, we recommend that the Secretary of Labor and the Commissioner of Internal Revenue establish a joint interagency effort with other federal and state agencies to address the misclassification of employees as independent contractors. Because tax data may provide useful leads on noncompliance, the task force should determine to what extent tax information would assist other agencies, and if it would be sufficiently helpful, seek a legislative change through the Department of Treasury to allow for sharing of tax information with appropriate privacy protections.

Response

WHD agrees that a joint effort between the Department of Labor and the Internal Revenue Service may prove useful in its efforts to enforce wage and hour laws. WHD will actively participate in any such interdepartmental effort.

Recommendation 4

To enhance understanding of classification issues by workers—especially those in low-wages industries—we recommend that the Secretary of Labor collaborate with the Commissioner of Internal Revenue to offer education and outreach to workers on classification rules and implications and related tax obligations. Such collaboration should include developing a standardized document on classifications that DOL would require employers to provide to new workers.

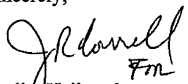
3

Response

WHD will reach out to the Internal Revenue Service to explore opportunities for joint outreach to workers.

WHD appreciates the seriousness of the adverse consequences to workers who are misclassified as independent contractors. Again, thank you for the opportunity to comment on the draft report.

Sincerely,


Shelby Hallmark
Acting Assistant Secretary

**Appendix III: Comments from the Department
of Labor**

U.S. Department of Labor

Assistant Secretary for
Occupational Safety and Health
Washington, D.C. 20210



JUL 14 2009

Mr. Andrew Sherrill, Director
Education, Workforce
and Income Security

Mr. Michael Brostek, Director
Tax Issues
Strategic Issues Team

United States Government Accountability Office
441 G Street, N. W.
Washington, D.C. 20548

Dear Messrs. Sherrill and Brostek:

The Occupational Safety and Health Administration (OSHA) appreciates the opportunity to review and comment on your draft report entitled *Employee Misclassification: Improved Coordination, Outreach and Targeting Could Better Ensure Detection and Prevention*.

The OSH Act requires all employers to maintain a safe and healthful workplace. It is the employer's responsibility to ensure the health and safety of the workers as the employer has direct control of the workplace and the actions of the employees who work there. Consequently, misclassification of employees as contingent workers generally will not result in an employer responsible for OSHA violations escaping citation.

Nonetheless, OSHA understands the serious ramifications workers face in lost protections and benefits due to misclassification. OSHA is committed to working closely with the Administrator of the Wage and Hour Division to enhance the exchange of information on this issue and improve protections afforded workers.

Again, thank you for the opportunity to respond to GAO's draft report.

Sincerely,

A handwritten signature in black ink, appearing to read "Jordan Barab", with a long horizontal flourish extending to the right.

Jordan Barab
Acting Assistant Secretary

Appendix IV: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 10, 2009

Mr. Michael Brostek
Director, Strategic Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Brostek:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled, "Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention (Job Code GAO-09-717)."

We recognize that when employers improperly classify workers as independent contractors instead of employees, those workers do not receive protections and benefits to which they are entitled, and the employers may fail to pay taxes they would otherwise be required to pay. We agree that coordination between the departments and agencies at the federal and state levels is an effective way to encourage voluntary compliance and help address employee misclassification.

The IRS enforces worker classification compliance primarily through administration of our SS-8 program and through employment tax examinations. IRS offers a classification settlement program where employers may be eligible to reduce audit assessments if they agree to prospectively treat their workers as employees in the future. IRS also provides general information on worker classification through publications and fact sheets available on our Web site and through outreach targeted to tax and payroll professionals and employers. However, IRS faces challenges with these compliance efforts because of resource constraints and legal limits placed on IRS in providing guidance under Section 530 of the Revenue Act of 1978.

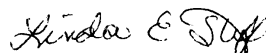
Your report identifies various options that could help address the misclassification of employees as independent contractors. We appreciate the suggestions and will carefully consider them as we work with the Secretary of Labor and others to explore those options.

2

The enclosed response addresses each recommendation separately.

If you have questions or concerns, please contact Christopher Wagner, Commissioner,
Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,

A handwritten signature in black ink, appearing to read "Linda E. Stiff".

Linda E. Stiff

Enclosure

Enclosure

Recommendation

To identify promising practices in addressing misclassification and use agency resources most effectively, we recommend that the Secretary of Labor and the Commissioner of Internal Revenue establish a joint interagency effort with other federal and state agencies to address the misclassification of employees as independent contractors. Because tax data may provide useful leads on noncompliance, the task force should determine to what extent tax information would assist other agencies, and if it would be sufficiently helpful, seek a legislative change through the Department of the Treasury to allow for sharing of tax information with appropriate privacy protections.

Comment

We agree that coordination between departments and agencies at the federal and state levels is an effective way to encourage voluntary compliance. We agree to work with the Secretary of Labor to explore developing a joint effort subject to disclosure rules under IRC Section 6103, as well as privacy rules under 5 U.S.C. 552a.

Recommendation

To enhance understanding of classification issues by workers – especially those in low-wage industries - we recommend that the Secretary of Labor collaborate with the Commissioner of Internal Revenue to offer education and outreach to workers on classification rules and implications and related tax obligations. Such collaboration should include developing a standardized document on classification that DOL would require employers to provide to new workers.

Comment

We agree to collaborate with the Secretary of Labor, and we will make education and outreach materials available to the DOL. We agree to work with the Secretary of Labor to explore developing a standardized document on classification for the DOL to provide to new workers.

Recommendation

To maximize the effectiveness of the relatively new QETP initiative, we recommend the Commissioner of Internal Revenue create a forum for regularly collaborating with participating states to identify and address data sharing issues, such as ensuring clear points of contact within IRS for states and expeditious sharing of data.

2

Comment

We agree to work with participating State Workforce Agencies (SWAs) in the Questionable Employment Tax Program (QETP) to establish a forum to identify and address data sharing and IRS points of contact issues. We will utilize the Enterprise Wide Employment Tax Program (EWETP) to achieve this.

Recommendation

To increase proper worker classification, we recommend that the Commissioner of Internal Revenue extend the Classification Settlement Program to include employers who volunteer to prospectively reclassify their misclassified employees, and as part of this extension test whether sending notices describing the program to potentially noncompliant employers would be cost effective. Employers to whom IRS would send notices could include those referred for examination but who may not be examined due to higher priorities, resource limitations, or other reasons.

Comment

We will review the existing Classification Settlement Program and consider the possibility of expanding to employers not under audit. If expansion of this program is appropriate, we will consider all options, including issuing notices and soft letters and soliciting volunteers through outreach and education.

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

Andrew Sherrill, (202) 512-7215 or sherrilla@gao.gov

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contacts named above, Revae Moran, Acting Director; Tom Short, Assistant Director; Amy Sweet, Analyst-in-Charge; Jeff Arkin, Analyst-in-Charge; Susan Bernstein; Jessica Bryant-Bertail; Scott Charlton; Doreen Feldman; Jennifer Gravelle; Maura Hardy; David Perkins; Ellen Phelps Ranen; Albert Sim; Andrew J. Stephens; and Gregory Wilmoth made key contributions to this report.

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