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2009

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### Repository Citation

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## Stretching the Law II:

# The Misclassification of Employees as Independent Contractors

*“Every year, workers [in the U.S.] lose \$19 billion in wages and benefits through illegal practices. . . . Taxpayers are cheated out of \$2.7 billion to \$4.3 billion each year in Social Security, unemployment, and income taxes from just one type of workplace fraud that misclassifies employees as independent contractors.”<sup>1</sup>*

### Background

The misclassification of many employees as “independent contractors” (ICs) is problematic in a number of industries and employment situations. An earlier paper by the Bureau of Labor Education (BLE) found widespread violations of IC classification in the state’s construction industry.<sup>2</sup> This paper provides a broader context for this issue with a discussion of the legal climate nationally.

Independent contractors and employees are not interchangeable with regard to job classification, and this distinction is important. An IC is generally a self-employed professional. S/he receives a 1099 tax form and is responsible for all payroll taxes and employment insurances. An employee, on the other hand, has these taxes and insurances withheld or paid by his or her employer, and s/he receives a W2 tax form.

The misclassification of employees as ICs is harmful in many ways. As stated in a recent Executive Order by Maine’s Governor John Baldacci, “employee misclassification has a significant adverse impact on the residents, businesses and economy in Maine,” ranging from reduced employer “compliance with employment and safety standards,” to depriving the state of “substantial revenues.”<sup>3</sup> The Governor’s office reports a high incidence of misclassification revealed by unemployment audits. The number of audited Maine employers who were not in compliance rose from 29 percent in 2004 to 41 percent for 2007.<sup>4</sup>

Misclassification ignores the fact that many workers cannot afford to pay IC expenses. Ultimately, it contributes to a growing “underclass” of low-paid workers without benefits or rights, who may have to depend on public assistance to get by. Also, it threatens the health of Workers’ Compensation and Unemployment Insurance, driving up costs for employers who are in compliance.

The problem is compounded by complicity from employees who may not realize the rights and benefits they give up without the employment relationship, or who prefer the IC status to avoid taxes and wage attachments. Some misclassified workers may feel that there is little incentive to come forward and report misclassification. Workers in these situations also are likely to fear employer retaliation if they complain.

With legislation on this issue under consideration in about half the states in 2008,<sup>5</sup> clearly this is an issue with national scope. This paper looks at the legal climate for IC issues nation wide, especially matters of enforcement, and the “safe harbor” tradition that has permeated the employment environment, making IC classification compliance optional for many employers.

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<sup>1</sup> Madland, David and Walter, Karla. *Enforcing Change: Five Strategies for the Obama Administration to Enforce Workers’ Rights at the Department of Labor*. Center for American Progress Action Fund: American Worker Project (AWP), December 2008, p. 1. Retrieved 4/13/09: <http://www.faircontracting.org/NAFCnewsite/prevwage.htm>

<sup>2</sup> *Stretching the Law, Stressing the State: Misclassified Workers in Maine’s Construction Industry*. Orono, Maine: University of Maine, Bureau of Labor Education, 2007. Available: <http://dll.umaine.edu/ble/pubs>

<sup>3</sup> State of Maine, Office of the Governor. “An Order Establishing the Joint Enforcement Task Force on Employee Misclassification.” Retrieved 4/13/09: [www.maine.gov/tools/whatsnew/index.php?topic=Gov\\_Executive\\_Orders&id=66730&v=Article](http://www.maine.gov/tools/whatsnew/index.php?topic=Gov_Executive_Orders&id=66730&v=Article)

<sup>4</sup> *Ibid.*; based on Unemployment Insurance audits performed by the Maine Department of Labor.

<sup>5</sup> Ruckelshaus, Catherine K. *Summary of Independent Contractor Reforms State and Federal Activity*. July 2008, p. 1. National Employment Law Project (NELP). Retrieved 4/13/09: <http://www.nelp.org/site/publications/>; scroll down to 2008 articles for link to this title.

## Job Classifications: Independent Contractors are Contingent Workers

The Government Accountability Office (GAO) states that: “[b]roadly defined, ‘contingent work’ refers to work arrangements that are not long-term, year-round, full-time employment with a single employer.”<sup>6</sup> Contingent workers “are not wage and salary workers working at least 35 hours a week in permanent jobs.”<sup>7</sup> The GAO also reports that “compared with standard full-time workers, contingent workers lagged behind in terms of income and benefits.”<sup>8</sup>

A traditional employee relationship is important in that employees have numerous statutory protections, and especially in that they are more likely to receive benefits such as health insurance. However, nearly a third of U.S. workers belong to a class referred to as the contingent workforce. In 2000, contingent workers made up just under 30 percent of the workforce; this relationship remained constant at about 31 percent in 2005, representing a total of 42.6 million workers.<sup>9</sup>

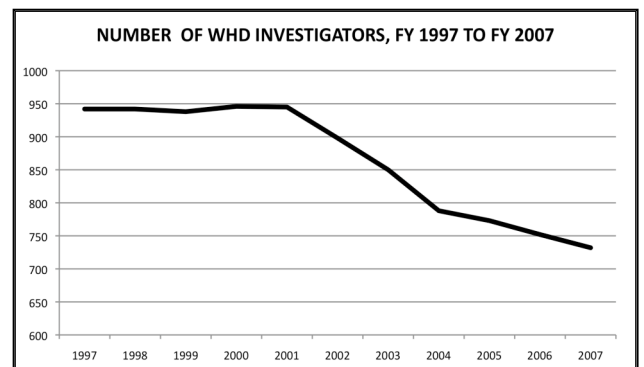
The second largest group in the contingent labor group, 24 percent, is made up of independent contractors.<sup>10</sup> Studies show that some workers in this group are actually employees who have been misclassified as ICs.<sup>11</sup> A disproportionate number are in the construction sector; the GAO reported that in 2005 “. . . the percentage of independent contractors in construction (22 percent) was greater than in other industries.”<sup>12</sup>

As we have noted earlier, ICs need to be properly classified. If they are not, economic distortions and other negative impacts will result. The GAO concludes that “[t]o the extent that contingent workers neither receive health or pension benefits nor qualify for unemployment or workers’ compensation, they may have to turn to needs-based programs such as Medicaid to make ends meet. To the extent that this occurs, *costs formerly borne by employers may be shifted to federal and state public assistance budgets.*” [emphasis added]<sup>13</sup> Thus while employers enjoy cost *savings*, this is actually cost *shifting* that can significantly inflate tax liabilities for the public.

## What Legal Protections Are Available for Misclassified Workers?

Many misclassified ICs, if classified correctly, would fall under the protection of the Wage and Hour Division (WHD) of the U.S. Department of Labor. Hourly workers in most industries depend on the WHD for minimum wage and overtime enforcement.

One factor contributing to widespread IC misclassification is lack of enforcement of wage and hour laws. The GAO found that: “[f]rom fiscal years 1997 to 2007, the number of the WHD’s enforcement actions decreased by more than a third, from approximately 47,000 in 1997 to just under 30,000 in



**U.S. Department of Labor**  
**Wage and Hour investigative staff, 1997-2007**  
Source: US GAO, *Fair Labor Standards Act*, p. 7  
GAO-08-962T July 15, 2008

<sup>6</sup> U.S. Government Accountability Office (GAO). *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*. GAO-06-656, July 2006. Retrieved 4/25/09: <http://www.gao.gov/new.items/d06656.pdf>, p. 5.

<sup>7</sup> *Ibid.*, p. 1.

<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*, pp. 1, 3.

<sup>10</sup> *Ibid.*, p. 12. The largest group is “standard part-time workers,” who make up 43 percent of the contingent workforce.

<sup>11</sup> BLE, *ibid.*

<sup>12</sup> GAO, *ibid.*, p. 13.

<sup>13</sup> *Ibid.*, p. 35.

2007.”<sup>14</sup> WHD investigative staff was reduced by more than 20 percent during this time.<sup>15</sup>

The enforcement situation at the U.S. Department of Labor is further complicated by the fact that under the George W. Bush administration, the WHD took a narrow view of its enforcement role, stating repeatedly in testimony before House investigators that the act of misclassification is not in itself a violation of the Fair Labor Standards Act.<sup>16</sup> As the Government Accounting Office observed in 2006, “[b]ecause employee misclassification is not a violation of FLSA, investigators are not required to discuss misclassification identified during FLSA investigations with employers or to include it in their investigation report.”<sup>17</sup> This makes follow-up of misclassification cases optional for WHD investigators.

State level enforcement of employee classification is especially important in this context. The Maine Department of Labor Bureau of Unemployment Compensation has successfully used targeted audits of general construction contractors to reveal the extent of misclassification in construction. As reported previously by the BLE, auditors determined that, for 2005, “nearly 40 percent of the audits revealed misclassified workers.” Targeted audits are effective: the Maine DOL found infractions that were “almost twice the number of misclassified workers usually found in a year when the same number of random audits are conducted over a random sampling of all industries.”<sup>18</sup>

### **Independent Contractor Classification: the Rules in Maine**

One approach to preventing IC misclassification is by defining “presumptive employee status.” Under this stipulation, a worker is assumed to be an employee unless the employer can make a case for an IC classification.<sup>19</sup> Maine regulations presume employment through the “**ABC Test**” used by the Bureau of Unemployment Compensation. The test states that “service performed by an individual for wages *shall be deemed employment* unless and until it is shown to the satisfaction of the Bureau of Unemployment Compensation that:

[A] The individual performing the service has been, and will continue to be, free from control or direction over the performance of the service, both under the contract and in fact; **and**

[B] The service is performed outside the usual course of the business for which the service is performed, or the service is performed outside of all the places of business of the enterprise for which the service is performed; **and**

[C] The individual is customarily engaged in an independently established trade, occupation, profession or business.” [emphasis added].<sup>20</sup>

This test is thorough, practical, and relatively simple. Employers must comply with **all three** rules; if a worker’s situation does not fit **any one** of these three categories, employment status is confirmed.

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<sup>14</sup> U.S. Government Accountability Office (GAO). *Fair Labor Standards Act: Better Use of Available Resources and Consistent Reporting Could Improve Compliance*. GAO-08-962T, *Highlights* page. Retrieved 4/15/09: [www.gao.gov/new.items/d08962t.pdf](http://www.gao.gov/new.items/d08962t.pdf)

<sup>15</sup> GAO, *ibid.*, p. 6. The GAO also reported that “in targeting businesses for investigation, WHD focused on the same industries from 1997 to 2007 despite information from its commissioned studies on low wage industries in which FLSA violations are likely to occur” *ibid.*, p. 15. While construction has a high rate of IC misclassification, construction was not one of the groups targeted for investigation by the WHD.

<sup>16</sup> Ruckelshaus, Catherine K. *Labor’s Wage War*. NY, NY: *Fordham Urban Law Journal*, vol. 35 no. 2, February 1, 2008, p. 378. Retrieved 4/25/09: [http://law.fordham.edu/ihtml/page3g\\_nob.ihtml?imac=1264&pubID=400&articleid=2791](http://law.fordham.edu/ihtml/page3g_nob.ihtml?imac=1264&pubID=400&articleid=2791) Note: post of Administrator for the WHD was vacant as of 4/25/09.

<sup>17</sup> GAO, *Employment Arrangements*, *ibid.*, p. 28.

<sup>18</sup> BLE, *ibid.*

<sup>19</sup> Ruckelshaus, Catherine K., *Summary of Independent Contractor Reforms State and Federal Activity*, *ibid.*, p. 4.

<sup>20</sup> Maine Department of Labor website, retrieved 4/27/09: [www.maine.gov/labor/uitax/I-41.pdf](http://www.maine.gov/labor/uitax/I-41.pdf) Employers must contact the Internal Revenue Service, Maine Revenue Service, the Workers’ Compensation Board, and the Maine Department of Labor Bureau of Unemployment Compensation to determine what taxes and insurances they must pay. Workers may be employees for the purposes of some of these departments, and ICs according to others.

## What Changes to the Federal Statutes Are Needed?

The GAO reports that “no definitive test exists to distinguish whether a worker is an employee or an independent contractor.”<sup>21</sup> Indeed, federal law sidesteps this issue in a manner very favorable to employers. As mentioned previously, the WHD stresses the fact that misclassifying workers is not per se against the law. However, some unexpected language in the IRS tax code plays a decisive role in IC misclassification by protecting it as an “industry practice,” or “safe harbor:”

A major problem barring effective enforcement against independent contractor abuses is the safe harbor provision in the Internal Revenue Code, at Section 530 of the Revenue Act of 1978, 26 U.S.C. § 7436. Currently, employers decide whether their workers are employees or independent contractors with little scrutiny from the IRS and no consequences. Under current law, an employer who is found by the IRS to have misclassified its workers can have all employment tax obligations waived. Section 530 also prevents the IRS from requiring the employer to reclassify the workers as employees in the future. Among other factors, a business can rely on its belief that a significant segment of the industry treated workers as independent contractors, thereby perpetuating industry-wide noncompliance with the law.<sup>22</sup>

After more than thirty years of arbitrary employer privilege under this safe harbor language, the tide may be turning on this issue. Two bills introduced in the 110<sup>th</sup> Congress focused on closing the safe harbor loophole.<sup>23</sup> Whatever the prospects of these bills may be as the current Congress grapples with economic problems, they show an intent to provide greater worker protection and ensure tax fairness.

## Conclusions

Injustice should not be codified. Compliant employers should not have to pay higher Workers' Compensation and Unemployment Insurance premiums due to misclassification by others, nor should they lose bids to employers who cheat. Bona fide employees are likewise entitled to collect Social Security when they retire, and to enjoy other legal benefits and protections provided by law. Taxpayers should not have to pick up costs for benefits that are the legal responsibility of employers. Misclassification costs our communities big money.

Depressing wages only exacerbates the downward spiral of recession. Inadequately paid workers can be a burden on taxpayers through dependence on public assistance. Properly classified workers with decent benefits, on the other hand, are more likely to earn a livable wage that can support their families, and to be self sufficient. In terms of fairness and equity, workers are entitled to a fair deal through proper classification of their employment status.

Prepared as a public service by the Bureau of Labor Education, University of Maine; Spring, 2009  
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<sup>21</sup> GAO, *ibid.*, p. 51.

<sup>22</sup> Ruckelshaus, Catherine K. “Testimony of the National Employment Law Project Before the United States Congress House of Representatives Committee on Education and Labor, Subcommittee on Workforce Protections; *Providing Fairness to Workers Who Have Been Misclassified as Independent Contractors.*” March 27, 2007, p.8, fn39. Retrieved 4/25/09: [http://www.nelp.org/site/issues/category/independent\\_contractor\\_misclassification\\_and\\_subcontracting](http://www.nelp.org/site/issues/category/independent_contractor_misclassification_and_subcontracting) Follow link on right to Independent Contractor Testimony US House.

<sup>23</sup> S. 2044 and H.R. 5804. See also H.R. 6111 and S. 3648, for IC issues in legislation.