Money under the Bridge: The Worker Misclassification Problem

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I. INTRODUCTION

On May 12, 2009, eighty workers from nine union groups gathered to protest FedEx Ground Inc. at its Miami office and truck yard. Organized by the South Florida AFL-CIO, the unions joined a nationwide workers’ rights movement opposing the long-time classification of FedEx ground-delivery truck drivers as independent contractors, rather than employees. Currently, FedEx classifies single work-area truck drivers as independent contractors rather than employees for employment and tax purposes.¹ At first glance, this may seem inconsequential because employers have been classifying various types of workers as independent contractors for years, often with varying degrees of success. But the practice of misclassifying workers is frequently a calculated business maneuver in which companies manipulate the law to justify deprivation of workers’ rights simply to minimize company costs. Classifying ground drivers as independent contractors instead of employees allows FedEx Ground to minimize the cost of withholding employment taxes, avoid providing unemployment compensation insurance, and minimize employment benefits such as overtime for single-area ground delivery drivers. Not only do misclassified workers suffer losses associated with denial of benefits, but many

also encounter tax problems due to misclassification that plague them financially for years.

Misclassification has dire consequences for exploited workers, but the effects of the problem reach every taxpayer. In an assessment that was issued by the Internal Revenue Service, but later withdrawn pending further investigation, FedEx was found to owe the federal government an estimated $319 million in unpaid employment-related taxes for 2002, 2004, 2005, and 2006. Because millions of workers are allegedly misclassified every year, the windfall revenue that would result from improving employment classification laws would be tremendous.

The employment classification system is complex and employer-centered, making it difficult for a worker to achieve an employment status determination in his favor. Legal battles concerning worker misclassification often result in fickle decisions. The common-law employment status test is vague, and decisions on the same facts can differ from state to state, and often from court to court. For example, FedEx ground delivery drivers are currently deemed “employees” in some courts, and “independent contractors” in others. In August of 2007, the California Fourth District Court of Appeal found that despite the obligatory operating contract signed by all FedEx ground-delivery drivers agreeing to independent contractor status, FedEx’s treatment of the drivers warranted an employee status determination under the common-law classification test. In June of 2009, the attorneys general of eight states spoke out against the independent contractor classification of FedEx ground delivery drivers. Insisting that laws related to workers’ compensation, unemployment insurance, wage and hour protections, and civil rights protections within their states are their responsibilities, the attorneys general formed a “working group” to represent the drivers’ interests in public discourse. However, FedEx drivers were not so lucky in other states. Following the attorney generals’ announcement, a jury in the Superior Court of Washington found that FedEx ground-delivery drivers were independent contractors for employment purposes. These cases are only the beginning of litigation

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5. *Id.*
between drivers and FedEx Ground: a federal class-action suit involving more than 30,000 current and former FedEx "contractors" is still pending in Indiana.\footnote{7}

While companies continue to defraud the government out of millions of dollars each year, the federal and most state governments have yet to improve, or even understand, worker misclassification. After years of ignoring the trend, the government has very little current information about the scope and actual cost of worker misclassification. However, misclassified workers, along with every taxpayer in the United States, consistently and often unknowingly feel the negative consequences of the problem year after year, and very little action is being taken to curb the effects. In this essay, I will explain and analyze the persisting problem of worker misclassification in the United States: its effects on workers and the tax gap, the actions and inaction of the federal government to respond to the issue, state actions being taken to combat misclassification, and new state and federal laws and policy proposals with the goals to minimize or eliminate the negative effects of misclassification.

II. BACKGROUND ON THE WORKER MISCLASSIFICATION TREND AND CURRENT EMPLOYMENT CLASSIFICATION LAW

The misclassification of workers as independent contractors is a complex problem that increases the tax gap and has long-reaching effects into our society. In a February 2009 treasury department report, the federal government stated that the IRS's most recent estimate of the tax gap, conducted in 2001, is approximately $345 billion.\footnote{8} The tax gap is the difference between the revenue the IRS expects to take in and the amount taxpayers actually pay; this gap creates a hole between the estimated income and spending potential of the federal government for a year and the actual income and spending potential. Conducted in 1984, the last comprehensive estimate of the impact of worker misclassification on tax revenues and the tax gap showed 3.4 million misclassified workers, leading to an estimated $1.6 billion tax loss in social security, unemployment, and income taxes that should


have been withheld from employee wages.\textsuperscript{9} In July of 2006, the Government Accountability Office adjusted the $1.6 billion estimate in 1984 to $2.72 billion in inflation-adjusted 2006 dollars.\textsuperscript{10} Without the data necessary to determine if worker misclassification has increased in frequency or effect since 1984, a problem which is only beginning to be addressed, it can be estimated only that the cost of worker misclassification on the tax gap has been increasing over time.

Worker misclassification affects the tax gap in a variety of ways. According to a May 2007 report from the Congressional Joint Committee on Taxation, independent contractors and their employers have lower IRS compliance rates compared with employees and their employers, resulting in a revenue loss associated with independent-contractor status.\textsuperscript{11} The difference in rules regarding the different classifications, such as reporting and withholding requirements, often contribute to the lower compliance rate.\textsuperscript{12} According to the Strategic Initiative to Establish a Research Project on Withholding Noncompliance and The Employment Tax Examination Program, two collaborative treasury department and IRS research initiatives conducted in 1984, employers often fail to report independent contractor payments to the IRS, and workers labeled as independent contractors often fail to declare those unreported payments as income.\textsuperscript{13} The non-compliance exists despite the current laws requiring employers of independent contractors to issue Form 1099 information returns to both their workers and the IRS annually to allow the government to track proper revenue reporting.\textsuperscript{14} The 1984 data programs also revealed that, during that year, nearly fifteen percent of employers misclassified their employees as independent contractors.\textsuperscript{15} When workers were classified as employees, more than ninety-nine percent of wage and salary income was reported to the IRS; workers classified as independent contractors who received a Form 1099 reported seventy-seven percent of gross income; and workers classified as independent contractors without a filed Form 1099 only reported twenty-nine percent of gross income.\textsuperscript{16} From 1988 through 1994, the Government

\textsuperscript{9} \textit{Id.}
\textsuperscript{10} \textit{Id.}
\textsuperscript{12} \textit{Id.}
\textsuperscript{13} \textit{Id.}
\textsuperscript{14} \textit{See I.R.C. § 6031(a) (2009).}
\textsuperscript{15} \textsc{Staff of J. Comm. on Taxation, supra} note 11.
\textsuperscript{16} \textit{Id.}
Accountability Office found that audits of employers who often did not classify workers as employees resulted in $751 million of tax assessment increases and the reclassification of 438,000 workers as employees. In addition to tax difficulties from withholding confusion, a worker who is misclassified may face additional problems, such as the inability to exclude certain types of worker's compensation from income or the capacity to take certain expense tax deductions.

Workers who are misclassified as independent contractors often would benefit from and prefer to have employee status for a variety of reasons. The relative simplicity of not having to withhold one's own employment, social security, and Medicaid taxes—and the ability to exclude employer-provided benefits such as: pension, health, and group-term life insurance benefits from gross income for federal income tax purposes—entice workers to favor employee status over independent contractor status.

Despite the drawbacks to many workers, independent contractor status is widely regarded as an acceptable alternative to employee classification. Companies maintain that a worker may be attracted to independent contractor classification because he can “be his own boss,” or can establish and closely maintain his own individual retirement arrangement, or IRA, by controlling and deducting contributions to the plan as he sees fit. While classification preference may vary among workers, a more uniform and complete method of interpreting proper classification is necessary to reduce the costs on the tax gap, limit employer withholding errors, and encourage and educate workers to comply with federal withholding requirements.

Currently, employers largely determine their workers' employment classifications. Numerous explanations exist for why an employer might misclassify his or her workers, some dubious and some erroneous. Employers may accidentally misclassify a worker; however, misclassification can be very advantageous to the employer and is often intentional. The treasury department claims that, employers who misclassify workers as independent contractors tend to gain a competitive advantage over employers who treat their workers as employees for employment and tax purposes. The misclassifying employers avoid withholding and paying their share of employment, social secur-

17. Id.
18. Id.
19. Id. at 2.
20. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION Office, supra note 8, at 1.
ity, and Medicaid taxes and other expenses such as workers’ compensation and unemployment insurance, among other benefits.\footnote{Id.}

The Revenue Act of 1978 § 530 provides a safe-harbor rule, which allows an employer with a reasonable basis to treat a worker as an independent contractor for employment tax purposes, even though the worker should be classified under the common-law test as an employee.\footnote{STAFF OF J. COMM. ON TAXATION, supra note 11, at 6.} The safe-harbor applies if the employer has never treated the worker as an employee for any period, and if for periods after 1978, the employer files all his federal tax returns on a basis consistent with treating such worker as an independent contractor.\footnote{See Revenue Act of 1978, 26 U.S.C.A. § 3401 (2009).} Further, the employer must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977.\footnote{Id.} Although the legislative history of § 530 states that the provision is to be “construed liberally in favor of taxpayers,” the safe-harbor rule is vague and often leads to non-uniform decisions on worker classification. Similar to classification problems attributable to the common-law definitions of “employee” and “independent contractor,” the safe-harbor rule is dependent on the analysis of facts and circumstances that often leads to dispute over the correct result for a specific set of facts.\footnote{STAFF OF J. COMM. ON TAXATION, supra note 11, at 9.} Oftentimes, different courts will apply the common-law employment test in different ways, and a very similar set of facts can result in different status determinations. The most recent FedEx Ground cases, which resulted in different employment status determinations for workers employed by the same company and with the same contract, are examples of how the application of the common-law rules varies from decision to decision.

The safe-harbor rule also can create confusion for workers who are classified under the § 530 provision because independent contractor classifications apply only to employers and only for employment tax purposes.\footnote{Id.} For example, if a worker is classified as an independent contractor under § 530, he may or may not be an independent contractor for the purposes of filing his federal income taxes and must look to the complex common-law employment test for a correct determination.\footnote{Id.} Section 530 is not codified in the Internal Revenue Code, or “the
Code”, thereby decreasing the accessibility and transparency of the current procedures.28

Another complication adding to the depth of the misclassification problem is the complexity of the common-law worker classification test. The common-law provides vague definitions and guidelines for determining worker classification, requiring an examination of a variety of factors and circumstances that often do not result in a clear answer. The Joint Committee on Taxation said that the opaqueness of the common-law test creates a significant gray area in close determinations, which leads to complexity and confusion with the potential for inadvertent error or abuse.29 Although the flaws of the worker misclassification system stem from various issues, the weakness of the law is rooted in the circumstantial nature of the common-law tests.

Generally, an employer-employee relationship exists when the employer has the right to control and direct a service provider.30 Control over the worker is not limited to the desired result for the work being done, but must address the details and means by which the result is accomplished.31 According to Treasury Regulations § 31.3401, the employer-employee relationship exists when the worker “is subject to the will and control of the employer not only as to what shall be done but how it shall be done.”32 Under this interpretation, the employer’s actual control over the worker is not important for classification. Rather, the employer’s right to control is at the nature of the decision.

The common-law test for worker classification status has been incorporated into specific provisions of the Code and is required and supported by treasury regulations and case law, respectively.33 However, the various treatments of the terms “employee” and “independent contractor” in different areas of law complicate the common-law employment status test. For example, § 3121(d)(2) of the Code defines “employee,” for the purpose of social security taxes, as any individual who under the applicable common-law rules has the status of an employee.34 On the other hand, § 3401 mentions the term “employee” for federal income tax purposes, but does not define the term35, instead relying on a regulatory guideline issued under § 3401 explaining the

28. Id. at 6.
29. Id. at 8.
31. Id.
33. Staff of J. Comm. on Taxation, supra note 11, at 2.
common-law test. In addition to the varying guidelines for defining terms in the Code, the courts have identified various factors in case law that are relevant to determine worker classification. In 1987, the IRS unified and documented the general employment status determination test established from case law. The service listed twenty factors that may be used to conclude whether a worker is an employee or an independent contractor. Adjudicating bodies are to examine all of the factors mentioned by the IRS before a determination is made, no single identified factor is determinative, and the resulting rulings are decided on a case-by-case basis, based on factual and circumstantial contexts.

Further codifying the common-law test, the IRS identified three categories of illustrative factors relevant to determine whether a worker satisfies the control test: behavioral control, financial control, and the relationship of the parties. The IRS stressed that other considerations may also contribute to a determination. The varying weight of the factors based on the specific circumstance, the changing importance of a specific factor over time, and all of the facts surrounding a specific situation may all be considered before a status determination is made.

Provisions in the Code that designate specific classifications to specific jobs, sometimes creating different classifications for different tax purposes, further complicate the system. Under § 3508 of the Code, certain real estate agents and direct sellers are treated as independent contractors for all tax purposes, while § 3121 allows for full-time life

36. STAFF OF J. COMM. ON TAXATION, supra note 11, at 2.
38. The factors include the employer's right to require compliance with instructions; employer provided worker training; the integration of the worker's services into the business operation of the employer; the services are required to be performed personally; the employer hires, supervises, or pays assistants and the worker agrees to provide more than a result; a continuing relationship exists; the employer establishes set hours for the worker; the worker works full time for the employer; the work is performed on the premises of the employer; the worker performs in the order or sequence set by the employer; the worker must submit regular reports to the employer; generally payment by the hour, week, or month; payment of business and/or traveling expenses; furnishing tools and materials; employer investment in facilities used by the worker; worker realization of profit or loss; the employer is the worker's sole employer; the worker relegates his services to his employer and not the general public; the employer holds the right to discharge the worker, and; the worker has the right to terminate the relationship with the employer at any time without incurring liability. STAFF OF J. COMM. ON TAXATION, supra note 11, at 3.
40. STAFF OF J. COMM. ON TAXATION, supra note 11, at 5.
insurance salesmen to be treated as employees for social security tax and employment benefits, but not for federal income tax purposes.\textsuperscript{42}

In addition to statutes and IRS internal publications, court-created caveats also exist that influence certain classifications. For example, because administrative courts commonly recognize that highly educated or skilled workers do not need as much supervision as other workers, the Joint Committee on Taxation found that the degree of an employer's day-to-day control over a highly educated or skilled worker is given less weight in determining the worker's employment status.\textsuperscript{43}

Coordinated action by many different state and federal government departments and agencies must be taken in order to address the numerous problems associated with misclassification. In order to improve the system and achieve revenue gains, Congress and state legislatures should focus on policy initiatives designed to curb the trend of misclassifying workers. The IRS, state agencies, and federal departments and agencies should attempt to better understand the problem through data collection, research, and collaborative data sharing in order to track the effectiveness of new programs, policies, and enforcement activities. Each relevant group must discover and embrace its role in helping to find a solution to the issue, formulate and take specific actions to achieve the desired result, and actively coordinate in information sharing to accelerate progress.

### III. The Federal Government

In 2007, the federal government began to pay more attention to the worker misclassification issue. The Treasury Department, the IRS, and Congress have all identified worker misclassification as a national problem and have proposed possible solutions and changes to current federal laws, but little substantive action has been taken to reduce or alleviate worker misclassification.

The IRS has been the most active federal entity in implementing and discussing actions to counter the number of worker misclassification problems in the United States, which is believed to be growing. Michael Phillips, the Treasury Department Deputy Inspector General for Audit, said that the IRS' interest in the issue is not to reclassify workers from independent contractors to employees, rather he said, "it is to ensure that employers are making the proper determina-

\textsuperscript{42} I.R.C. § 3121 (2008),

\textsuperscript{43} \textit{Staff of J. Comm. on Taxation}, supra note 11, at 5.
tion and that workers are being treated appropriately.”

Phillips’ line of thinking has led to IRS initiatives aimed at improving the efficiency and accuracy of current classification policies, but the IRS has a long way to go before it can truly impact the misclassification trend.

The February 2009 Treasury report on worker misclassification identified disorganization within the Internal Revenue Service and lack of relevant data on worker misclassifications as the key problems facing the IRS in addressing the subject. The IRS does not have an agency-wide employment tax program to address the issue, which contributes to the disorganization that is impeding progress. While different IRS business divisions keep track of employment tax issues, no single point of accountability exists for employment tax below the IRS Deputy Commissioner level, and no agency-wide strategy is in place to coordinate the efforts among the divisions.

In order to properly respond to misclassification issues, the IRS needs to create a uniform method of determining priorities, developing work plans, identifying work, and setting work goals and objectives. The Treasury Department report proposed that an agency-wide employment tax program specifically designed to address worker misclassification is needed to coordinate the business divisions, improve compliance, and ultimately reduce the tax gap.

The IRS agreed with the recommendation, even having a similar plan already drafted prior to the report that included collaborative initiatives to address employment tax non-compliance. However, as of the date of the report, the IRS had not yet approved such a program for agency-wide use and implementation.

The second problem identified in the Treasury Department report is that limited data exists regarding the frequency and overall impact of worker misclassification. As previously stated, most of the current data concerning worker misclassification is over twenty years old, dating back to 1984. Since that time, the problem has continued to exist, yet little research or data collection has been done on the topic outside of anecdotal research. The Treasury Department report recommended that upon the formation of an agency-wide employment tax program, the IRS should consider conducting a formal National Research Program for employment tax, analogous to the program carried out in 1984, which measure the impact of worker misclassification on

45. Id. at 3.
46. Id. at 5.
47. Id. at 7.
48. Id. at 6.
49. Id. at 3.
the tax gap. Until more research is completed, any efforts taken to improve worker classification laws and policies will be taken blindly, without any indication of their effectiveness.

Despite the limited IRS responses to combat worker misclassification, the few initiatives that have been implemented by the agency, specifically in the realm of public education, have been the extent of the federal government's recent actions to address the issue. While not all of the IRS's actions seem to be of substantial benefit to workers, and the lack of data on the topic limits evaluation of the programs' effectiveness, a few of the programs seem to be positive. The establishment of the SS-8 Status Determination program seems to be one of the most effective steps taken by the agency to combat misclassification. The program allows both workers and employers to submit a form, Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, requesting an employment status determination directly from the IRS. With an IRS status determination, a taxpayer has more guidance in managing his finances without having to struggle over the application of the vague common-law test. The IRS website, www.IRS.gov, is frequently producing and updating new publications to guide taxpayers through the worker classification process and inform them of their rights. Finally, in 2007, the IRS and the Department of Labor, along with several states, created the Questionable Employment Tax Practices Initiative (QETP) to begin tax data collection, audit report sharing, and to coordinate enforcement efforts between states and the IRS to track worker misclassification, among other employment law issues. The primary goals of the initiative are to identify employers who are trying to avoid employment tax payments and increase employer voluntary compliance with employment status laws. According to Catherine Ruckelshaus of the National Employment Law Project (NELP), as of July 2009, thirty-two states have joined the QETP initiative.

In contrast to the IRS's slow progress in researching and changing the application of employment and tax law, Congress has done little past symbolic gesturing to change the current policies behind

50. Id. at 9.
53. Id. at 6.
54. Id.
worker classification. Three bills dealing with classification were proposed in the 2007-2008 legislative session. However, none of the bills made it past initial committee reviews. Sponsored by then Senator Barak Obama in September 2007, the “Independent Contractor Proper Classification Act of 2007”, or S. 2044, was the first federal bill to recently address worker misclassification.\textsuperscript{55} The bill was aimed at altering the § 530 safe-harbor provisions to allow the IRS to require employers to reclassify workers that had been misclassified in the past, to allow the publication of revenue rulings or regulations pertaining to individual taxpayer classifications for the purpose of employment taxes, and to remove the factor giving weight to traditional industry practices from the common-law status test.\textsuperscript{56} The bill would also have created an administrative evaluation process to determine employment status similar to the IRS SS-8 program, safeguards for employer retaliation against misclassified employees seeking a status redetermination, provisions to force employers to pay attorney’s fees if a worker is deemed misclassified, a mandate to the IRS to issue annual reports documenting their efforts to curtail misclassification, and a limited collaborative effort to open the channels of communication between the IRS and the Department of Labor concerning misclassification trends and practices.\textsuperscript{57} The policies of S. 2044 suggested that perhaps Congress identified worker misclassification as an economic burden, but we have yet to see successful legislation on the issue at a federal level.

Furthermore, the Obama administration has not yet commented on the worker misclassification problem. On September 5, 2009, Labor Day weekend, President Barak Obama and Treasury Secretary Tim Geithner announced efforts to help employees save money, and in return stimulate the economy, by encouraging worker savings programs.\textsuperscript{58} A large aspect of the administration’s savings encouragement proposal was to make it easier for small- and medium-sized businesses to automatically enroll employees in workplace savings programs and allow employees to convert unused vacation or leave into savings.\textsuperscript{59} While the administration’s plan may be well-intentioned, the methods proposed will only be available to employer recognized “employees”; misclassified employees and independent contractors,

\textsuperscript{55} S. 2044, 110th Cong. (1st Sess. 2007).
\textsuperscript{56} See id.
\textsuperscript{57} Catherine K. Ruckelshaus (2008), supra note 52, at 8.
\textsuperscript{59} Id.
who are supposed to enjoy the element of freedom in allocating their own funds into their IRAs, will receive no benefit.

IV. PROPOSALS FOR EMPLOYMENT CLASSIFICATION POLICY REFORM

Any possibility of effective legislation in the future to alter current classification policies must first include the same types of solutions found in S. 2044 to pave the way for sweeping reform. The key problems cited by the Treasury Department reports were addressed by S. 2044, which would have unrestricted the IRS's ability to publicize classification adjudication trends and required more extensive data sharing and collaboration within the federal government to combat misclassification. By making the SS-8 program law, Congress would have enabled workers to obtain proper classification determinations to prevent status problems before they happened. Giving workers the ability to sue for attorney's fees, creating harsher penalties against employers who retaliate against misclassified workers seeking status re-determination, and sealing the hole in the law created by § 530 are the initial steps to position Congress to reverse the trend of employers misclassifying workers to cut costs. However, these provisions are only a small step towards achieving a change. Upon the effectiveness of such efficiency-based provisions, which will only be able to be determined after more extensive research and data sharing initiatives are under way, the federal government will then be poised to properly analyze various policy options and move to change and improve existing employment classification laws.

Two House bills, “The Employee Misclassification Prevention Act of 2008” (EMPA)\(^60\) and “The Taxpayer Responsibility, Accountability, and Consistency Act” (TRACA)\(^61\) addressed worker misclassification; however, each bill was less comprehensive than S. 2044 and was inadequate in addressing the issue. With the introduction of the EMPA, Congress sought to amend the “Fair Labor Standards Act” to require employers to keep accurate records reflecting their workers’ employment statuses, allow states to conduct audits of employers that misclassify their workers, and promote collaboration and data sharing between the Department of Labor and the IRS.\(^62\) While Congress proposed better enforcement against employers who

\(^60\) Employee Misclassification Prevention Act, H.R. 6111, 110th Cong. (2nd Sess. 2008).


\(^62\) Ruckelshaus, supra note 52, at 8.
misclassify workers and called for some state and federal government collaboration, it failed to provide methods to stop misclassification before it occurs and did not provide workers with any additional rights over employers to assure proper classification.

TRACA, introduced in April 2008, would have made the SS-8 program law, provided Code provisions preventing employer retaliation against workers seeking status determinations, and called for annual Treasury reports on misclassification.\(^\text{63}\) The omission of any collaborative research and data sharing policy and the rewording and reformatting, yet retention of, the section 530 safe-harbor are both unacceptable to create an effective policy to curb worker misclassification. New federal laws must provide for efficient analysis of policy effectiveness through data comparisons and research, as well as eliminate the § 530 safe-harbor, in order to begin to reverse misclassification trends. Without a way to determine if a change in law is working to achieve the desired result of reducing worker misclassifications, a new policy can easily become a costly experiment.

Introduced in the 2009-2010 legislative session, the “Employee Free Choice Act of 2009”\(^\text{64}\) (EFCA) would allow employees better access to labor organizations and would provide for mandatory injunctions for unfair labor practices during organizing efforts. If the EFCA becomes law, it may enable labor organizations to challenge more successfully individual employers who misclassify their workers on a large scale, but will have minimal effects in halting the misclassification trend. The reason that the policies of the EFCA alone will not effectively address the worker misclassification problem is because Congress again failed to include research and data-sharing provisions in the bill and did not provide an immediate change to the Code to make employment status determinations more efficient.

Before the recent wave of worker classification bills were proposed in Congress, the Joint Committee on Taxation reviewed possible policy paths to improve worker classification laws.\(^\text{65}\) At the beginning of its report, the joint committee staff stressed two major policy concerns regarding altering worker classification determination policy. The first concern was that proposals that seek to add safe-harbor provisions or other modifications to existing rules will further increase the complexity of an already complex law, by adding layers of law to policy


\(^{65}\) See STAFF OF J. COMM. ON TAXATION, supra note 11.
that is already difficult to understand.\textsuperscript{66} The second concern was that proposals that seek to replace existing rules entirely are likely to have their own uncertainties and ultimately may not be effective.\textsuperscript{67} In order to fix, or even improve the misclassification issue, the government must first understand the problem. Therefore, any policy that does not include provisions for extensive research, collaboration, and data sharing among states and different departments of the federal government is incomplete. Even if a policy is successful at some level, a lack of organized and accessible information and data on the subject will make it impossible to review whether the policy is truly effective or a failed effort.

Some general implications will apply to any new federal policy concerning worker misclassification. Any changes to the law will likely produce different results in some cases than would the present law.\textsuperscript{68} There is a chance that altering the law could result in the reclassification of a significant number of workers, which in turn, could have negative effects on the employment tax system.\textsuperscript{69} In her listing, “[t]hings to watch out for (they sound good but can be bad)” concerning new misclassification bills and proposals, Ruckelshaus, legal co-director of NELP, warns that policies that purport to “simplify” the definitions of “employee” or “independent contractor”, under labor and employment laws, water down the more expansive laws currently in place that make it easier for workers to claim “employee” status and tend to create a stricter common-law analysis of “employee” that is easier for employers to manipulate.\textsuperscript{70} A policy initiative that would reclassify a large number of workers has the potential to severely and negatively affect compliance with federal tax laws, especially when a worker is reclassified as an independent contractor, and could create confusion among workers over employee benefit eligibility.\textsuperscript{71} Such a reclassification could also spill over into State tax rules, creating more confusion for reclassified workers. The reclassification of a worker to independent contractor status will increase compliance responsibilities, and taxpayer compliance rates drop significantly when a worker is classified as an independent contractor instead of an employee.\textsuperscript{72} Furthermore, reclassification to either status would have an unknown

\begin{itemize}
  \item \textsuperscript{66} Id. at 12.
  \item \textsuperscript{67} Id.
  \item \textsuperscript{68} Id.
  \item \textsuperscript{69} See Staff of J. Comm. on Taxation, supra note 11
  \item \textsuperscript{70} Ruckelshaus, supra note 52, at 9.
  \item \textsuperscript{71} Staff of J. Comm. on Taxation, supra note 11, at 12.
  \item \textsuperscript{72} Id. at 10.
\end{itemize}
effect on retirement plans and other benefit coverage because it is impossible to determine if workers reclassified as independent contractors would take advantage of the benefits of a self-controlled pension plan over an employer-controlled pension plan.\textsuperscript{73}

Because of the inevitable obstacles to changing long-standing policies deeply-entrenched in the Code, only a total policy overhaul coupled with extensive information gathering and sharing will greatly contribute to marginalizing the worker misclassification problem. NELP published a list of positive and negative approaches to formulating and altering new and existing worker classification policies.\textsuperscript{74} According to NELP, the top priority for new legislation includes providing aggrieved workers, and the workers’ representatives, with a private right of action against employers who purposefully misclassify workers.\textsuperscript{75} This provision would create a substantial enforcement mechanism against offending employers without draining government resources and would protect workers from employer retaliation. Along with allowing a claim for attorney’s fees to workers who prevail in adjudicated status determinations, this proposal would greatly improve workers’ rights under current employment classification laws. Providing legal recourse for aggrieved workers and imposing damages on violating employers is an important step to eradicating misclassification problems. Other policy priorities include setting high punitive damage award limits against employers who purposefully misclassify, per each worker misclassified, to punish and deter future violations and providing debarment remedies if the violating employers are state public contractors.\textsuperscript{76}

Of the existing proposals to change worker classification laws, three approaches have gained momentum within legislative circles: the check-the-box approach, limiting the number of relevant factors in the determination test, and providing similar treatment for all workers for all federal tax purposes.\textsuperscript{77}

The main aim of the “check-the-box” approach is to eliminate the complex and confusing classification determination system and allow the worker to negotiate with his employer and contract his employment status for all federal tax purposes.\textsuperscript{78} In this plan, a negotiation process would replace the current fact-based determination

\textsuperscript{73} \textit{Id.} at 13.
\textsuperscript{74} \textit{See} Ruckelshaus, \textit{supra} note 52.
\textsuperscript{75} \textit{Id.} at 8.
\textsuperscript{76} \textit{Id.} at 9.
\textsuperscript{77} \textit{STAFF OF J. COMM. ON TAXATION, supra} note 11.
\textsuperscript{78} \textit{Supra} note 11, at 14.
system by allowing the party with the greater bargaining power to heavily influence the worker's status.\textsuperscript{79} According to the Joint Committee on Taxation, one drawback to this approach is that the burden is placed on the worker to determine his own employment status and to decide which status would best suit his needs, a problem that can only be reduced with better public education.\textsuperscript{80} Another drawback to the approach is that workers often have significantly less bargaining power than employers, especially if the employer is a large corporation and the worker does not belong to a union or labor organization.\textsuperscript{81} In order for a "check-the-box" approach to be successful, the policies proposing the change would need to take an employer-worker power imbalance into account.

Despite its drawbacks, the "check-the-box" approach has the greatest potential for significantly reducing worker classification problems. If the policy were correctly implemented, worker misclassification would most likely cease to be an issue. However, the "check-the-box" approach necessitates detailed guidelines for classification; increased public education efforts to inform workers of their rights and of the differences between "independent contractor" status and "employee" status; measures to prevent employers from changing longstanding classification statuses upon the renegotiation of a worker's contract; and strict administrative regulations to tilt the employers' bargaining power advantages back towards workers. One way to strengthen the position of workers is to give unions and labor organizations greater bargaining powers. The passage of the "Employee Free Choice Act of 2009" or a similar law would strengthen workers' positions against large businesses and would pave the way towards the end of the determination process and the adoption of a "check-the-box" approach to worker classification.

A more commonly considered approach to combating worker misclassification is to make the current system less complex and more worker-friendly. This would entail limiting the number of relevant factors in the worker classification determination test to those that are more universally relevant.\textsuperscript{82} Some lawmakers have suggested that in order to use simplifying measures to affect new policy, an additional safe-harbor rule or the replacement of some present-law rules may be needed.\textsuperscript{83} While this solution is popular and may be the easiest to carry

\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} STAFF OF J. COMM. ON TAXATION, supra note 11, at 14.
\textsuperscript{83} Id.
out legislatively, limiting relevant factors would ultimately fail to clarify the law. The approach does not correct one of the major flaws associated with current classification laws: factors themselves often give rise to fact-questions with multiple interpretations, leading to disputes between taxpayers and the IRS and ultimately to litigation. Terms such as “substantial”, “special skills”, and “highly educated or skilled” will remain open to interpretation, and the confusion that plagues the current system will persist. “The Taxpayer Responsibility, Accountability, and Consistency Act” is an example of proposed legislation intending to limit relevant factors.

Another policy approach to the issue is to provide similar treatment to all workers for all federal tax purposes. Like the “check-the-box” approach, the equal treatment approach would make classification determinations irrelevant. This approach would require the government to make decisions that would not always be popular with the general public, and could potentially result in worse conditions for workers than under the current employment classification system. Three major areas of the law would need to be modified to achieve equal treatment: withholding and estimated tax rules, eligibility for employee benefit plans, and deductibility of business expenses. To achieve equal treatment, legislators would have to formulate policies to either withhold taxes from all workers, or to require all workers to pay estimated tax payments. Because of lower compliance rates associated with estimated taxes and worker difficulties in correctly predicting estimated taxes, a policy imposing an estimated tax on all workers would likely cause more problems than it would solve. However, policies forcing employers to withhold all employment taxes and increasing enforcement for noncompliance would probably increase compliance rates significantly as a whole, based on the ninety-nine percent compliance rate for employer-withheld taxes. Because of the probable dissatisfaction of some reclassified workers, the politics associated with the equal treatment proposal will make it difficult to implement on a federal level. A major research initiative would also be required to calculate the cost of the total system overhaul, to determine whether the switch would result in improved conditions for a majority of workers, and to estimate whether the switch will reduce the tax gap.

84. Id.
85. Staff of J. Comm. On Taxation, supra note 11, at 15.
86. Id.
87. Id.
88. Id.
The National Employment Law Project highlighted the proposed provisions for worker classification reform that could produce negative effects or render the reform less effective.\textsuperscript{89} One such provision involves creating a law that only includes criminal violations or penalties for misclassifying workers.\textsuperscript{90} However, criminal penalties alone are an inefficient solution. The state must prosecute criminal violations, and due to limited resources and prosecutor's burden to prove the violation, employers who misclassify workers may not always be punished.\textsuperscript{91} Therefore, a private right of action for workers provision, including worker organizations and unions, is integral to establishing an effective enforcement mechanism for any type of worker classification reform.\textsuperscript{92}

V. STATE GOVERNMENTS

Following the failure of the federal government to pass legislation to reform the worker classification system, state governments have begun to broach the issue. According to Catherine Ruckelshaus, since 2007, many states have been busily addressing employment misclassification.\textsuperscript{93} In the 2007–2008 legislative session, states across the country began taking steps to institute employment classification reform: One bill was passed in Washington and two sample bills were introduced in Rhode Island and Massachusetts; four states issued reports on the issue; Colorado and Minnesota passed area-specific construction bills; and Louisiana and New York introduced sample bills.\textsuperscript{94} Five states formed investigative task forces to research the problem; four states had their governor issue an executive order creating a task force to research the problem; and Arizona and Illinois included provisions addressing misclassifications in broader labor legislation.\textsuperscript{95}

So far, the 2008-2009 legislative sessions have seen an even larger movement within the states to change existing laws and policies regarding worker classification. At the end of 2008, and thus far in 2009, fourteen states have introduced one or more bills addressing worker classification laws, and of those states, two have passed bills;

\begin{itemize}
  \item \textsuperscript{89} See Catherine K. Ruckelshaus (2008), \textit{supra} note 52.
  \item \textsuperscript{90} \textit{Id.} at 10.
  \item \textsuperscript{91} \textit{Id.}
  \item \textsuperscript{92} See \textit{generally id.}
  \item \textsuperscript{93} Report from Catherine K. Ruckelshaus, NELP Independent Contractor Round-Up (Work-In-Progress) (Jul. 23, 2009) (on file with author).
  \item \textsuperscript{94} See \textit{id}.
  \item \textsuperscript{95} \textit{Id}.
\end{itemize}
four states have passed statutes; Iowa and Maine developed misclassification task forces pursuant to Executive Order; Ohio created a new government agency unit to track worker misclassification; and Nevada and Indiana passed Senate Resolutions to investigate misclassification.\textsuperscript{96} Washington produced guidelines for employing independent contractors; Iowa, Ohio, and Vermont issued reports discussing misclassification; five states introduced sector-specific bills for the construction industry and traveling salesmen; and Wisconsin proposed initiatives to combat misclassification in the yearly budget.\textsuperscript{97} Furthermore, the QETP collaboration and data sharing initiative between the IRS, federal agencies, and states has grown over recent years from only a few states to approximately thirty-two participating states.\textsuperscript{98} The expansion of this program to every state is crucial to the collection of information and data necessary to successfully reform worker classification policy and practice at both the Federal and state levels.

While most of the employment classification bills introduced in the states this past year have not yet been passed, their activity has opened the door for discussion, research, and ultimately, reform. On the other hand, twenty states have yet to address worker misclassification in any way in recent years.\textsuperscript{99} While several of the non-acting states are in the West—Hawaii, Idaho, Alaska, New Mexico, and Utah—and a few others are in the rustbelt and the Midwest—Missouri, West Virginia, South Dakota, and North Dakota—the entire South has failed to initiate action or research regarding misclassification, including: Georgia, Washington D.C., Alabama, Arkansas, Mississippi, North Carolina, Texas, South Carolina, Tennessee, Virginia, and Florida.\textsuperscript{100} Unfortunately, by limiting the availability of data that is needed to determine the nation-wide effects of misclassification on the tax gap and on the prevalence of misclassification throughout the country, these states are stalling national reform.

Most of the state actions taken in recent years involve data sharing, research collaboration efforts, and the implementation of one or a combination of the three classification reform proposals previously mentioned: the “check-the-box” approach, the limited relevant factors approach, and the similar treatment proposal. However, most reform efforts are still young, and states are learning how to handle the misclassification issue largely on a trial-and-error basis.

\textsuperscript{96} Id.
\textsuperscript{97} Id.
\textsuperscript{98} See Catherine K. Ruckelshaus (2008), supra note 52, at 6.
\textsuperscript{99} See Ruckelshaus, supra note 93.
\textsuperscript{100} Id.
The most common action states are taking is to organize data-sharing and research initiatives to investigate and trace misclassification frequency and the effects of the problem on the state. At the end of 2008 and into 2009, four states took action or proposed to create collaborative data collection systems within the states, separate from the QETP initiative. In Nebraska and Wisconsin, bills were proposed to require all independent contractors to register with the state as such to allow for better record keeping; and in Kentucky, a bill called for employers to keep records of the workers employed for three years. Another employer penalty, proposed in Indiana, Kentucky, and Massachusetts, calls for employers to suffer debarment from public works contracts for a period of time after knowingly misclassifying workers.

Ohio has implemented the farthest reaching data collection and research initiative in the country. After initial research, the state developed a special unit for investigating and tracking misclassification trends and proposing solutions to the issue. An initial analysis of the worker misclassification problem in Ohio showed that the trend cost the state about $100 million annually in unemployment compensation, about $510 million in Bureau of Workers’ Compensation premiums, and approximately $180 million in state income tax revenues. Towns and cities in Ohio failed to recover approximately $100 million in local income tax revenues in 2006, costing school districts $7.8 million in 2008. These shocking statistics encouraged Ohio lawmakers to take action, and with many other states beginning to research, collect, and share data on worker misclassification, more will probably follow suit and take similar actions.

Another policy provision gaining popularity among state legislatures is to expand the administrative remedies and civil penalties available to workers whose employers have knowingly misclassified them as independent contractors. In 2009, policies were proposed in Rhode Island, Delaware, Iowa, New York, Massachusetts, and Kentucky to allow misclassified workers a civil right of action against misclassifying employers. New York and several other states have also recently provided rights of action to businesses disadvantaged by

101. Id.
102. Id.
103. Id.
104. See Ruckelshaus, supra note 93
105. Id.
106. Id.
107. Id.
worker misclassification.\textsuperscript{108} The legislation provides relief against misclassifying employers for construction contractors suffering economic harm as a result of losing public works bids to said employer.\textsuperscript{109} Policies that allow for civil actions against misclassifying employers are an important step towards regulating industries prone to the practice, such as construction contracting. However, if worker misclassification is as large of a problem as economic statistics suggest, applying similar provisions on a wider-scale could lead to an unmanageable increase in worker misclassification litigation.\textsuperscript{110}

Minnesota was the first state to propose a "check-the-box"-like solution for worker misclassification.\textsuperscript{111} Although the Minnesota proposal was limited to truck drivers, the bill changed the definition and test for independent contractor status, requiring employment classification to be written into a contract between employer and worker.\textsuperscript{112}

Most state legislatures that have addressed the worker misclassification issue seem to believe that the flaw in worker classification procedure lies in the convoluted language of the law, and not in the process. Rather than change the substance of employment classification, the states have chosen to limit the relevant factors in employment status determinations in order to increase efficiency and reduce the complexity of the decision. A popular proposal for achieving this goal is to create presumptive employee status for industries that are prone to employment misclassification. So far, Delaware, Pennsylvania, Maryland and Kansas have proposed bills that create presumptive employee status for construction workers.\textsuperscript{113} In general, the reforms include a broad definition of "employee" and place the burden of proof on the employer to prove a worker's independent contractor classification. The Pennsylvania bill included a provision forcing employers to contract worker status with an employee before classifying him as an independent contractor, similar to the "check-the-box" approach.\textsuperscript{114} In Kentucky, proposed legislation includes giving all workers presumptive employee status.\textsuperscript{115} Another bill, in Iowa, would reduce the number of factor in the employment determination test to five and would require the adjudicator of the status determination to look at the

\begin{thebibliography}{99}
\bibitem{108} \textit{Id.}
\bibitem{109} \textit{Id.}
\bibitem{110} \textit{See Treasury Inspector General for Tax Administration Office, supra} note 8.
\bibitem{111} \textit{See Ruckelshaus, supra} note 91.
\bibitem{112} \textit{Id.}
\bibitem{113} \textit{Id.}
\bibitem{114} \textit{Id.}
\bibitem{115} \textit{Id.}
\end{thebibliography}
intentions of the worker and the employer before deciding employment status.\textsuperscript{116}

VI. THE FUTURE OF WORKER MISCLASSIFICATION

Although many states are advancing efforts to curb the worker misclassification trend, both policy and legal reform is being tested on a largely trial-and-error basis. While some states, and the federal government, are beginning to research worker misclassification, limited understanding of the scope and effects of the problem makes reform efforts virtually impossible to measure. Thus, it is politically and economically risky for cash-strapped states and a frugally cautious Congress. However, it is clear that employers who use worker misclassification to manipulate the system have consistently violated the dignity of American workers and are a dead-weight on the economy. If the present need for nationwide economic stimulus requires the government to evaluate the efficiency of programs and initiatives that have not been evaluated in years, then worker misclassification reform is an area that will likely yield high return for the federal government, for the states, and for the conscience and wallets of many recession-effected workers.

\textsuperscript{116} Id.