



National Employment
Law Project

Testimony of
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National Employment Law Project

Hearing Before the
United States Congress
Senate Committee on Health, Education, Labor & Pensions
Subcommittee on Employment and Workplace Safety

*Payroll Fraud: Targeting Bad Actors Hurting Workers and
Businesses*

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Senator Casey and members of the Subcommittee: thank you for this opportunity to testify today on the important subject of payroll fraud and its impacts on workers and their families, law abiding employers, and the broader economy.

My name is Cathy Ruckelshaus, and I am a General Counsel of the National Employment Law Project (NELP), a non-profit organization that promotes policies and programs that create good jobs, strengthen upward mobility, enforce hard-won worker rights, and help unemployed workers regain their economic footing through improved benefits and services. It has been a little over three years since I appeared before the HELP Committee to talk about independent contractor misclassification¹, and I am disheartened to say that the problems have exacerbated despite some state activity to combat the problems, and call for federal leadership and action.

At NELP, we see low-wage workers in our economy's growth sectors being forced to sign contracts saying they are "independent contractors" as a condition of getting a job; we see employers changing employees into independent contractors, franchisees, or other non-employee labels to cut costs, and we see workers being paid off the books completely, with no reporting or withholding of the basic payroll taxes or insurance. Janitors, home care workers, construction laborers and drywallers, cable installers, delivery persons, and even restaurant servers – these are the workers we see who are called non-employees by their employers. They are not running their own businesses by any definition. They want to work and they too often accept whatever arrangement gets them a job. These same occupations with high rates of independent contractor misclassification are among the jobs with the highest numbers of workplace violations.²

This hurts the workers, who lose out on labor and employment protections including workers compensation, unemployment insurance, fair pay, and health and safety safeguards. They also bear a tax burden that their employers are supposed to incur. It hurts law-abiding employers who treat their workers as employees but who cannot compete with those who perpetrate fraud. This has resulted in a race to the bottom and rewards cheaters. This affects the quality of what should be middle class jobs that could stimulate our economy.

My testimony will update what I presented in 2010, describing independent contractor misclassification and its impacts on workers, on state and federal government coffers, and

¹ See, Testimony of Catherine Ruckelshaus before Senate HELP Committee, June 2010, <http://www.help.senate.gov/imo/media/doc/Ruckelshaus.pdf>.

² See, National Employment Law Project, *Holding the Wage Floor*, http://nelp.3cdn.net/95b39fc0a12a8d8a34_iwm6bhbv2.pdf

on law-abiding employers. I will describe the recent downturn in state legislative activity on this important issue, and conclude with comments on federal efforts to address the problem, including the Payroll Fraud Protection Act.

I. What is Independent Contractor Misclassification, or Payroll Fraud?

Companies looking to cut payroll costs to compete for work have become increasingly emboldened in the ways they seek to skirt basic labor standards, insurance and tax laws that apply to employers. They call employees “independent contractors,” even when the worker is not running his own business; they require employees to form a limited liability corporation or franchise company-of-one as a condition of getting a job, and they pay workers off the books, without any payroll treatment at all. These workers are sometimes required to sign boilerplate contracts attesting to independent contractor status even where the functional relationships do not reflect true independence.

These practices are increasingly being called “payroll fraud” because they are intentional and aimed at evading the law. Legitimate business-to-business transactions are not payroll fraud, because true independent contractors have a specialized skill and have invested in a business that enables them to earn a profit.³

Companies do this to avoid having to report and pay FICA and FUTA taxes, evade labor organizing, skirt baseline labor standards like minimum wage and overtime, discrimination protections, health and safety and workers compensation, and unemployment insurance.⁴ And they construct these arrangements because they can under-bid competitors in labor-intensive sectors by saving as much as 30% of payroll and related costs.

A. Misclassification persists in labor-intensive and lower-wage jobs.

The most recent Government Accountability Office (GAO) report on employment arrangements states in 2009 that “[t]he 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.”⁵ A 2000 study commissioned by the US Department of Labor found that up to 30% of firms misclassify their employees as independent contractors.⁶ In January 2013, the U.S. Department of Labor sought comments on a planned classification survey of workers, which should update these earlier studies with much-needed more recent information.⁷

³ See, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (July 2006), at p. 43.

⁴ See, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (July 2006), at p. 25.

⁵ See, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (July 2006), at p. 43.

⁶ Lalith de Silva *et al.*, “Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs” i-iv, prepared for U.S. Department of Labor, Employment and Training Division by Planmatics, Inc. (Feb. 2000), available at <http://wdr.doleta.gov/owsdrr/00-5/00-5.pdf>.

⁷ Proposed Information Collection Request (ICR) for the Worker Classification Survey; Comment Request

Many states have studied the problem and find high rates of misclassification, especially in construction, where as many as 47% of employers were found to have misclassified their employees.⁸

Most of these studies do not capture the so-called “underground economy,” where workers are paid off-the-books, sometimes in cash.⁹ These workers are *de facto* misclassified independent contractors, because the employers do not withhold and report taxes or comply with other basic workplace rules. Many of these jobs are filled by immigrant workers and pay low wages.¹⁰

Payroll fraud is persistently common in jobs where the workers are not truly running their own independent businesses: construction,¹¹ day labor,¹² janitorial and building services,¹³ home health care,¹⁴ agriculture¹⁵, poultry and meat processing,¹⁶ high-tech,¹⁷ delivery,¹⁸ trucking,¹⁹ home-based work²⁰, and the public²¹ sectors.

<http://www.gpo.gov/fdsys/pkg/FR-2013-01-11/html/2013-00389.htm>.

⁸ See Fiscal Policy Institute, “New York State Workers Compensation: How Big is the Shortfall?” (January 2007); Michael Kelsay, James Sturgeon, Kelly Pinkham, “The Economic Costs of Employee Misclassification in the State of Illinois” (Dept of Economics: University of Missouri-Kansas City: December 2006); Sturgeon and Kelsay, “The Economic Costs of Employee Misclassification in the State of Indiana,” Department of Economics, University of Missouri-Kansas City (2010); Peter Fisher *et al*, “Nonstandard Jobs, Substandard Benefits”, Iowa Policy Project (July 2005); Francois Carre, J.W. McCormack, “The Social and Economic Cost of Employee Misclassification in Construction (Labor and Worklife Program, Harvard Law School and Harvard School of Public Health: December 2004); State of New Jersey, Commission of Investigation, “Contract Labor: The Making of an Underground Economy” (September 1997); Canak and Adams, “Misclassified Construction Employees in Tennessee” (2010).

⁹ Bear Stearns in 2005 estimated that the U.S. is losing \$35 billion annually due to off-the-books employment. Justich and Ng, “The Underground Labor Force is Rising to the Surface,” at p. 3, Bearns Stearns Asset Management (2005).

¹⁰ Francois Carre, J.W. McCormack, “The Social and Economic Cost of Employee Misclassification in Construction (Labor and Worklife Program, Harvard Law School and Harvard School of Public Health: December 2004), at p. 8.

¹¹ Workers Defense Project, “Building Austin, Building Injustice: Working Conditions in Austin’s Construction Industry” (2009); Francois Carre, J.W. McCormack, *et al.*, “The Social and Economic Cost of Employee Misclassification in Construction” 2, Labor & Worklife Program, Harvard Law School and Harvard School of Public Health, Dec. 2004, available at

http://www.faircontracting.org/NAFCnewsite/prevalingwage/pdf/Work_Misclass_Stud_1.pdf

¹² Abel Valenzuela and Nik Theodore, *On the Corner: Day Labor in the United States* (January 2006).

¹³ See *Bulaj v. Wilmette Real Estate and Management Co., LLC*, 2010 WL 4237851 (N.D.Ill.2010); *Coverall North America, Inc. vs. Commissioner of the Division of Unemployment Assistance*, SJC-09682, 447 Mass. 852 (2006); *Vega v. Contract Cleaning Maintenance*, 10 Wage & Hour Cases 2d (BNA) 274 (N.D. IL 2004).

¹⁴ See *Crouch v. Guardian Angel Nursing, Inc.*, 2009 WL 3737887 (M.D.Tenn.2009); *Bonnette v. Cal. Health & Welfare Agcy.*, 704 F.2d 1465 (9th Cir. 1983).

¹⁵ *Sec’y of Labor v. Lauritzen*, 835 F.2d 1529 (7th Cir. 1988).

¹⁶ *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (July 2006), at p. 30.

¹⁷ *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187 (9th Cir. 1996).

¹⁸ *Ansoumana et al v. Gristedes et al*, 255 F.Supp.2d 184 (S.D.N.Y. 2003).

Press accounts and queries coming into the NELP offices indicate that employer payroll fraud and related practices rise during periods of high unemployment, where workers will take a job under nearly any circumstance. When job opportunities are scarce, workers face increased pressure to acquiesce to independent contractor arrangements. An Ohio worker who agreed in 2010 to be labeled an independent contractor as a condition of getting a job building housing for the homeless under a federal grant explained, “I went along with it because I felt my back was up against the wall. I have a family. My fiance was in school. I’m the only bread winner.”²²

Permitting employers in these jobs to get away with skirting basic labor and tax requirements will have a significant and long-term effect on the nature of jobs and our economy.

II. Federal and State Governments Lose Billions

Federal and state governments suffer hefty loss of revenues due to independent contractor misclassification, in the form of unpaid and uncollectible income taxes, payroll taxes, and unemployment insurance and workers’ compensation premiums.

A. Losses to Federal Revenues.

As detailed in my 2010 testimony, several government studies document the extent to which misclassification drains federal revenues:

- A 1994 study by Coopers and Lybrand estimated the federal government would lose \$3.3 billion in revenues in 1996 due to independent contractor misclassification, and \$34.7 billion in the period from 1996 to 2004.²³
- A 2000 study commissioned by the U.S. Department of Labor (DOL) – the “Planmatics” study – found that misclassification exacts an enormous toll: misclassifying just one percent of workers as independent contractors would cost unemployment insurance (UI) trust funds \$198 million annually.²⁴

¹⁹ See Smith, Bensman, Marvy, “The Big Rig: Poverty, Pollution and the Misclassification of Truck Drivers at America’s Ports,” (2010), http://nelp.3cdn.net/000beaf922628dfea1_cum6b0fab.pdf; Steven Greenhouse, The New York Times, *Clearing the Air at American Ports*, <http://www.nytimes.com/2010/02/26/business/26ports.html>.

²⁰ *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (July 2006), at p. 31.

²¹ Phillip Mattera, “Your Tax Dollars at Work... Offshore,” Good Jobs First (July 2004) http://www.goodjobsfirst.org/publications/Offshoring_release.cfm

²² <http://www.bloomberg.com/news/2013-10-18/states-clamping-down-on-workers-mislabeled-as-contractors.html>

²³ Coopers & Lybrand, *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, Prepared for the Coalition for Fair Worker Classification (1994).

²⁴ Lalith De Silva, et al., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, Planmatics, Inc., Prepared for the US Department of Labor Employment and Training Administration (2000), available at <http://wdr.doleta.gov/owsdrr/00-5/00-5.pdf>.

- A 2009 report by the Government Accountability Office (GAO) estimated independent contractor misclassification cost federal revenues \$2.72 billion in 2006.²⁵
- A 2010 study by the Congressional Research Service estimated that a proposed modification to the IRS’s “Safe harbor” rules, which currently allow employers significant leeway to treat workers as independent contractors for employment tax purposes and would yield \$8.71 billion for FYs 2012-21.²⁶

B. Losses to State Revenues.

The 2010 testimony I provided enumerated the various state task force studies showing staggering losses in the billions of dollars to state workers’ compensation, unemployment insurance, and income tax revenues.²⁷ Updates to the state and federal costs reports show continued and damaging drains on public funds. Recent results from state task force reports include:

- A 2013 bill in the California legislature finds that an estimated nine billion dollars of corporate, personal, and sales and use taxes goes uncollected in California each year, with unreported and underreported economic activity responsible for the vast majority of that total. In 2012 California’s Employment Development Department’s (EDD) Tax Branch conducted 4,290 audits and investigations, resulting in assessments totaling \$230.6 million, and identifying 89,063 unreported employees. EDD’s Compliance Development Operations which concentrates on the underground economy, conducted 2,600 joint inspections, identified 13,226 previously unreported employees, assessed \$36 million in payroll tax assessments and assessed over \$9 million on fraud cases in 2012.²⁸

²⁵ U.S. General Accounting Office, *Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention* (August 2009), available at <http://www.gao.gov/products/GAO-09-717>. See also, Treasury Inspector General for Tax Administration, *While Actions Have Been Taken to Address Worker Misclassification, and Agency-Wide Employment Tax program and Better Data are Needed* (February 4, 2009), available at <http://www.treas.gov/tigta/auditreports/2009reports/200930035fr.pdf> (explaining that “Preliminary analysis of Fiscal-Year 2006 operational and program data found that underreporting attributable to misclassified workers is likely to be markedly higher than the \$1.6 billion estimate from 1984.”)

²⁶ A 2010 study by the Congressional Research Service built on earlier national studies to compare the costs and benefits of improved classification if President Obama’s proposed modification of Section 530 of the Revenue Act of 1978 were passed. The modification would permit the IRS to prospectively reclassify workers who are misclassified. The US Treasury estimated that the proposal would yield \$8.71 billion for the period of FY 2012 through 2021. The CRS study acknowledged, however, that the work needed to reduce misclassification “would impose significant costs.” James M. Bickley, *Tax Gap: Misclassification of Employees as Independent Contractors*, Congressional Research Service (March 10, 2011), available at [http://op.bna.com/dlrcases.nsf/id/vros-8euvqa/\\$File/taxgap.pdf](http://op.bna.com/dlrcases.nsf/id/vros-8euvqa/$File/taxgap.pdf).

²⁷ See, Testimony of Catherine Ruckelshaus before Senate HELP Committee, June 2010, at pp. 7-8; <http://www.help.senate.gov/imo/media/doc/Ruckelshaus.pdf>; Leberstein, “Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries,” National Employment Law Project (2012); http://nelp.3cdn.net/0693974b8e20a9213e_g8m6bhyfx.pdf.

²⁸ California Employment Development Department, *Annual Report: Fraud Deterrence and Detection Activities*, report to the California Legislature (June 2013), available at http://www.edd.ca.gov/about_edd/pdf/Fraud_Deterrence_and_Detection_Report13.pdf.

- The New York Joint Enforcement Task Force on Employee Misclassification said in February 2013 that since its inception in 2007, it has identified over 88,700 instances of employee misclassification and discovered over \$1.4 billion in unreported wages and conducted 142 joint sweeps. In 2012, the JETF identified over 20,200 cases of employee misclassification; discovered over \$282.5 million in unreported wages; and assessed over \$9.7 million in unemployment insurance taxes.²⁹
- In 2012, Massachusetts' Joint Task Force on the Underground Economy and Employee Misclassification recovered over \$15.4 million through its enforcement efforts: the Department of Unemployment Assistance recovered \$13 million in unpaid employer contributions to the UI Trust Fund; the Department of Revenue recovered \$328,000 in unpaid taxes; and the Attorney General's Office brought in \$593,400 in restitution, penalties, and fines related to violations of the state's wage and hour and independent contractor laws. Based on the review and investigation of all JTF referrals in 2012, the Department of Industrial Accidents issued 15 stop work orders for lack of workers' compensation coverage.³⁰

III. State and Federal Policy Reforms

A. State reforms

State legislation seeking to combat independent contractor abuses has dwindled since the initial spate of laws were passed in the mid- to late 2000's, with much of the more recent activity pertaining to small provisions allowing discretionary penalties or weakening previously-enacted laws.³¹

The state reforms fall into a few general categories, and with one possible exception, are not comprehensive laws applying to all sectors. Some themes that emerge from an analysis of state laws are:

- Laws that create a presumption of "employee" or "employer" status for those performing or receiving labor or services for a fee. State UI and other laws that use the so-called "ABC" test are an example of these laws; they create a presumption of employee status and require employers to overcome this presumption by showing that: (a) an individual is free from control or direction over performance of the work, both under contract and in fact; (b) the service

²⁹ *Annual Report of the Joint Enforcement Task Force on Employee Misclassification*, (February 1, 2013), available at <http://www.labor.ny.gov/agencyinfo/PDFs/Misclassification-Task-Force-Report-2-1-2013.pdf>.

³⁰ Massachusetts Department of Labor, *Joint Task Force on the Underground Economy and Employee Misclassification 2012 Annual Report* (August 2013), available at <http://www.mass.gov/lwd/eolwd/jtf/annual-report-2012.pdf>.

³¹ For state legislative round-ups of leading independent contractor legislation, see National Employment Law Project, "NELP Summary of Independent Contractor Reforms: New State and Federal Activity," November 2011, http://nelp.3cdn.net/85f5ca6bd2b8fa5120_9qm6i2an7.pdf. Earlier year round-ups are cited in the 2011 report footnotes.

provided is outside the usual course of the business for it is performed; and (c) an individual is customarily engaged in an independently established trade, occupation or business. This “ABC” test for non-employee status is the most objective and the most difficult for employers to manipulate.³²

- Construction industry-specific laws that apply the standard across multiple state workplace laws to determine the status of construction workers.³³
- Laws creating a study commission or task force to coordinate audits and enforcement.³⁴

The state reforms, including the state task forces and executive branch activity, are an important first step and have brought real results to the state treasuries. There is however a continued need for federal leadership and oversight, as nearly half of the states have no payroll fraud provisions in place, and because the practices continue largely unabated in many sectors.

B. Federal Reforms

To date, no federal legislation has been enacted to address this growing problem. The U.S. Department of Labor has launched a multi-agency task force to combat payroll fraud, which is an important step.

Department of Labor Employee Misclassification Initiative: The Department of Labor’s multi-agency initiative to strengthen and coordinate federal and state efforts to identify and deter employee misclassification was launched in 2010.³⁵ In its Strategic Plan, the Department described Wage & Hour Division investigations in industries with the most substantial independent contractor abuses, and training for investigators on the detection of misclassified workers; targeted efforts to recoup unpaid payroll taxes due to misclassification, including a pilot program to reward states with the most success at detecting and prosecuting employers that misclassify; coordination with the states on enforcement litigation against multi-state employers that routinely abuse independent

³² 24 states have this definition in their unemployment insurance law Alaska, Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Louisiana, Massachusetts, Maryland, Nebraska, New Hampshire, New Jersey, New Mexico, Nevada, Oklahoma, Rhode Island, Tennessee, Virginia, Vermont, Washington, and West Virginia. Another eight states use a test that includes part "C" in combination with other factors (Colorado, Georgia, Idaho, Minnesota, Oregon, Pennsylvania, South Dakota, and Utah). This is also the law in over ten states’ workers’ compensation acts: AZ, CA, CO, CT, DE, HI, NH, ND, WI, WA. Massachusetts’ minimum wage act and its wage payment law use the ABC test as well. <http://www.mass.gov/legis/laws/mgl/149-148b.htm>.

³³ E.g., DE, IL, MD, MN, NB, NM, NY, PA, WI.

³⁴ For a recent summary of state task forces and their results, *see* National Employment Law Project, “Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries,” National Employment Law Project (2012); http://nelp.3cdn.net/0693974b8e20a9213e_g8m6bhfyx.pdf.

³⁵ The DOL has signed Memoranda of Understanding with thirteen states and is undertaking targeted enforcement in collaboration with other agencies to combat the worst abuses; *see* <http://www.dol.gov/whd/workers/misclassification/>.

contractor status; training for Occupational Safety and Health inspectors on misclassification issues; and legislative changes requiring proper classification, providing penalties for misclassification, and restoring protections for employees who have been improperly classified.³⁶

The Internal Revenue Service has also launched its **Voluntary Worker Classification Settlement Program**, which enables employers to resolve past worker misclassification problems by voluntarily reclassifying their workers prospectively and making a minimal payment covering past payroll tax obligations.³⁷ To be eligible, the employer must have (1) consistently treated the workers in the past as nonemployees; (2) filed all required Forms 1099 for the workers for the previous 3 years; and (3) not currently be under audit by the IRS, the Department of Labor or a state agency concerning the classification of these workers. Employers accepted into the program will pay an amount equaling just over one percent of the wages paid to the reclassified workers for the past year.

The Payroll Fraud Prevention Act³⁸ was introduced in April 2011 by Senator Brown, and would amend the recordkeeping requirements of the Fair Labor Standards Act (FLSA) to require employers to notify all employees and non-employees who perform services for remuneration of their status, would establish a presumption that an individual is an employee under the FLSA if the employer violates the notice requirements; and would provide for the imposition of civil penalties. The bill would also amend the Social Security Act to require state unemployment insurance programs to implement investigative procedures and establish penalties for misclassification; would require the Department of Labor (DOL) to measure state performance in this independent contractor misclassification enforcement when conducting unemployment compensation tax audits; would require information-sharing within the DOL regarding possible independent contractor abuses under the FLSA, and authorize the sharing of such information with the IRS; and would require that targeted audits conducted by the Wage & Hour Division include industries with frequent incidence of employee misclassification.

This law, if enacted, would provide important transparency for workers and their employers, and enable workers to question their designated employment status if the notification appeared incorrect or was confusing.

Closing the IRS Safe Harbor - Fair Playing Field Act

Under current law, an employer who is found by the IRS to have misclassified its workers as independent contractors can have all employment tax obligations waived. This "Safe harbor", at Section 530 of the Internal Revenue Act of 1978, 26 U.S.C. § 7436, also prevents the IRS from requiring the employer to reclassify the workers as employees in the future. Among other factors, to get the safe harbor, a business can assert its belief that a significant segment of its industry treated workers as independent contractors, thereby perpetuating industry-wide noncompliance with the law.

³⁶ See http://www.dol.gov/sec/media/congress/20100310_appropriations.htm

³⁷ See <http://www.irs.gov/newsroom/article/0,,id=246203,00.html> .

³⁸ <https://www.govtrack.us/congress/bills/112/s770>.

This loophole prevents the IRS from collecting back payroll taxes and even issuing regulations or guidance clarifying the agency's analysis of independent contractor practices for purposes of payroll taxes, and has thus been a major bar to effective enforcement against independent contractor abuses. To close this loophole, Senator Kerry introduced the Fair Playing Field Act of 2012 (**S. 2145**). This bill would amend the Internal Revenue Code to modify the rules giving employers a "safe harbor" when they misclassify employees, and would permit the IRS to issue guidance on the subject. This change is vital to serious reform seeking to combat independent contractor abuses. Without this monetary and tax incentive for employers to fix the problem, it will continue unabated.

In addition, the Congress should support more federal criminal prosecutions for egregious violators of federal criminal laws, including the failure to report currency transactions, mail and wire fraud, and tax fraud. The IRS could extend 1099 transaction reporting requirements to any payments made to incorporated businesses; this would help the IRS track down the companies who received those payments but did not pay taxes. And finally, comprehensive immigration reform would enable more immigrants to come forward and inquire about and protect their rights.