Tax Gap: Misclassification of Employees as Independent Contractors

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Summary

The misclassification of employees as independent contractors contributes to the tax gap. Consequently, congressional interest has been expressed about the importance of the proper classification of workers. The Internal Revenue Service (IRS) defines the *gross* tax gap as the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay voluntarily and timely for that year.

A business owner must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. In contrast, a business owner does not have to withhold or pay any taxes on payments to independent contractors. Employers are more likely to withhold and submit taxes than independent contractors are to voluntarily pay their tax liabilities. In 1984, the IRS made its last comprehensive misclassification estimate, which found that 15% of employers misclassified 3.4 million workers as independent contractors, causing an estimated total tax loss of $1.6 billion in Social Security tax, unemployment tax, and income tax.

Under common-law rules, a worker is an employee if the employer can control what the worker does and how the worker does it. The definition of "employee" has been affected by Section 530 "Safe Harbor Rules," IRS Ruling 87-41, and current IRS common law rules. Congress enacted Section 530 of the Revenue Act of 1978 (P.L. 95-600), which established "safe harbor rules" generally allowing an employer to treat a worker as not being an employee for employment tax purposes, regardless of the individual's actual status under the common-law test. In January 1987, the IRS issued Revenue Ruling 87-41 specifying 20 factors that identified whether or not an employee-employer relationship existed under common law. Currently, the IRS states that three categories of common-law rules provide evidence of the degree of control and independence: behavior, financial, and type of relationship.

On February 4, 2009, the Treasury Inspector General for Tax Administration (TIGTA) issued a report concerning IRS actions to address the misclassification of employees as independent contractors. In the 112th Congress, two companion bills have been introduced concerning the misclassification of employees: the *Payroll Fraud Prevention Act* (S. 770) and the *Employee Misclassification Prevention Act* (H.R. 3178). In his FY2012 budget, President Barack Obama proposed to "increase certainty with respect to worker classification" by a modification of the Section 530 of the Revenue Act of 1978. In September 2011, the IRS announced two new programs concerning misclassification of employees: a "Memorandum of Understanding" with the Department of Labor and a new "Voluntary Classification Settlement Program."

In conclusion, the misclassification of employees as independent contractors contributes to the tax gap and imposes numerous costs on the economy. A reduction in this misclassification would reduce federal, state, and local tax gaps and provide other important benefits. But, this decline in misclassification would impose significant costs. Accurate data on the current size of the tax gap caused by misclassification are unavailable. Furthermore, the magnitude of many effects of improved classification are unavailable or inherently subjective. With the current state of knowledge, whether or not the benefits of curtailing misclassification of workers outweigh the costs is a value judgment.

This report will be updated as warranted by legislative and economic events.

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Introduction

The misclassification of employees as independent contractors contributes to the tax gap. Consequently, congressional interest has been expressed about the importance of the proper classification of workers.

The Internal Revenue Service (IRS) defines the *gross* tax gap as the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay *voluntarily* and timely for that year. And it defines the *net* tax gap as the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year. For tax (calendar) year 2001 (the most recent year available), the IRS estimated a gross tax gap of $345 billion, equal to a noncompliance rate of 16.3%. For the same tax year, IRS enforcement activities, coupled with other late payments, recovered about $55 billion of the gross tax gap, resulting in an estimated net tax gap of $290 billion.[1]

A business owner "must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee."[2] In contrast, a business owner does not "have to withhold or pay any taxes on payments to independent contractors."[3] Employers are more likely to withhold and submit taxes than independent contractors are to voluntarily pay their tax liabilities. In 1984, the IRS made its last comprehensive misclassification estimate, which found that 15% of employers misclassified 3.4 million workers as independent contractors, causing an estimated total tax loss of $1.6 billion in Social Security tax, unemployment tax, and income tax.[4]

> For 84 percent of the workers misclassified as independent contractors in tax year 1984, employers reported the workers' compensation to IRS and the workers, as required, on the IRS Form 1099-MISC information return. These workers subsequently reported most of their compensation (77 percent) on their tax returns. In contrast, workers misclassified as independent contractors for whom employers did not report compensation on Form 1099-MISC reported only 29 percent of their compensation on their tax returns.[5]

The Government Accountability Office (GAO) estimated that in February 2005, independent contractors numbered 10.342 million or 7.4% of the U.S. workforce.[6] GAO also estimated that independent contractors accounted for 24% of the total contingent workforce of 42.6 million.[7]

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[1] For a comprehensive examination of the tax gap, see CRS Report R41582, *Tax Gap, Tax Enforcement, and Tax Compliance Proposals in the 112th Congress*, by (name redacted).

[2] Internal Revenue Service, *Independent Contractor (Self-Employed) or Employee?* February 18, 2011, p. 1. Available at http://www.irs.gov.

[3] Ibid.

[4] U.S. Government Accountability Office, *Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention*, Report number GAO-09-717, August 2009, p. 10.

[5] Ibid., pp. 10-11.

[6] U.S Government Accountability Office, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker* Classification, Report number GAO-06-656, July 2006, p. 11.

[7] Ibid., p. 12.

GAO states that "broadly defined, contingent work refers to work arrangements that are not long-term, year-round, full-time employment with a single employer."[8]

Independent contractors and other contingent workers provide flexibility to the labor market for both employers and workers. Because they can be readily terminated and receive fewer fringe benefits, employers are more willing to hire these workers. Consequently, the overall unemployment rate for the economy is lower and total output level is somewhat higher. Independent contractors, however, have less job security and workplace protections.

Usually an employer prefers to classify a worker as an independent contractor but the worker prefers to be classified as an employee. But sometimes a worker may prefer to be classified as an independent contractor because he or she can establish his or her own pension plan, deduct contributions to this plan, and have a greater ability to deduct work-related expenses.[9]

This report examines the policy question of whether or not the benefits of a reduction in the misclassification of employees, including a decrease in the tax gap, are greater than the costs. In order to analyze this issue, the evolution of the definition of employee versus independent contractor is discussed. Then, the findings of a Treasury Inspector General for Tax Administration (TIGTA) report are presented, proposed legislation in the 112th Congress is described, President Obama's proposal for modification is examined, and two new IRS programs relating to the misclassification of employees are explained. Next, the costs and benefits of improved classification are compared.[10]

Definition of Employee Versus Independent Contractor

Under common-law rules, a worker is an employee if the employer can control what the worker does and how the worker does it.[11] The definition of "employee" has been affected by Section 530 "Safe Harbor Rules," IRS Ruling 87-41, and current IRS common-law rules.

Section 530 "Safe Harbor Rules"

In the late 1960s and 1970s, the IRS increased enforcement of the collection of employment taxes. Some employers complained about the reclassification of their workers by the IRS as employees rather than independent contractors. In response, Congress enacted Section 530 of the Revenue Act of 1978 (P.L. 95-600), which established "safe harbor rules" generally allowing an employer to treat a worker as not being an employee for employment tax purposes, regardless of the individual's actual status under the common-law test. Initially a temporary provision, the safe

[8] Ibid., p. 5.

[9] Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes* (JCX-26-07), May 7, 2007, available at http://www.house.gov/jct.

[10] **Appendix A** presents factors in an IRS revenue ruling used to determine independent contractor status, and **Appendix B** describes proposed relevant legislation in the 111th Congress.

[11] Internal Revenue Service, *Employee (Common-Law Employee)*, May 19, 2008, p. 1.

harbor provisions were extended indefinitely by P.L. 97-248, the Tax Equity and Fiscal Responsibility Act of 1982. These safe harbor rules were amended by subsequent legislation.

Currently, the IRS specifies that, in order to qualify for "safe harbor," the employer must meet the following three Section 530 relief requirements:[12]

1. *Reasonable Basis*. The employer must have a reasonable basis for not treating workers as employees. The employer can establish reasonable basis by showing that (1) the employer relied on a court case about federal taxes or a ruling issued by the IRS, (2) the employer was audited by the IRS at a time when the employer treated similar workers as independent contractors and the IRS did not reclassify those workers as employees, (3) the employer treated its workers as independent contractors because he knew that was how a significant segment of his industry treated similar workers, or (4) the employer relied on some other reasonable basis such as the advice of a business lawyer or accountant who knew the facts about the employer's business.
2. *Substantive Consistency.* The employer must have treated his workers, and any similar workers, as independent contractors.
3. *Reporting Consistency.* The employer must have filed all required federal tax returns (including information returns) consistent with his treatment of each worker as not being employees.

These safe harbor rules prevent the Internal Revenue Service (IRS) from retroactively reclassifying workers as employees for employment tax purposes, thus shielding employers from retroactively imposed employment taxes as well as penalties and interest on those taxes.

IRS Ruling 87-41

In January 1987, the IRS issued Revenue Ruling 87-41 specifying 20 factors that identified whether or not an employee-employer relationship existed under common law. An "employee status" of the worker would obligate the employer for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages. A list of these 20 factors is shown in **Appendix A**. Eight of these 20 factors refer to independent contractors at least once, which suggests that this list of factors was compiled by the IRS to distinguish an employee-employer relationship from an independent contractor-employer relationship. There is no relative weighing of these 20 factors, hence the classification of the status of a worker is at least partially subjective.

Current IRS Common Law Rules

Currently, the IRS states that three categories of common-law rules provide evidence of the degree of control and independence that an employer or worker can use to determine if the worker is an employee or an independent contractor. These categories are as follows:

[12] Department of the Treasury, Internal Revenue Service, *Do You Qualify for Relief Under Section 530?* IRS Publication 1976, available at http://www.irs.gov.

1. *Behavioral*: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. *Financial*: Are the business aspects of the worker's job controlled by the payer? (These include things like how the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. *Type of Relationship*: Are there written contracts or employee-type benefits (i.e., pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?[13]

After reviewing these categories, if an employer or worker still is unclear about the proper classification of employee or independent contractor, either party may file with the IRS *Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.[14] Form SS-8 includes a series of questions about each of the three categories of common-law rules: behavior, financial, and type of relationship.[15] Then, an IRS official will review the form and determine the worker's status, but this review may take at least six months.[16]

TIGTA Report

On February 4, 2009, the Treasury Inspector General for Tax Administration (TIGTA)[17] issued a report concerning IRS actions "to address the misclassification of employees as independent contractors."[18] TIGTA maintains that the misclassification of employees as independent contractors continues to grow and contribute to the tax gap.[19] Because the last study of the impact of worker misclassification on the tax gap was done in 1984 by the IRS, the study indicates that the IRS does not know the current magnitude of the problem and is unable to determine the overall effectiveness of its policies to reduce misclassification.[20]

> We recommended that the Deputy Commissioner for Services and Enforcement develop and implement an agency-wide employment tax program to address the issue of worker classification to improve coordination among the business divisions, improve compliance, and reduce the tax gap. The Deputy Commissioner for Services and Enforcement should also consider conducting a formal National Research Program reporting compliance study to measure the impact of worker misclassification on the employment tax gap.[21]

In a memorandum, the IRS agreed with the TIGTA recommendations and stated that

[13] *Independent Contractor (Self-Employed) or Employee?* p. 1.

[14] Ibid.

[15] Internal Revenue Service, Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, pp. 2-3.

[16] *Independent Contractor (Self-Employed) or Employee?* p. 1.

[17] The Treasury Inspector General for Tax Administration organization was established in January 1999, in accordance with the Internal Revenue Service Restructuring and Reform Act of 1998 to provide independent oversight of IRS activities.

[18] Treasury Inspector General for Tax Administration, *While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed*, February 4, 2009, p. 1.

[19] Ibid.

[20] Ibid., p. 2.

[21] Ibid., p. 14.

> The Enterprise-Wide Tax Program has already made significant strides to develop an agency-wide employment tax program to improve coordination among the business operating divisions, improve compliance, and reduce the tax gap. We have also started planning for a formal National Research Program reporting compliance study to measure the impact of worker misclassification on the employment tax gap.[22]

Proposed Legislation in the 112th Congress

Two companion bills have been introduced in the 112th Congress concerning the misclassification of employees as independent contractors. On April 8, 2011, Senator Sherrod Brown introduced S. 770, the *Payroll Fraud Prevention Act*. On October 13, 2011, Representative Lynn C. Woolsey introduced H.R. 3178, the *Employee Misclassification Prevention Act*.[23]

Each bill would amend the Fair Labor Standards Act of 1938 (FLSA) to require every person (including every employer and enterprise) that employs an employee or non-employee who performs labor or services, including through an entity such as a trust, estate, partnership, association, company, or corporation, to (1) classify such individuals accurately as employees or non-employees; and (2) notify each new employee and new non-employee of his or her classification as an employee or non-employee, together with information concerning their rights under the law.

Each bill would make it unlawful for any person to (1) discharge or otherwise discriminate against an individual (including an employee) who has opposed any practice, or filed a complaint or instituted any proceeding related to this act, including with respect to an individual's status as an employee or non-employee; and (2) wrongly classify accurately an employee or non-employee.

Each bill would double the amount of liquidated damages for maximum hours, minimum wage, and notice of classification violations by an employer. Each bill would subject a person who: (1) violates such requirements (including recordkeeping requirements) to a civil penalty of up to $1,100; or (2) repeatedly or willfully violates such requirements to a civil penalty of up to $5,000 for each violation.

Each bill directs the Secretary of Labor to establish a webpage on the Department of Labor website that summarizes the rights of employees and nonemployees under the FLSA and this act.

Each bill would amend the Social Security Act to require, as a condition for a federal grant for the administration of state unemployment compensation, for the state's unemployment compensation law to include a provision for: (1) auditing programs that identify employers that have not registered under the state law or that are paying unreported compensation where the effect is to exclude employees from unemployment compensation coverage, and (2) establishing administrative penalties for misclassifying employees or paying unreported unemployment compensation to employees.

[22] Memorandum from Linda E. Stiff, IRS Deputy Commissioner, Services and Enforcement, January 7, 2009.

[23] The summary of these bills in the subsequent paragraphs is from the Legislative Information System (LIS) published by CRS.

Each bill would require any office, administration, or division of the Department of Labor to report any misclassification of an employee by a person subject to the FLSA that it discovers to the Department's Wage and Hour Division (WHD). Each bill would authorize the WHD to report such information to the Internal Revenue Service.

As shown in **Appendix B**, Senator Brown and Representative Woolsey introduced similar companion bills in the second session of the 111th Congress. **Appendix B** also describes of bills introduced in the 111th Congress relating to the misclassification of employees.

President Obama's Proposal in the Budget for FY2012

In his 2012 budget, President Barack Obama proposed to "increase certainty with respect to worker classification" by a modification of Section 530 of the Revenue Act of 1978.[24]

> The proposal would permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law.
>
> The Department of the Treasury and the IRS also would be permitted to issue generally applicable guidance on the proper classification of workers under common law standards. This would enable service recipients to properly classify workers with much less concern about future IRS examinations. Treasury and the IRS would be directed to issue guidance interpreting common law in a neutral manner recognizing that many workers are, in fact, not employees. Further, Treasury and the IRS would develop guidance that would provide safe harbors and/or rebuttable presumptions, both narrowly defined. To make that guidance clearer and more useful for service recipients, it would generally be industry- or job-specific. Priority for the development of guidance would be given to industries and jobs in which application of the common law test has been particularly problematic, where there has been a history of worker misclassification, or where there have been failures to report compensation paid.[25]

This proposed change would become effective for taxable years beginning after December 31, 2011. For FY2012 through FY2021, the U.S. Treasury estimates that this proposal will yield $8.71 billion.[26]

New IRS Programs Announced in September 2011

In September 2011, the Internal Revenue Service announced two new programs concerning worker misclassification: a "Memorandum of Understanding between the IRS and the U.S. Department of Labor (DOL)" and a new "Voluntary Classification Settlement Program" (VCSP). Although these announcements were only two days apart, an IRS official stated that there was no

[24] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, pp. 105-107.

[25] Ibid., p. 107.

[26] Ibid, p.148.

connection between the "Memorandum of Understanding" and the VCS.[27] This official maintained that the announcement of the two programs at almost the same time was "just a coincidence."[28]

Memorandum of Understanding between IRS and DOL

On September 19, 2011, the Commissioner of the IRS and the Secretary of Labor signed a "Memorandum of Understanding."[29] In addition, labor commissioners and other agency leaders representing seven states signed memorandums of understanding with different parts of the DOL.[30] The stated purpose of the "Memorandum of Understanding" was the following:

> The sharing of information and collaboration between the parties will help reduce the incidence of misclassification of employees as independent contractors, help reduce the tax gap, and improve compliance with federal labor laws. Increased collaboration will also strengthen the relationship between the IRS and DOL, enable both agencies to leverage existing resources and send a consistent message to employers about their duties to properly pay their employees and to pay employment taxes. This multi-agency approach presents a united compliance front to employers and their representatives.[31]

The IRS Commissioner Douglas Shulman reportedly said that the IRS would not initiate or participate in any new industry-specific investigations into employee misclassification.[32]

New Voluntary Classification Settlement Program

On September 21, 2011, the IRS announced a new "Voluntary Classification Settlement Program."[33] The purpose of this program was the following:

> The Internal Revenue Service (IRS) has developed a new program to permit taxpayers to voluntarily reclassify workers as employees for federal employment tax purposes. The Voluntary Classification Settlement Program (VCSP) allows eligible taxpayers to voluntarily reclassify their workers for federal employment tax purposes and obtain relief similar to that obtained in the current Classification Settlement Program (CSP). The VCSP is optional and provides taxpayers with an opportunity to voluntarily reclassify their workers as employees for future tax periods with limited federal employment tax liability for the past nonemployee treatment. To participate in the program, the taxpayer must meet certain eligibility

[27] Lorraine McCarthy, "IRS Addressing Worker Classification Issues Through New Enforcement, Relief Initiatives," *Daily Report for Executives*, November 18, 2011, p. G2.

[28] Ibid.

[29] Department of Labor, *Labor Secretary, IRS Commissioner Sign Memorandum of Understanding to Improve Agencies' Coordination on Employee Misclassification Compliance and Education*, DOL News Release Number 11-1373-NAT, September 19, 2011, p. 1.

[30] Ibid.

[31] Internal Revenue Service, *Memorandum of Understanding between the Internal Revenue Service and the U.S. Department of Labor*, September 19, 2011, p. 1.

[32] Eric Kroh, "IRS to Combat Worker Misclassification with Labor Department, States," *Tax Notes Today*, September 20, 2011, p. 1.

[33] Internal Revenue Service, *Voluntary Classification Settlement Program*, Announcement 2011-64, September 21, 2011, p. 1.

requirements, apply to participate in VCSP, and enter into a closing agreement with the IRS.[34]

In order to be eligible, an employer must have (1) consistently treated its workers in the past as nonemployees, (2) have filed all required Forms 1099 for the workers for the previous three 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.[35]

An employer participating in the VCSP program will pay 10% of the employment tax liability that may have been due on the compensation paid to the workers for the most recent year, with no liability for any interest or penalties.[36] The employer will not be subject to an employment tax audit for prior years for those workers who are reclassified.[37]

Costs and Benefits of Improved Classification

The misclassification of employees as independent contractors has been an ongoing congressional issue. As previously indicated, the classification of the status of a worker is at least partially subjective. There are numerous costs and benefits of improving worker classification.

Benefits

1. *Reduced federal tax gap.* Employers are required to withhold and pay certain taxes (personal income, Social Security, Medicare, and unemployment taxes) for employees but not independent contractors. The tax compliance level is high when tax withholding is required. In contrast, the tax compliance level of independent contractors is much lower because each contractor must take the initiative to file his or her taxes. As previously indicated, misclassification of workers added an estimated $1.6 billion to the tax gap in 1984 or $2.72 billion in inflation-adjusted 2006 dollars.[38]
2. *Reduced state and local tax gaps.* Not only would the federal tax gap decline, but state and local governments would experience reductions in their tax gaps. A study of misclassification for the state of New York found a loss in unemployment insurance tax revenue for audited industries of $205.9 million in 2005.[39]
3. *Reduction on government outlays for employee benefits*. Workers misclassified as independent contractors receive fewer benefits such as health care insurance and

[34] Ibid.

[35] Internal Revenue Service, *IRS Announces New Voluntary Worker Classification Settlement Program*, IRS New Release (IR-2011-95), September 21, 2011, p. 1.

[36] Internal Revenue Service, *Voluntary Classification Settlement Program (VCSP) Frequently Asked Questions*, September 20, 2011, p. 2.

[37] Ibid.

[38] U.S. Government Accountability Office, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, p. 2.

[39] Linda H. Donahue, James Ryan Lamare, and Fred B. Kotler, *The Cost of Worker Misclassification in New York State*, Cornell University, February 2007, p. 10.

workman's compensation. Consequently, many of these workers may rely more heavily on publicly provided assistance such as Medicaid, food stamps, and Temporary Assistance for Needy Families (TANF).

4. *Higher worker compensation and protection*. Deliberate misclassification by employers of employees as independent contractors denies these workers fringe benefits and protections under federal legislation. Key laws designed to protect workers but that only apply to employees include the Fair Labor Standards Act, Family and Medical Leave Act, Occupational Safety and Health Act, National Labor Relations Act, Unemployment Insurance, and Workers' Compensation.[40] Thus, improving worker classification would raise worker compensation and protection.
5. *Better allocation of resources*. Employers who misclassify employees as independent contractors have an "unfair" competitive advantage over employers who properly classify their workers.[41] Employers that have high levels of misclassification of workers earn higher profits and expand relative to compliant employers, which results in an inefficient allocation of productive resources.

Costs

1. *Higher federal outlays for tax enforcement*. Increased enforcement of the classification of workers requires higher federal outlays or a reallocation of federal resources. These resources for increased enforcement have alternative uses that may yield greater social benefits.
2. *Reduction in privacy*. Personal privacy is reduced as the IRS collects and cross-checks more data. Audits of individuals are intrusive and often stressful.
3. *Reduction in labor market flexibility*. A reduction in the ability of employers to hire independent contractors would lessen employers' flexibility in expanding or contracting their workforces. Employers are less willing to hire workers if they must pay them higher fringe benefits and are subject to more worker protections. This decreased employer flexibility may result in a higher unemployment rate and lower gross domestic product.

Conclusions

The misclassification of employees as independent contractors contributes to the tax gap and imposes numerous costs on the economy. A reduction in this misclassification would reduce federal, state, and local tax gaps and provide other important benefits. But, the work necessary to reduce misclassification would impose significant costs. Accurate data on the current size of the tax gap caused by misclassification are unavailable. Furthermore, the magnitude of many effects of improved classification are unavailable or inherently subjective. With the current state of knowledge, whether or not the benefits of curtailing misclassification of workers outweigh the costs is a value judgment.

[40] Government Accountability Office, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, p. 7.

[41] Ibid., p. 7.

Appendix A. Factors in IRS Revenue Ruling 87-41

1. *Instructions*. A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions.
2. *Training*. Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.
3. *Integration*. Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.
4. *Services Rendered Personally*. If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.
5. *Hiring, Supervising, and Paying Assistants*. If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
6. *Continuing Relationship*. A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.
7. *Set Hours of Work*. The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.
8. *Full Time Required*. If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.
9. *Doing Work on Employer's Premises*. If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which

an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.

10. *Order of Sequence Set*. If a worker must perform services in order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed.
11. *Oral or Written Reports*. A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.
12. *Payment by Hour, Week, Month*. Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.
13. *Payment of Business and/or Traveling Expenses*. If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.
14. *Furnishing of Tools and Materials*. The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.
15. *Significant Investment*. If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices.
16. *Realization of Profit or Loss*. A worker who can realize a profit or suffer a loss as a result of the worker's service (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. For example, if the worker is subject to a real economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. *Working for More Than one Firm at a Time*. If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
18. *Making Service Available to General Public*. The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.
19. *Right to Discharge*. The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specification.
20. *Right to Terminate*. If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

Appendix B. Proposed Legislation in the 111th Congress

In the 111th Congress, six bills were introduced concerning the misclassification of employees as independent contractors.[42]

Legislation in the First Session

In the first session, two similar bills were introduced to address concerns about the misclassification of employees as independent contractors. On July 30, 2009, Representative Jim McDermott introduced H.R. 3408, the Taxpayer Responsibility, Accountability, and Consistency Act of 2009, and this bill was referred to the House Ways and Means Committee. Representative McDermott stated on the House floor that

> The aim of this legislation is to reverse the growing trend of the misclassification of employees as independent contractors. Independent contractors serve a legitimate purpose in our workforce, our economy, and in many business models. These contractors are important to our economy and often provide the flexibility that many businesses need. Some employers, however, are using a loophole that exists in the Internal Revenue Code to treat workers that are actually employees as contractors in order to reduce their own tax liability and avoid federal and state labor law. When employees are misclassified as contractors, responsible companies lose business, workers lose rights and protections, and the federal and state governments lose out of billions of dollars in much-needed revenue.[43]

On December 15, 2009, Senator John F. Kerry introduced a similar bill with the same title, S. 2882.

These proposed bills would require reporting to the IRS of payments of $600 or more made by or to corporations, other than tax-exempt organizations. These bills would modify the three "statutory standards" under Section 530 of the Revenue Act of 1978. These modifications would make it more difficult for an employer to be eligible for safe harbor treatment of workers as non-employees in order for the employer to be exempt from paying employment taxes. In addition, the bill would place the burden of proof of entitlement to safe harbor relief on the employer.

These bills would require the Secretary of the Treasury to issue an annual report on worker misclassification. This report would include the following:

- Information on the number and type of enforcement actions against, and examinations of, employers who have misclassified workers
- Relief obtained as a result of such actions against, and examinations of, employers who have misclassified workers

[42] In the 110th Congress, four bills were introduced concerning the misclassification of employees: H.R. 611, H.R. 2657, H.R. 5804, and S. 2044. When he was a Senator, President Barack Obama introduced S. 2044, which would have modified Section 530 "safe harbor rules."

[43] Honorable Jim McDermott, Speech concerning the *Taxpayer Responsibility, Accountability, and Consistency Act of 2009*, *Congressional Record*, July 31, 2009, p. E2124.

- An overall estimate of the number of employers misclassifying workers, the number of workers affected, and the industries involved
- The impact of such misclassification on the federal tax system
- Information on the outcomes of the petitions filed requesting review of employment statue classification

Finally, these bills would increase information return penalties for (1) failure to file correct information returns, (2) failure to furnish correct payee statements, and (3) failure to comply with other information-reporting requirements.

Legislation in the Second Session

In the second session of the 111th Congress, two set of companion bills (a total of four bills) were introduced to address concerns about the misclassification of employees as independent contractors.

Misclassification Prevention Act

On April 22, 2010, Representative Lynn C. Woolsey introduced H.R. 5107, the Misclassification Prevention Act. Also on April 22, 2010, Senator Sherrod Brown introduced S. 3254, the Misclassification Prevention Act. On June 17, 2010, the Senate Committee on Health, Education, Labor, and Pensions held hearings on S. 3254.

The Employee Misclassification Prevention Act would amend the Fair Labor Standards Act of 1938 (FLSA) to require every person to (1) keep records of non-employees (contractors) who perform labor or services (except substitute work), including through an entity such as a trust, estate, partnership, association, company, or corporation, for remuneration; and (2) provide certain notice to each new employee and new non-employee, including their classification as an employee or non-employee and information concerning their rights under the law.[44]

This bill would make it unlawful for any person to (1) discharge or otherwise discriminate against an individual (including an employee) who has opposed any practice, or filed a complaint or instituted any proceeding related to this act, including with respect to an individual's status as an employee or non-employee; and (2) fail to classify accurately an employee or non-employee.

This bill would double the amount of liquidated damages for maximum hours, minimum wage, and notice of classification violations by an employer. This act would subject a person who (1) violates such requirements (including recordkeeping requirements) to a civil penalty of up to $1,100; or (2) repeatedly or willfully violates such requirements to a civil penalty of up to $5,000 for each violation.

This bill directs the Secretary of Labor to establish a webpage on the Department of Labor website that summarizes the rights of employees under this act and other appropriate information.

[44] The summary of this bill in this and subsequent paragraphs is from the Legislative Information System (LIS) published by CRS.

This bill would amend the Social Security Act to require, as a condition for a federal grant for the administration of state unemployment compensation, the state's unemployment compensation law to include a provision for (1) auditing programs that identify employers that have not registered under the state law or that are paying unreported compensation where the effect is to exclude employees from unemployment compensation coverage; and (2) establishing administrative penalties for misclassifying employees or paying unreported unemployment compensation to employees.

The bill would require any office, administration, or division of the Department of Labor to report any misclassification of an employee by a person subject to the FLSA that it discovers to the Department's Wage and Hour Division (WHD). The act would authorize the WHD to report such information to the Internal Revenue Service.

Fair Playing Field Act of 2010

On September 15, 2010, Senator John F. Kerry and Representative Jim McDermott introduced the Fair Playing Field Act of 2010 (S. 3786 and H.R. 6128). This act declares Congress finds that

> Many workers are properly classified as independent contractors. In other instances, workers who are employees are being treated as independent contractors. Such misclassification for tax purposes contributes to inequities in the competitive positions of businesses and to the federal and state tax gap, and may also result in misclassification for other purposes, such as denial of unemployment benefits, workplace health and safety protections, and retirement or other benefits or protections available to employees.
>
> Workers, businesses, and other taxpayers will benefit from clear guidance regarding employment tax status. In the interest of fairness and in view of many service recipients' reliance on current section 530, such guidance should apply only prospectively.

Consequently, This act states that its purposes are "to permit the Secretary of the Treasury to provide guidance allowing workers and businesses to clearly understand the proper federal tax classification of workers and to provide relief allowing an orderly transition to new rules designed to increase certainty and uniformity of treatment."

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