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"The Misclassification of Employees as Independent Contractors"

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Chairman Andrews, Chairwoman Woolsey, honorable Members of the Subcommittees: good morning. I am David J. Socolow, New Jersey's Commissioner of the Department of Labor and Workforce Development. I am honored to have the opportunity to appear before you today to discuss the problem of misclassification of workers as independent contractors.

Our state and national labor laws are designed to protect all of the nation's workers. Unfortunately, it has become all too common for unscrupulous employers to find loopholes in order to unfairly reduce their tax burden and increase their profits, while risking their workers' future health, safety, and security. Companies that misclassify workers as independent contractors to lower their labor costs hurt their workers, hurt the public, and unfairly gain an advantage in the marketplace.

New Jersey Governor Jon S. Corzine has led our state in an important initiative to protect workers by fighting independent contractor misclassification and rooting out the abuses of the underground economy. Our Governor recognizes that the misclassification of employees as independent contractors, in addition to putting workers at risk and unfairly disadvantaging honest employers, costs the state millions of dollars in foregone tax revenue.

Employer Avoidance of the Obligations of the Employer-Employee Relationship

There are two related employee practices by which employees are improperly classified: (1) those workers who should get a W-2 form from their employer but instead are given a 1099 form and treated as if they were self-employed: and (2) those workers paid in cash "off the books." In both of these situations, workers are denied their rights as employees, including the right to organized representation, safety and health protections on the job, family and medical leave, whistleblower protections, vital social insurance benefits and health insurance and retirement benefits offered to employees.

When employers misclassify their employees, those workers and their families are left vulnerable when they are in greatest need of the benefits routinely accrued through employment. The practice not only threatens the ability of honest businesses to effectively compete, but it also leads to reduced tax revenue and less funding for benefit programs.

In our experience in New Jersey, employee-employer relationships are being deliberately severed by employers driven by the quest to improve their bottom line. Many employers are intentionally, and illegally, cutting their legitimate business costs by choosing to treat bona-fide employees as if they were self-employed contractors. In so doing, these employers leave it to their employees to pay for social insurance programs and take on their own tax withholding liabilities. While some misclassification may be due to legitimate misunderstanding of the law, the primary reason that most employers choose to misclassify employees is a desire to avoid the employer costs of payroll taxes for social security, unemployment and disability insurance as well as worker's compensation insurance premiums.

Deliberate misclassification of employees as independent contractors is not the benign issue that offenders engaging in this practice would have us believe. Even if, as several have argued, some workers voluntarily participate and find this practice advantageous, it still does not remove any of the injuriousness of misclassification. Many employees who find themselves misclassified are ill-prepared and undereducated as to the responsibilities of self-employment.

A report released by Cornell University in April of this year indicated that "[w]ith less tax revenues flowing into government coffers, public resources are strained. State unemployment insurance systems, for example, are forced to compensate by raising contribution rates for employers who comply with the regulations. According to the Government Accountability Office, underpayment of Social Security, unemployment insurance, and income taxes in 2006 due to misclassification amounted to an estimated $2.72 billion; the researchers here argue that the real cost is substantially higher, particularly when losses at the state level are factored in."

Employers who pay workers in cash "off the books" create additional difficulties. When an employer issues a 1099 form to an individual, enforcement agencies at least have a paper trail to follow. Individuals who work "off the books" for cash payment are hidden still further in the underground economy. Sometimes these workers are exploited because they are undocumented residents. Other times employers hire a worker for a short time without keeping proper records, paying insurance premiums, or arranging for withholding.

How prevalent is the problem?

In the New Jersey Department of Labor and Workforce Development's recent yearly audits of 2.2 percent of employers – around 6,000 annually – we have found either independent contractor misclassification or workers being paid in cash "off the books" in 42 percent of cases. Even among the more than 750 employers selected totally at random for an audit, 38 percent of these firms violated the law by misclassifying their employees. The Department also conducts approximately 1,500 targeted investigations annually. Some of these investigations are triggered when misclassified workers apply for unemployment insurance, temporary disability, or workers' compensation benefits that they assumed their employers were paying on their behalf. When these workers attempt to file for benefits, their claims are often initially denied because they are not recorded in

the system as an employee. In most cases, subsequent investigations show that the individual was misclassified and should have been treated as an employee.

Overall, in 2006, our audits found nearly 25,000 workers misclassified and uncovered more than half-a-billion dollars in misclassified or unreported wages ($565 million). In 2005, New Jersey's audits found 28,286 misclassified workers, with misclassified or unreported wages of $644 million. In calendar year 2004, these audits turned up more than 26,000 workers whose employers misclassified their employment and failed to provide these workers with New Jersey unemployment and disability insurance coverage.

We find an even greater level of non-compliance when we target our investigations to industries known to have widespread abuses. This practice first attracted our attention as a result of audit patterns and complaints about building contractors filed with the Division of Wage and Hour Compliance, which led the Department to uncover a significant number of misclassification violations in the construction industry. In 2006, out of 871 audits and investigations in the construction industry, 41 percent found misclassification of employees, identifying nearly 3,000 misclassified construction workers, $78.2 million in under-reported gross wages and $2.1 million in under-reported contributions. However, the misclassification of employees is no longer primarily limited to the construction industry. We have also found significant patterns of violation in food processing plants, courier services, dental assistants, waitresses, nail salons, nurses, secretaries and landscaping.

For example, the New Jersey Department of Labor and Workforce Development recently conducted a program of unannounced investigations of nail salons and found workers not properly classified as employees in more than two-thirds of all establishments examined (350 investigations, 240 assessments). Field investigations of several hundred landscapers disclosed failure to classify worker as employees in nearly 62 percent of all businesses examined. Our investigations of dentists found that 53 percent of the employers improperly treated their dental assistants as independent contractors and not employees. The Department has also greatly benefited from data-sharing with the Internal Revenue Service (IRS). Investigations initiated as the result of analysis of 1099 information provided by the IRS since 2003 resulted in findings of non-compliance in 75 percent of cases (111 cases, 84 assessments).

In another example, for unemployment insurance tax purposes, New Jersey law treats an employee leasing company as the employer of the workers of its various clients. The tax accounts of the client companies are then recorded as inactive accounts while the leasing company reports the payroll for the workers. Our examination of inactive client company records, however, has disclosed that many of these companies continue making payments for services, generally to "independent contractors" or other temporary workers not included on the new payroll reports from the employee leasing company. Our recent investigations have found this type of non-compliance in 61.5 percent of all these investigations (367 investigations, 226 assessments).

The New Jersey Department of Labor and Workforce Development also has uncovered significant patterns of employers' misclassification of workers through monthly enforcement sweeps by our State Division of Wage and Hour Compliance. These enforcement efforts are targeted in the residential and commercial construction sectors, the garment and apparel industry and large-scale farming operations. Employers who refuse to provide timesheets or payroll records are issued subpoenas. Employers who ignore the subpoenas are subject to prosecution as disorderly persons for a first offense and even more serious criminal penalties for subsequent or egregious violations. During the first six months of 2007, the Wage and Hour Compliance Task Force has made 158 referrals to the New Jersey Division of Workers' Compensation and 228 referrals to the Unemployment Insurance Division of Employer Accounts for suspected misclassification of workers.

We find that employees who are misclassified rarely feel that they are in a position to demand that they be correctly classified as an employee. By contrast, true independent contractors choose to be self-employed. They not only receive a 1099 form that they use to declare their income for taxes but also must assume much of the tax and insurance liabilities normally paid by employers, including paying both the employer and employee portions of Social Security taxes, contributing to unemployment insurance, and providing their own workers' compensation insurance. True independent contractors set their compensation at levels high enough to cover payroll taxes, insurance and other expenses for which they are responsible. This is not possible for employees who are expected to work for their employer as independent contractors while receiving relatively the same pay as an hourly worker.

How we are addressing the challenge

In April 2006, soon after taking office, New Jersey Governor Corzine directed the Treasury Department's Division of Taxation and the Department of Labor and Workforce Development to work together to combat the practice of misclassification of employees. We formed a task force that included the Divisions of Employer Accounts, Wage and Hour Compliance, Workers' Compensation, and Taxation to identify common areas of concern and develop a process to exchange information. By leveraging the resources and findings of each agency, findings from one department could be used by the other without the need to duplicate the entire investigative process. The sharing of information among agencies and programs is an important part of this initiative, which aims to break down "silos" within government and have the various agencies of government cooperate on tips, leads, and investigations.

Following up on the Governor's initiative, last summer the Legislature sent a bill to the Governor's desk to support our efforts. This law, P.L. 2006, Chapter 85, now provides that New Jersey's Gross Income Tax law, wage and hour laws, Unemployment Insurance law, and Temporary Disability Insurance law use the identical legal test to decide whether an individual is an employee or an independent contractor – the "ABC test."

Under the "ABC test," an individual paid for services is presumed to be an employee unless he or she meets all three characteristics of a self-employed, independent contractor. These are: (A) that the individual has been and will continue to be free from control or direction over the performance of such service, both under his contract of service and in fact; (B) The service provided is either outside the usual course of the business for which service is performed, or that the service is performed outside of all the places of business of the enterprise for which such service is performed; and (C) The individual is customarily engaged in an independently established trade, occupation, profession or business, so that the individual would not routinely become unemployed when his or her relationship with this particular employer ended.

Because these sister state agencies use the same legal definition of a true independent contractor, Division of Taxation staff, for example, can use the Labor Department's findings to enforce the income tax law without the unnecessary duplication of effort. The Division of Taxation is also able to use the findings of compliance audits by Labor Department auditors to pursue income taxes owed to the state. The Labor Department also can follow up on audits by the Division of Taxation to ensure that employees are properly paid and covered for Unemployment Insurance and Temporary Disability Insurance benefits.

Additionally, we have recently begun a cross match of audit data with Workers' Compensation data to identify employers who are not properly providing Workers' Compensation coverage for their employees. This innovative data-sharing procedure has led to more than 75 investigations of employers involving more than 1,300 workers. Investigators from both Wage and Hour and Employer Accounts now check for Workers' Compensation Insurance coverage. In addition, by sharing tax-audit information with the Compensation Rating and Inspection Bureau that oversees Workers' Compensation insurance premiums, the State can better identify employers who are underpaying Workers' Compensation premiums.

New Jersey was also an original volunteer, one of four states, to join a partnership with the Internal Revenue Service in dealing with Questionable Employer Tax Practices, or QETP. This federal-state partnership is developing and implementing a federal/state approach to addressing worker misclassification and other attempts to avoid employment taxes. Our State has gained positive results from previous exchanges of information from the IRS. As mentioned above, 75% of the leads from these IRS 1099 data have found non-compliance. We anticipate similar results under the QETP federal-state partnership, which has been designed to enhance enforcement of tax laws, protect accurate worker classifications and discover and address tax avoidance schemes through the sharing of information and by leveraging federal and individual state resources.

Most recently, on July 13, 2007, Governor Corzine signed into law the Construction Industry Independent Contractor Act (P.L. 2007, c. 114). This law provides even stronger enforcement tools and more effective penalties, including criminal penalties for the first time, for employers who cheat their employees, their government and competitors by misclassifying workers as independent contractors. Under this law, a

contractor that has knowingly misclassified workers can be guilty of a crime of the second degree. Such a contractor can be held liable to make up any loss to the employees if they were underpaid in connection with the misclassification. The law also authorizes the Commissioner of Labor and Workforce Development to assess and collect administrative penalties, up to $2,500 for a first violation and up to $5,000 for each subsequent violation. Contractors that engage in this practice can be made ineligible to receive public contracts.

Recommendations for Federal Action

The Congress should address five areas that can be improved to reduce the misclassification of workers as independent contractors:

1. **Establish a strong, universal federal definition of employee**: As I mentioned, New Jersey recently amended its statutes to have enforcement agencies use the strong "ABC test" to determine the employee-employer relationship. Similarly, federal laws should adopt the "ABC test," as used in New Jersey, to distinguish an employee from an independent contractor. A strong, consistent test for independent contract status would enhance federal enforcement of such laws as the National Labor Relations Act, the Civil Rights Act, the Internal Revenue Code, the Fair Labor Standards Act, the Occupational Safety and Health Act, and the Employee Retirement Income Security Act.
2. **Enhance collaboration**: New Jersey's aggressive multi-agency approach to addressing the problem of employee misclassification provides a model for improved coordination among federal enforcement agencies. New Jersey's increased data sharing, joint enforcement efforts, unified definition of the employee-employer relationship, and our collaborative approach bring a broad array of resources to bear on this problem. Similarly, federal agencies should adopt universal standards for all investigators that clarify the procedures for referring misclassification cases to the other appropriate federal and state agencies charged with enforcement. This recommendation was also made in May 2007 by the GAO in its testimony on employee misclassification to the Subcommittees on Income Security and Family Support and on Select Revenue Measures, which referenced GAO's finding that USDOL district offices have varying referral procedures and inconsistently referred misclassification cases.
3. **Amend Section 530 of the Revenue Act of 1978**: Section 530, commonly referred to as the "safe harbor" provision, prevents the IRS from reclassifying workers prospectively as employees, contains deficient reporting requirements on employers who make payments to independent contractors, and establishes insufficient penalties for employers who pay their workers under the table and fail to file 1099's. Section 530 also allows employers to misclassify workers as independent contractors in certain industries, regardless of the employment relationship, if, in a particular industry, there is a "long-standing recognized practice" of classifying the workers as independent contractors or if the employer underwent an IRS audit anytime in the past. Reforms to Section 530 are long overdue and both the GAO and the IRS are on record urging reforms

that would increase the effectiveness of compliance programs and increase collection of tax revenue by the US Treasury.

4. **Empower workers to assist in ensuring proper classificatio**n: Workers and their representatives should have the option of receiving an employee status determination from the IRS to ensure their proper classification. When requesting a determination, the workers should have their confidentiality maintained to the greatest extent possible, should be protected from retaliation by employers when requesting a determination, and should be afforded appeal rights. Also, the Fair Labor Standards Act workplace poster should be revised to include information that informs workers how and where to file complaints.
5. **Increase enforcement**: The USDOL should expand the types of unemployment insurance tax audits that states may count in the statistics reported to USDOL, including those audits that fail to find a source document (such as a cancelled check or an original time sheet). This would provide state unemployment insurance agencies with an incentive to pursue audits in cases where employers fail to produce or maintain payroll records. Additionally, enforcement by USDOL's Wage and Hour Division could be improved by establishing adequate administrative penalties for the knowing and willful misclassification of workers and for record-keeping violations. The New Jersey Division of Wage and Hour Compliance has enjoyed the statutory authority to assess and collect administrative penalties since 1991 and this has proven to be a useful compliance tool. Lastly, the USDOL should be urged to target enforcement in industry sectors known to have high rates of misclassification and to assist states in their enforcement efforts through supplemental funding.

I thank you for the opportunity to testify and I would be happy to answer any questions you may have.