THE MISCLASSIFICATION OF INDEPENDENT CONTRACTORS: THE FIFTY-FOUR BILLION DOLLAR PROBLEM

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I. INTRODUCTION

Employers[1] are required to categorize their workers as either employees[2] or independent contractors.[3] On average, most independent contractors are properly classified, but the problem is that many employers misclassify their workers in order to save on labor costs and avoid liability under various employment Acts.[4] A

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[1] BLACK'S LAW DICTIONARY 604 (9th ed. 2009). An employer is defined as "[a] person who controls and directs a worker under an express or implied contract of hire and who pays the worker's salary or wages." *Id.*

[2] *Id.* at 602. An employee is defined as "[a] person who works in the service of another person (the employer) under an express or implied contract of hire, under which the employer has the right to control the details of work performance." *Id.*

[3] *Id.* at 839. Independent contractor is defined as:

> One who is entrusted to undertake a specific project but who is left free to do the assigned work and to choose the method for accomplishing it. It does not matter whether the work is done for pay or gratuitously. Unlike an employee, an independent contractor who commits a wrong while carrying out the work does not create liability for the one who did the hiring.

Id.

[4] *See Obama Targets Employers that Misclassify Workers as Independent Contractors*, COMPENSATION.BLR.COM (Feb. 2, 2010), http://compensation.blr.com/Compensation-news/Compensation/Independent-Contractors/Obama-

disheartening story told during a committee hearing involved a dishwasher at a family-style restaurant who was being paid less than minimum wage and did not receive overtime.[5] When the dishwasher confronted his employer about the situation, he was told that he would be paid for all the overtime wages and back pay he was owed.[6] A few days later, the dishwasher was approached by the employer's attorney who said the employer would only pay a fraction of the back wages, and if he made trouble for the employer, trouble would be made for the dishwasher.[7] After filing a wage complaint with the state, the dishwasher was fired, and the employer argued that overtime was not owed because he was an independent contractor.[8] Here, it was evident that the dishwasher was being misclassified to simply save on labor costs.[9] Furthermore, the dishwasher was being illegally deprived of minimum wage, overtime pay, and even worker's compensation coverage.[10]

For those workers classified as employees, the Internal Revenue Code of 1986, as amended (the "Code"), requires that the employer withhold federal income taxes and half of the Social

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Targets-Employers-that-Misclassify-Workers-a/# (reporting that President Barack Obama's federal budget proposal for 2011 includes an allocated $25 million targeting the misclassification of employees as independent contractors).

[5] *See Leveling the Playing Field: Protecting Workers and Businesses Affected by Misclassification: Hearing Before the Subcomm. on Health, Educ., Labor, and Pensions*, 111th Cong. 7 (2010) (statement of Seth D. Harris, Deputy Secretary, United States Department of Labor), *available at* http://www.help.senate.gov/imo/media/doc/Harris4.pdf [hereinafter Harris Statement, Leveling the Playing Field].

[6] *Id.*

[7] *Id.*

[8] *Id.* at 7-8.

[9] It seems clear that a dishwasher cannot be an independent contractor as "these workers do not bring their own equipment, do not decide their own hours of work, and do not have a profit or loss motive." *Id.* at 8.

[10] *Id.* at 7-8.

Security and Medicare taxes from the employee's compensation.[11] The employer also has to pay the full amount of federal and state unemployment taxes relating to those classified as employees.[12] For those workers classified as independent contractors, the Code does not require that the employer withhold any taxes from a worker's compensation.[13] Not only do unemployment funds lose out on any taxes for independent contractors, but because on average, independent contractors underreport more than employees,[14] the federal government and state and local governments lose billions of dollars in tax revenue.[15]

Misclassification[16] suggests some sort of technical violation or a simple paperwork error that is innocently made.[17] However, misclassification is a purposeful and intentional action that results

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[11] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-717 EMPLOYEE MISCLASSIFICATION: IMPROVED COORDINATION, OUTREACH, AND TARGETING COULD BETTER ENSURE DETECTION AND PREVENTION 5 (2009), *available at* http://www.gao.gov/new.items/d09717.pdf (reporting on the difference between how employees and independent contractors are treated for tax purposes and various other labor purposes).

[12] *Id.*

[13] *Id.*

[14] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-717 EMPLOYEE MISCLASSIFICATION: IMPROVED COORDINATION, OUTREACH, AND TARGETING COULD BETTER ENSURE DETECTION AND PREVENTION 5 (2009), *available at* http://www.gao.gov/new.items/d09717.pdf

[15] *See* SARAH LEBERSTEIN, NAT'L EMP.'T LAW PROJECT, INDEPENDENT CONTRACTOR MISCLASSIFICATION IMPOSES HUGE COSTS ON WORKERS AND FEDERAL AND STATE TREASURIES 1 (2012), *available at* http://nelp.3cdn.net/0693974b8e20a9213e_g8m6bhyfx.pdf (laying out the results of numerous national and state surveys that have been completed regarding the cost effects of misclassification on employees unemployment insurance funds, federal tax revenue, and state/local tax revenue).

[16] *See* Harris Statement, *Leveling the Playing Field*, *supra* note 5, at 5-6 ("In simple terms, worker misclassification is the practice of treating a worker who is an employee under the law as something other than an employee, thus depriving the employee of rights and benefits to which they are entitled.").

[17] *Id.* at 1.

in illegally depriving employees of employment protections along with tax evasion that correlates to a loss of federal and state revenue.[18] According to a study done in 2000 of nine states commissioned by the Department of Labor's Employment Administration, "[t]he number one reason employers use ICs and/or misclassify employees is the savings in not paying workers' compensation premiums and not being subject to workplace injury and disability-related disputes."[19] While some misclassification is the result of uncertainty or misapplication of complicated common law tests,[20] most of the cases involving misclassification were done on purpose in order to gain a competitive advantage over employers that obey the law.[21]

One study found that up to 30% of audited employers misclassified their employees.[22] Misclassification results when a worker who meets the legal standards for being classified as an employee is instead treated as an independent contractor by an employer or when an employee is paid off-the-books and is not reported at all for tax or other purposes.[23] Unfortunately, it is all

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[18] *Id.*

[19] LALITH DE SILVA ET AL., PLANMATICS, INC., INDEPENDENT CONTRACTORS: PREVALENCE AND IMPLICATIONS FOR UNEMPLOYMENT INSURANCE PROGRAMS III (2000), *available at* http://wdr.doleta.gov/owsdrr/00-5/00-5.pdf (stating that this report was prepared for the U.S. Department of Labor Employment and Training Administration).

[20] *See infra* Part III.

[21] *See* DALE L. BELMAN & RICHARD BLOCK, MICH. STATE UNIV., INFORMING THE DEBATE: THE SOCIAL AND ECONOMIC COSTS OF EMPLOYEE MISCLASSIFICATION IN MICHIGAN 11 (2009), *available at* http://ippsr.msu.edu/publications/ARMisClass.pdf. Employers can reduce their labor costs by 20–40% by misclassifying their employees as independent contractors, thus having a huge competitive advantage over other similarly situated employers who follow the law. *Id.*

[22] SILVA ET AL., *supra* note 19, at iii.

[23] *Leveling the Playing Field: Protecting Workers and Businesses Affected by Misclassification: Hearing Before the Subcomm. on Health, Educ., Labor, and Pensions*, 111th Cong. 3 (2010) (statement of Colleen C. Gardner, Comm'r of the New York State Department of Labor), *available at* http://www.help.senate

too easy for employers to misclassify employees and get away with it. For one, misclassification itself does not violate any of the employment related Acts.[24] Additionally, the vagueness of the common law factors test creates gray areas from which an employer can create uncertainty in order to avoid a misclassification determination by an auditor or judge.[25] Finally, an employer is allowed a safe harbor[26] from which to avoid retroactive liability, penalties, and is even allowed to continue misclassifying the worker.[27] As stated during a hearing before the Subcommittee on Workforce Protection:

> The misclassification of employees as independent contractors has become such a rampant problem, so great in its scope, that it can no longer be thought of as just a labor issue . . . [i]t is a crisis of national . . . urgency, because it depresses wage markets, threatens the finances of our government and, most importantly, it undermines the fundamental dignity of workers and degrades the fabric of our society.[28]

.gov/imo/media/doc/Gardner.pdf (discussing the impact of misclassification on the state of New York).

[24] *See* sources cited *infra* notes 80-84.

[25] *See infra* Part III.A.

[26] BLACK'S LAW DICTIONARY 1453 (9th ed. 2009). A safe harbor is defined as "[a] provision (as in a statute or regulation) that affords protection from liability or penalty." *Id.*

[27] S*ee* Deja Vu-Lynnwood, Inc. v. United States, 21 F. App'x 691, 696 (9th Cir. 2001) (stating that a taxpayer who owned various nightclubs featuring exotic dancers met the reasonable basis requirement of the section 530 safe harbor, and thus was not subject to reclassifying by the IRS); *see also infra* Part IV.

[28] *Providing Fairness to Workers Who Have Been Misclassified as Independent Contractors: Hearing Before the Subcomm. on Workforce Protection of the H. Comm. on Educ. & Labor*, 110th Cong. 6 (2007) (testimony of John J. Flynn, President, International Union of Bricklayers and Allied Craftworkers), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg34139/pdf/CHRG-110hhrg34139.pdf [hereinafter Flynn Testimony, *Providing Fairness to Workers*].

Independent contractor misclassification cannot be completely stopped as it would require classifying all workers as employees, which would ultimately devastate small businesses who are already struggling in this economy.[29] Many industries such as consulting, home health care, and insurance rely on the ability to use independent contractors.[30] In 2005, it was estimated that 10.3 million workers were classified as independent contractors.[31] Another study found that between 10% and 30% of audited employers were misclassifying their workers.[32] Even though those statistics shed light on vast revenue losses, a higher percentage of workers are still properly classified. Considering states have enacted specific laws to help employers in various industries determine a worker's status shows that the legislature understands

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[29] *See* George G. Jones & Mark A. Luscombe, *Stakes Grow Higher for Worker Classification: Tackling the Problem Would Reduce Federal, State, and Local Tax Gaps*, WEBCPA (Aug. 16, 2010), http://www.webcpa.com/ato_issues/24_10/stakes-grow-higher-for-worker-classification-55118-1.html?zkPrintable=true (commenting on the impact of recent trends involving misclassification from an accounting perspective).

[30] *See, e.g., Leveling the Playing Field: Protecting Workers and Businesses Affected by Misclassification: Hearing Before the Subcomm. on Health, Educ., Labor, and Pensions*, 111th Cong. 3 (2010) (statement of Gary Uber, co-founder of Family Private Care, Inc.), *available at* http://help.senate.gov/imo/media/doc/Uber.pdf [hereinafter Uber Statement, *Leveling the Playing Field*]. Caregivers in the home health care industry make more money as independent contractors because they tend to receive a larger portion of the client payment than an employee caregivers does. *Id.* These caregivers prefer the flexibility allotted by their independent contractor status because they get to choose where and who they work for. *Id.*; Robert M. Shea, *The Massachusetts Independent Contractor Law: Serious Problems and Difficult Choices for Businesses in Massachusetts*, NEW ENGLAND IN-HOUSE 2 (Oct. 21, 2005), http://www.mbbp.com/resources/employment/pdfs/independent_contractor.pdf (stating that consulting companies like accounting firms use accountants that are independent contractors to provide actual consulting work in client's locations).

[31] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-717 EMPLOYEE MISCLASSIFICATION: IMPROVED COORDINATION, OUTREACH, AND TARGETING COULD BETTER ENSURE DETECTION AND PREVENTION 1 (2009), *available at* http://www.gao.gov/new.items/d09717.pdf (reporting on the difference between how employees and independent contractors are treated for tax purposes and various other labor purposes).

[32] SILVA ET AL., *supra* note 19, at iii.

that independent contractor status promotes small business and thus helps the economy.[33] So the problem facing Congress is how to come up with a solution that allows independent contractor classification but with enough penalties and deterrence to curtail the misclassification.

This comment will examine the basics of misclassification and its effect. Part II will outline the impact of misclassifying employees. Part III will compare the various tests used to determine whether a worker is an employee or an independent contractor. Part IV will examine the section 530 safe harbor, which prevents the Secretary of the Treasury from publishing further clarification on classification issues and prevents retroactive penalties. Part V takes an in-depth look at the various legislative and state reform actions that have been attempted to reduce the illegal misclassification. Part VI will conclude the comment with a recommendation as to what Congress should do with respect to ending the loopholes of misclassification, clarifying the legal definitions of employee, and punishing future misuse.

II. THE IMPACT OF MISCLASSIFICATION

Independent contractor misclassification illegally deprives employees of basic labor employment rights because the majority of the employment-related federal Acts do not provide protection for independent contractors.[34] In addition, misclassification causes billions in federal, state, and local tax revenue loss due to underreporting and non-filing.[35] Unemployment compensation programs also miss out on billions of dollars because employers

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[33] *See infra* Part V.B.

[34] Harris Statement, *Leveling the Playing Field*, *supra* note 5, at 2.

[35] *See* MICHAEL PHILLIPS, U.S. DEPT. OF THE TREAS., REFERENCE NUMBER 2009-30-035, WHILE ACTIONS HAVE BEEN TAKEN TO ADDRESS WORKER MISCLASSIFICATION, AN AGENCY-WIDE EMPLOYMENT TAX PROGRAM AND BETTER DATA ARE NEEDED 8 (2009), *available at* http://www.treas.gov/tigta/auditreports/2009reports/200930035fr.pdf (reporting on the impact of misclassification by summarizing various studies and providing numerous recommendations pertaining to specific examples).

only have to pay federal and state unemployment taxes for employees.[36]

A. EMPLOYEES' RIGHTS

The majority of workers in the U.S. are under the assumption that they are protected by our nation's basic employment laws: minimum wage, overtime, health and safety, workers' compensation, anti-discrimination, and unemployment insurance.[37] Unfortunately, most workers do not realize they have been misclassified until they need the law's protection.[38] These protections are directly linked to their status as employees, and independent contractors are not protected by the various employment Acts.[39] FedEx has recently come under scrutiny as to its delivery drivers being treated as independent contractors rather than employees and has been sued by both previous workers and various state Attorney Generals.[40] Some jurisdictions have found FedEx to be guilty of misclassification.[41] Interestingly enough, UPS treats its delivery drivers, who have nearly identical responsibilities and duties, as employees with fully paid medical

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[36] *Id.*

[37] Harris Statement, *Leveling the Playing Field*, *supra* note 5, at 2.

[38] *Id.* at 7.

[39] *See* sources cited *infra* notes 80-84.

[40] *E.g.*, Hunton & Williams LLP, *Kentucky Attorney General Sues FedEx for Employee Misclassification*, HUNTON L. BLOG (Sept. 27, 2010), http://www.huntonlaborblog.com/2010/09/articles/employeeindependent-contractor/kentucky-attorney-general-sues-fedex-for-employee-misclassification/ (stating that Jack Conway, Kentucky Attorney General, brought suit against FedEx alleging violations of state law).

[41] *Compare* FedEx Home Delivery v. NLRB, 563 F.3d 492, 504 (D.C. Cir. 2009) (holding that after considering all the common law factors, FedEx's delivery drivers favored an independent contractor status because of various entrepreneurial factors available to the drivers), *with* Estrada v. FedEx Ground Package Sys., Inc., 154 Cal. App. 4th 1 (Cal. Ct. App. 2007) (finding that FedEx's delivery drivers were employees as a matter of law).

insurance, overtime pay, and other benefits.[42] Many accredit FedEx's fast growth to the competitive advantage it attained in classifying its drivers as independent contractors.[43]

Finally, employers who misclassify avoid paying health insurance for those workers, which in itself contributes to the public health crisis and the Medicaid crunch.[44] When considering the future costs of the Patient Protection and Affordable Care Act,[45] misclassification could have a huge cost impact on its implementation because the employers who correctly classify their workers will end up with higher rates due to employers who do not classify their workers correctly.[46] The overall impact of misclassification has a substantial effect on workers' health and safety and weakens this country's basic rights, specifically the right to work and earn a living.

B. THE LOSS OF REVENUE

The Internal Revenue Service (IRS) estimated that in 2005, the tax gap[47] was approximately $345 billion, stemming from

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[42] *See FedEx Ground vs. UPS: Two Worldviews*, BRAUN CONSULTING NEWS, http://www.braunconsulting.com/bcg/newsletters/winter2004/winter20041.html (last visited Feb. 1, 2015) (analyzing the differences in worker status between FedEx Ground and UPS).

[43] *Id.*

[44] *See* Flynn Testimony, *Providing Fairness to Workers*, *supra* note 28, at 6.

[45] *See generally* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended at 42 U.S.C. § 18001 (Supp. 2010)).

[46] *See* Mario K. Castillo, *Independent Contractor Misclassification Penalties Under the Affordable Care Act*, 36 HOUS. J. INT'L L. 323 (2014). The Patient Protection and Affordable Care Act creates a national insurance exchange for employees of small businesses, independent contractors, and unemployed people not already receiving assistance through programs like Medicare. *Id.* at 329. This national insurance exchange will be funded by a portion of the premiums paid for employees of other businesses. *Id.* The Affordable Care Act has attempted to curtail independent contractor misclassification by adding increased penalties. *Id.* at 331.

[47] PHILLIPS, *supra* note 35, at 1, n.1 ("The tax gap is the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily

underreporting, underpayment, and non-filing.[48] According to the Bureau of Labor Statistics, independent contractors made up 7.4% of the workforce in 2005, with an estimated 10.3 million independent contractors.[49] The IRS estimated that in 1984, 3.4 million workers were misclassified as independent contractors.[50] Employers who misclassify their employees as independent contractors are robbing Social Security, Medicare, unemployment insurance, and workers' compensation funds of billions of dollars and reducing federal, state, and local tax revenues.[51] According to a 2009 report, the IRS's most recent estimates of the costs of misclassification are $54 billion in underreported employment tax, including losses of $15 billion in unpaid FICA taxes and UI taxes.[52]

Social Security and Medicare are funded with tax imposed by the Federal Insurance Contributions Act (FICA).[53] Employees and employers split the cost of the FICA tax, which for 2010 was 12.4% for the Social Security portion and 2.9% for the Medicare

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and on time. It is composed of underreporting of tax liabilities on tax returns, underpaying taxes reported on filed returns, and nonfiling of required tax returns altogether or on time.").

[48] U.S. DEP'T OF THE TREASURY, UPDATE ON REDUCING THE FEDERAL TAX GAP AND IMPROVING VOLUNTARY COMPLIANCE 2-3 (2009), *available at* http://www.irs.gov/pub/newsroom/tax_gap_report_-final_version.pdf (reporting on the status of the federal tax gap and the legislative actions that have been introduced to lower the tax gap).

[49] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-717 EMPLOYEE MISCLASSIFICATION: IMPROVED COORDINATION, OUTREACH, AND TARGETING COULD BETTER ENSURE DETECTION AND PREVENTION 1 (2009), *available at* http://www.gao.gov/new.items/d09717.pdf (reporting on the difference between how employees and independent contractors are treated for tax purposes and various other labor purposes).

[50] *Id.* at 10.

[51] LEBERSTEIN, *supra* note 15, at 1.

[52] PHILLIPS, *supra* note 35, at 8.

[53] Federal Insurance Contributions Act, I.R.C. §§ 3101-3102, 3111-3112, 3121-3124, 3128 (2006) (establishing payroll tax collection to fund Social Security and Medicare).

portion.[54] In an employee-employer relationship, 100% of the employee's income is taxed for FICA.[55] Independent contractors are responsible for a similar tax under the Self-Employment Contributions Act (SECA).[56] SECA imposes the same rate of 15.3%, but only taxes 92.35% of the independent contractor's income.[57] Additionally, the IRS provides that "section 530 employees" are only required to pay half of their FICA taxes.[58] The employer of a section 530 employee is not required to pay the other half of the FICA taxes because the employer is protected by the section 530 safe harbor.[59] Not only is that portion of FICA revenue lost, but independent contractors tend to underreport at a higher percentage, which also results in less revenue.[60]

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[54] *Id.* §§ 3101, 3111.

[55] *See id.*

[56] Self-Employment Contributions Act, I.R.C. §§ 1401-1403 (1954) (creating a tax collection on independent contractors to fund Social Security and Medicare).

[57] *Id.* § 1401 (imposing a 12.40% tax to fund Medicare and a 2.90% tax to fund Social Security on independent contractors' income); *see also* INTERNAL REVENUE SERV., OMB NO. 1545-0074, SELF-EMPLOYMENT TAX 2 (2009) (stating that the independent contractor's income is multiplied by 92.35% so that the independent contractor is not paying SECA tax on a portion of income that is comparable to the employee not having to pay FICA tax on their employer's contributed portion of their FICA tax).

[58] *See* INTERNAL REVENUE SERV., PUBLICATION 15 (CIRCULAR E): EMPLOYER'S TAX GUIDE 29 (2011) [hereinafter IRS PUBLICATION 15]. A section 530 employee is defined as a worker "who was determined to be an employee by the IRS prior to January 1, 1997, but whose employer has been granted relief from payment of employment taxes under section 530 of the Revenue Act of 1978." *See* INTERNAL REVENUE SERV., OMB NO. 1545-0074: UNCOLLECTED SOCIAL SECURITY AND MEDICARE TAX ON WAGES 2 (2010) [hereinafter IRS Form 8919].

[59] S*ee* Revenue Act of 1978, Pub. L. No. 95-600, § 530(a)(1), 92 Stat. 2763 (1978)*; infra* Part IV.

[60] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-717 EMPLOYEE MISCLASSIFICATION: IMPROVED COORDINATION, OUTREACH, AND TARGETING COULD BETTER ENSURE DETECTION AND PREVENTION 10 (2009), *available at* http://www.gao.gov/new.items/d09717.pdf (reporting on the difference between how employees and independent contractors are treated for tax purposes and various other labor purposes). In 1984, the IRS reported that of the workers whose

Unemployment insurance is funded by the Federal Unemployment Tax Act (FUTA),[61] which for 2010, requires that every employer pay an unemployment tax of 6.2% for the first $7,000 of each employee's income.[62] The FUTA tax is used to cover each state's costs relating to the administration of unemployment insurance and job service programs.[63] FUTA tax revenue also covers half the cost of each state's extended unemployment benefits and provides an emergency pool that states can borrow from.[64] On a state level, each state has their own unemployment tax rate that funds the first twenty-six weeks of an individual's unemployment benefits.[65] As only employers are

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employers reported their compensation, those workers tended to only report 77% of their compensation. *Id.* Of the workers whose employers did not report their compensation, those workers only reported 29% of their total compensation. *Id.* at 10-11.

[61] *Federal Unemployment Tax*, IRS, http://www.irs.gov/Individuals/International-Taxpayers/Federal-Unemployment-Tax (last updated June 2, 2014)*; see also* Federal Unemployment Tax Act, I.R.C. §§ 3301-3311 (2010) (authorizing payroll taxes to fund unemployment services).

[62] *Id.* § 3301.

> There is hereby imposed on every employer . . . for each calendar year an excise tax, with respect to having individuals in his employ, equal to: (1) 6.2 percent in the case of calendar years 1988 through 2010 and the first 6 months of calendar year 2011; or (2) 6.0 percent in the case of the remainder of calendar year 2011 and each calendar year thereafter . . . .

Id.; *see also* IRS PUBLICATION 15, *supra* note 58, at 29.

[63] S*ee* I.R.C. § 3304. There are nineteen listed requirements of how a state program can be approved by the Secretary of Labor in order to receive funding from the FUTA tax revenues. *Id.* § 3304(a)(1)-(19); QUESTIONS AND ANSWERS ABOUT FUTA TAXES, NAT'L EMP.'T LAW PROJECT (Apr. 2001), *available at* http://www.nelp.org/page/-/UI/Questions and Answers About FUTA Taxes.pdf.

[64] *See* Federal-State Extended Unemployment Compensation Act of 1970, Pub. L. No. 91-373, §§ 201–205, 84 Stat. 708 (1970) (creating an extended benefit fund to provide additional weeks of unemployment insurance benefits for periods of high unemployment in a state); QUESTIONS AND ANSWERS ABOUT FUTA TAXES, *supra* note 63.

[65] RESPONDING TO RECESSION: STRENGTHEN STATE UNEMPLOYMENT INSURANCE PROGRAMS, NAT'L EMP.'T LAW PROJECT 1 (Jan. 2009), *available at*

required to pay FUTA taxes and state unemployment taxes, a study done in 2000 reported that a mere 1% of misclassification would cost unemployment insurance trust funds $198 million (or $263 million in inflation-adjusted 2009 dollars) annually.[66]

The IRS estimated that in 1984, misclassification of independent contractors resulted in a federal income tax loss of $1.6 billion (or $3.26 billion in inflation-adjusted 2009 dollars), and nearly 60% of the revenue loss was attributable to the misclassified individuals failing to report and pay income taxes on compensation received as misclassified independent contractors.[67] Misclassification results in billions of dollars in lost state income tax revenue;[68] a 2010 study estimated that that the state of Indiana lost $134.8 million in uncollected state income tax revenues in 2008.[69] One recent estimate of the total tax loss due to misclassification in California is as high as $7 billion.[70] Local

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http://www.nelp.org/page/-/UI/UIStateRecession.pdf (reporting on the basic framework of unemployment insurance with emphasis on that state's role).

[66] SILVA ET AL., *supra* note 19, at iv; LEBERSTEIN, *supra* note 15, at 1.

[67] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-717 EMPLOYEE MISCLASSIFICATION: IMPROVED COORDINATION, OUTREACH, AND TARGETING COULD BETTER ENSURE DETECTION AND PREVENTION 10 (2009), *available at* http://www.gao.gov/new.items/d09717.pdf (reporting on the difference between how employees and independent contractors are treated for tax purposes and various other labor purposes).

[68] *See, e.g.*, BELMAN & BLOCK, *supra* note 21, at 10 (stating that in 2009 the state of Michigan lost as much as $32.5 million in state income tax revenue from misclassification and underreporting of those misclassified); FRANÇOISE CARRÉ & RANDALL WILSON, HARVARD UNIV., THE SOCIAL AND ECONOMIC COSTS OF EMPLOYEE MISCLASSIFICATION IN THE MAINE CONSTRUCTION INDUSTRY 11 (2005) (reporting that in 2004 the state of Maine lost an estimated $4.3 million in tax revenue just from the construction industry).

[69] JAMES I. STURGEON & MICHAEL P. KELSAY, UNIV. OF MO.-KANSAS CITY, SUMMARY FINDINGS REGARDING THE ECONOMIC COSTS OF EMPLOYEE MISCLASSIFICATION IN THE STATE OF INDIANA 4 (2010) (estimating that Indiana's unemployment insurance fund lost an average of $36.7 million per year from 2007–2008).

[70] *See* United Bhd. of Carpenters and Joiners of Am., *1099 Misclassification*, UNITED BROTHERHOOD OF CARPENTERS EMPLOYER PAYROLL FRAUD IT'S TIME TO PLAY BY THE RULES, https://www.carpenters.org/EmployerPayrollFraud/

municipal governments supported by payroll taxes also lose millions in tax revenue from workers who are misclassified.[71] Many scholars believe that the reports released still underestimate the true scope of misclassification.[72]

III. EMPLOYEE OR INDEPENDENT CONTRACTOR

One of the major difficulties in determining whether a worker has been misclassified is actually determining whether he is an employee based on the facts of his employment.[73] In general, the basic test looks at factors relating to the employer's right to control the worker.[74] The IRS lays out certain factors as guidance for whether a worker is an employee or independent contractor; which is further split into three categories and provides per se categories for employees and independent contractors.[75]

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video_summary.aspx (last visited Feb. 1, 2015) (interviewing Jerome Horton, a California State Assembly Member of the 51st Assembly District, in an informational video for union members).

[71] LEBERSTEIN, *supra* note 15, at 4.

[72] *Id.* The National Employment Law Project report states that:

> Many of the studies are based on unemployment insurance tax audits of employers registered with the state's UI program . . . [UI audits] rarely identify employers who fail to report any worker payments to state authorities and workers paid completely off-the-books – the "underground economy" – where misclassification is generally understood to be even more prevalent.

Id.

[73] *See* Jenna A. Moran, *Independent Contractor or Employee? Misclassification of Workers and Its Effect on the State*, 28 BUFF. PUB. INT. L.J. 105, 106 (2009) ("Due to the difficulty of ascertaining which factors establish independent contractor status, misclassification . . . [occurs].").

[74] *Id.* at 108, 120 (discussing a New York specific test).

[75] *See Independent Contractor (Self-Employed) or Employee?*, IRS, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-Self-Employed-or-Employee (last visited Feb. 1, 2015).

A. JUDICIAL COMMON LAW

Generally, under common-law rules, a worker is an employee if the person for whom the service is performed has the right to control and direct the worker performing the services, not only for the result, but also as to how it is to be accomplished.[76] Control does not have to be exercised; the existence of the right to control is sufficient.[77] However, control is a vague and often litigated element.[78] The Supreme Court has held:

> In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.[79]

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[76] *See, e.g.*, Tina Quinn, *Worker Classification Still Troublesome*, 207.3 J. Acct. 83 (2009) (discussing how the Tax Court ruled that a worker was an employee rather than an independent contractor, despite worker only ever receiving Forms 1099).

[77] *Id.*

[78] *Id.*

[79] Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318, 323-24 (1992) (citing Cmty. for Creative Non-Violence v. Reid, 490 U.S.730, 751-52 (1989)) (reversing the trial court's grant of summary judgment because the appellate failed to apply the common law definition of an employee for a suit brought under the Employee Retirement Income Security Act).

The common law test has been used in numerous cases brought under Title VII,[80] the Age Discrimination & Employment Act (ADEA) of 1967,[81] the Fair Labor Standard Act (FLSA) of 1938,[82] and the Employee Retirement Income Security Act (ERISA) of 1974;[83] none of which provide protection for independent contractors.[84] None of the factors are individually determinative,[85]

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[80] Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e-2000e-17 (2010). The Act was passed by Congress, which makes it unlawful for an employer "to hire or discharge any individual, or otherwise to discriminate against any individual with respect to his/her compensation, terms, conditions, or privileges of employment because of an individual's race, color, religion, sex or national origin." *Id.* § 2000e-2. This covers hiring, firing, promotions, and all workplace conduct. *Id.*

[81] Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-634 (2010). The ADEA was enacted by Congress "to promote [the] employment of older persons based on their ability rather than their age, to prohibit arbitrary age discrimination in employment," and to help employers and employees find solutions to the problems arising from the impact of age on employment. *Id.* § 621.

[82] Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (2010). The FLSA was passed by Congress to establish a minimum wage, overtime pay, record-keeping, and child labor standards. *Id.* §§ 206-212.

[83] Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (2010). ERISA was enacted by Congress to protect the interests of employee benefit plan participants and their beneficiaries by requiring the disclosure of financial and other information concerning the plan by establishing standards of conduct for plan fiduciaries, and by providing for appropriate remedies and access to the federal courts. *Id.* § 1001.

[84] *See, e.g.*, *Darden*, 503 U.S. at 321 (holding that ERISA does not provide protection for independent contractors); EEOC v. Seafarers Int'l Union, 394 F.3d 197, 202 (4th Cir. 2005) (finding that the ADEA does not provide a cause of action for workers who are in an apprenticeship program, and are thus independent contractors); Hopkins v. Cornerstone Am., 545 F.3d 338, 342 (5th Cir. 2008) (holding that the FLSA does not provide coverage for independent contractors); Lyons v. Kender, No. 2:08-cv-76-FtM-36DNF, 2010 U.S. Dist. LEXIS 24862, at *5 (M.D. Fla. Jan. 20, 2010) (finding no protection under Title VII for workers who were independent contractors).

[85] Anderson v. PPCT Mgmt. Sys., Inc., 145 P.3d 503, 510 (Alaska 2006) (holding that a state employee who attended a training academy could not sue the corporation which hosted the academy because the instructor that injured the employee was an independent contractor who the corporation did not have a duty to properly train).

nor have the courts expressed a minimum amount of factors that must be met in order to classify an employee.[86] Instead, courts have looked to the analysis as more of a sliding scale, in which a strong showing in a various number of factors can lead to a determination of employee or independent contractor.[87] The common law test is primarily used when the definition of employee is circular, explains nothing, and the statute does not provide further guidance.[88]

B. IRS'S CLASSIFICATION TEST

The IRS has created a three-category test in determining whether a worker is an employee or an independent contractor.[89] The three categories are: behavioral, financial, and type of relationship.[90] The IRS will determine whether a worker is an employee or an independent contractor through a series of questions, but this determination is usually made by audit or at the taxpayer's request.[91] Behavioral control[92] refers to facts that show

[86] *See id.* at 510-11.

[87] *See id.*

[88] *Darden*, 503 U.S. at 323; Daughtrey v. Honeywell, Inc., 3 F.3d 1488, 1495 (11th Cir. 1993) (determining that the common law test was appropriate because the statute defined employee as "an individual employed by an employer").

[89] *Independent Contractor (Self-Employed) or Employee?, supra* note 75.

[90] *Id.*

[91] *See* INTERNAL REVENUE SERV., OMB NO. 1545-0004, DETERMINATION OF WORKER STATUS FOR PURPOSES OF FEDERAL EMPLOYMENT TAXES AND INCOME WITHHOLDING (2009) [hereinafter IRS Form SS-8] (determining whether a worker is an employee or an independent contractor according to the IRS).

[92] *Id.* at 2. The following questions are asked by the IRS to determine whether there is "behavioral control":

> (1) What specific training and/or instruction is the worker given by the firm? (2) How does the worker receive work assignments? (3) Who determines the methods by which the assignments are performed? (4) Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution? (5) What types of reports are required

whether there is a right to direct or control how the worker completes the work.[93] As stated by the IRS, "A worker is an employee when the business has the right to direct and control the worker."[94] The type of instruction given, the degree of instruction, evaluation systems, and training are evidence of behavioral control, which slide the fictitious scale towards an employee.[95]

Financial control[96] refers to facts that show whether the business has the right to control the economic aspects of the

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> from the worker? Attach examples. (6) Describe the worker's daily routine such as, schedule, hours, etc. (7) At what location(s) does the worker perform services (e.g., firm's premises, own shop or office, home, customer's location, etc.)? Indicate the appropriate percentage of time the worker spends in each location, if more than one. (8) Describe any meetings the worker is required to attend and any penalties for not attending (e.g., sales meeting, monthly meetings, staff meetings, etc.). (9) Is the worker required to provide the services personally? (10) If substitutes or helps are needed, who hires them? (11) If the worker hires the substitutes or helpers, is approval required? If "Yes," by whom? (12) Who pays the substitutes or helpers? (13) Is the worker reimbursed if the worker pays the substitutes or helpers? If "Yes," by whom?

Id.

93 *Behavioral Control*, IRS, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Behavioral-Control (last visited Feb. 1, 2015).

94 *Id.*

95 *Id.*

96 IRS Form SS-8, *supra* note 91, at 2. The following questions are asked by the IRS to determine whether there is "Financial Control":

> (1) List the supplies, equipment, materials, and property provided by . . . the firm, the worker, [or] other party. (2) Does the worker lease equipment? If "Yes," what are the terms of the lease? (3) What expenses are incurred by the worker in the performance of services for the firm? (4) Specify which, if any, expenses are reimbursed by the firm [or] other party. (5) [What] [t]ype of pay [does] the worker receive: salary, commission, hourly wage, piece work, lump sum, [or] other [means]? (6) Is the worker allowed a drawing account for advances? If "Yes," how often [and] [s]pecify any restrictions.

worker's job.[97] Some factors that fall into the category of financial control include significant investment, unreimbursed expenses, opportunity for profit or loss, services available to the market, and method of payment.[98] A strong factor indicating a worker is an employee is evidence of compensation based on wage payments of hourly, weekly, or other period of time.[99]

Type of relationship[100] refers to facts that show how the worker and the business perceive their relationship with each other.[101] In

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> (7) Whom does the customer pay? If worker, does the worker pay the total amount to the firm? (8) Does the firm carry worker's compensation insurance on the worker? (9) What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary (e.g., loss or damage of equipment, material, etc.)?

Id.

[97] *Financial Control*, IRS, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Financial-Control (last visited Feb. 1, 2015) (stating the financial control factors which determine whether a worker is an employee or an independent contractor).

[98] *Id.*

[99] *Id.*

[100] IRS Form SS-8, *supra* note 91, at 3. The following questions are asked by the IRS to determine the "Relationship of the Worker and Firm":

> (1) List the benefits available to the worker (e.g., paid vacations, sick pay, pensions, bonuses, paid holidays, personal days, insurance benefits). (2) Can the relationship be terminated by either party without incurring liability or penalty? If "No," explain your answer. (3) Did the worker perform similar services for others during the same time period? If "Yes," is the worker required to get approval from the firm? (4) Describe any agreements prohibiting competition between the worker and the firm while the worker is performing services or during any later period. (5) Is the worker a member of a union? (6) What type of advertising, if any, does the worker do (e.g., a business listing in a directory, business cards, etc.)? (7) If the worker assembles or processes a product at home, who provides the materials and instructions or pattern? (8) What does the worker do with the finished product (e.g, return it to the firm, provide it to another party, or sell it)? (9) How does the firm represent the worker to its customers (e.g., employee, partner,

order to determine the type of relationship that exists between the worker and the employer, the IRS will look at written contracts, employee benefits, the permanency of the relationship, and whether the services provided were key activities of the business.[102]

C. THE IRS'S PER SE STATUTORY EMPLOYEES AND NONEMPLOYEES.

If workers are independent contractors under the common law rules or the IRS's classification test, such workers may nevertheless be treated as employees by statute.[103] There are four categories in which a worker is deemed to be an employee per se: (1) a delivery driver who distributes certain produce items or dry cleaning, and so long as the driver is an agent of the employer or is paid on commission; (2) a full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company; (3) an individual who works at home on materials or goods that are supplied by the employer and must be returned to the employer (or employers choosing), so long as the employee is furnished specifications for the work; and (4) a full-time traveling or city salesperson who works on the employer's behalf and turns in orders to the employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar

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> representative, or contractor)? (10) If the worker no longer performs services for the firm, how did the relationship end (e.g., worker quit or was fired, job completed, contract ended, firm or worker went out of business)?

[101] *Type of Relationship*, IRS, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Type-of-Relationship (last visited Feb. 1, 2015) (discussing the factors which relate to what type of relationship exists between the worker and the employer).

[102] *Id.*

[103] INTERNAL REVENUE SERV., PUB. 15-A: EMPLOYER'S SUPPLEMENTAL TAX GUIDE 5 (2014) [hereinafter IRS Publication 15-A] (guiding employers in determining whether a worker is an independent contractor or employee).

establishments.[104] Additionally, there are three other conditions that must be met in order for a worker to be considered an employee: (a) the service/sales contract states or implies that substantially all the services/goods come from the employer; (b) the employee does not have a substantial investment in the equipment and property used to perform the services; and (c) the services are performed on a continuing basis for the employer.[105]

Conversely, there are several categories in which the government statutorily deems a worker to be a nonemployee, despite having enough factors to be an employee under one of the tests.[106] The three per se nonemployee categories are: (1) direct sellers, including persons engaged in the sale or solicitation, of consumer products, in the home or place of business, on a commission basis, or persons engaged in delivering and distributing newspapers or shopping news; (2) licensed real estate agents, including individuals engaged in appraisal activities for real estate sales; and (3) companion sitters[107] who are not employees of a companion sitting placement service.[108] Considering the ease of applying the per se categories, which are narrow as they come only from common law precedent, it would seem beneficial to have a governmental agency create broader categories, but the section 530 safe harbor prevents the Secretary of Treasury from releasing regulations pertaining to misclassification.[109]

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[104] *Id.*

[105] *Id.*

[106] *Id.* at 6.

[107] *Id.* ("Companion sitters are individuals who furnish personal attendance, companionship, or household care services to children or to individuals who are elderly or disabled.").

[108] IRS PUBLICATION 15-A, *supra* note 103, at 6.

[109] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763 (1978); *infra* Part IV.

IV. SAFE HARBOR, IMMUNITY FROM TAX LIABILITY

A safe harbor is provided to employers who establish a reasonable basis for classifying their workers as independent contractors.[110] The safe harbor requires substantive and reporting consistency as requirements for protection.[111] However, if an employer is able to meet the requirements of the safe harbor, then the employer is free from liability under the federal employment Acts, not subject to retroactive penalties, and may continue classifying those workers as independent contractors.[112] The safe harbor requirements are not difficult to satisfy considering the requirements are to be construed liberally in favor of the taxpayer.[113] Those independent contractors which fall under the safe harbor are called "section 530 employees."[114]

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[110] WILLIAM H. WEISSMAN, NAT'L ASS'N OF TAX REPORTING & PROF'L MGMT. (NATRPM), SECTION 530: ITS HISTORY AND APPLICATION IN LIGHT OF THE FEDERAL DEFINITION OF THE EMPLOYER-EMPLOYEE RELATIONSHIP FOR FEDERAL TAX PURPOSES 6 (2009), *available at* http://www.irs.gov/pub/irs-utl/irpac-br_530_relief_-_appendix_natrm_paper_09032009.pdf (discussing the section 530 safe harbor from historical view along with breaking down the statute and various other definitions used to define employee).

[111] *Id.* at 6-7.

[112] *Id.* at 6.

[113] *See* Am. Inst. of Family Relations v. United States, No. 72-1402-WMB, 1979 U.S. Dist. LEXIS 14250, at *3-5 (C.D. Cal. Feb. 22, 1979) (entering judgment in favor of the taxpayer as the he reasonably relied on Treas. Reg. 31.3401(c)-(1), which contained guidelines for determining whether an employment relationship exists).

[114] IRS Form 8919, *supra* note 58, at 2 (stating that a "section 530 employee" is a worker who is classified by his employer as an independent contractor despite the worker really being an employee, but the employer is protected by the section 530 safe harbor).

A. SECTION 530 – A SAFE HARBOR

Section 530 of the Revenue Act of 1978[115] was enacted in response to complaints by taxpayers that the IRS was being too aggressive with respect to worker classification.[116] It was originally intended as a temporary measure and is not actually part of the Federal Revenue Code.[117] It was made permanent by the Tax Equity and Fiscal Responsibility Act of 1982.[118] Since then, it has been amended twice. First, by section 1706 of the Tax Reform Act of 1986,[119] which exempts anyone that provides services for another person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[120] The second amendment to section 530 was section 1122 of the Small Business Job Protection Act (SBJPA) of 1996,[121] which changed a tax examiner's first step

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[115] Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763 (1978).

[116] WEISSMAN, *supra* note 110, at 6.

[117] *See id.*

[118] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 269, 96 Stat. 324 (1982) (amending section 530 of the Revenue Act of 1978 by striking out the termination date of July 1, 1982, thus, making it permanent).

[119] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1706, 100 Stat. 2085. (1986).

[120] *Id.* Section 530 of the Revenue Act of 1978 was amended with a new subsection at the end of the provision:

> Exception.–This section shall not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

Id.; *accord* James M. Campagne, *Employee vs. Independent Contractor Status: The Section 530 Safe Harbor*, 23 TAX ADVISER 816 (1992), *available at* http://www.thefreelibrary.com/Employee+vs.+independent+contractor+status%3A+the+section+530+safe...-a013322621.

[121] *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1122(a), 110 Stat. 1755 (1996) (amending section 530 of the Revenue Act of 1978 by

in any case involving worker classification.[122] Prior to the Act, a tax examiner would first determine the worker's status in dispute.[123] After the Act, a tax examiner is to first determine whether the safe harbor applies.[124] As a result, an employer may be freed of tax liability before a determination of the worker's status.

Section 530 is a safe harbor provision that prevents the IRS from retroactively reclassifying independent contractors as employees and subjecting the employer to federal employment taxes, penalties, and interest for such misclassification.[125] In addition, the Act prohibits the Secretary of Treasury from publishing regulations or revenue rulings on workers' employment tax status.[126] Three requirements must be met in order to qualify for the safe harbor.[127] First, employers must have a reasonable basis for their classification of a worker as an independent contractor by: (1) judicial precedent, published rulings, technical

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adding a new subsection that prohibits a taxpayer from relying upon an audit commenced after December 31, 1996 unless the audit included an examination determining worker classification for the individual involved).

[122] *Id.* Section 530 of the Revenue Act of 1978 was amended with a new closing subsection, which provides in relevant part:

> Special rules relating to [the] determination [of] whether individuals are employees for purposes of employment taxes. . . . An officer or employee of the Internal Revenue Service shall, before . . . any audit inquiry relating to the employment status of one or more individuals who perform services for the taxpayer, provide the taxpayer with a written notice of the provisions of this section.

Id.

[123] *See id.*

[124] *Id.*

[125] WEISSMAN, *supra* note 110, at 6.

[126] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 530(b), 92 Stat. 2763 (1978).

[127] *See id.* § 530(a)(2).

advice with respect to the taxpayer, or a letter ruling to the taxpayer;[128] (2) a past IRS audit of the taxpayer in which there was no assessment of a different classification for individuals holding similar positions to the one in question;[129] and (3) a showing of a long-standing recognized practice of classifying such a worker as an independent contractor in a significant segment of the industry in which the worker was involved.[130]

Second, the taxpayer must show that there has been substantive consistency in the way they have treated other workers in substantially similar positions in the past.[131] A well-known case illustrating the substantive consistency requirement is *Halfhill v. United States IRS*.[132] In *Halfhill*, the taxpayer purchased a tractor-trailer hauling service and hired his son as an employee and the sole driver.[133] After a couple of years, the taxpayer began to grow his business and hired additional drivers as independent contractors.[134] After an audit, the taxpayer was assessed a

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[128] *Id.* § 530(a)(2)(A)*; see also* IRS Form SS-8, *supra* note 91, at 5 (establishing that the IRS will advise a taxpayer on the proper classification of any employee if the taxpayer were to submit form SS-8); Select Rehab, Inc. v. United States, 205 F. Supp. 2d 376, 384 (M.D. Pa. 2002) (holding that a rehab center had a reasonable basis for treating the physicians as independent contractors acting in good faith and in reliance of the advice of in-house and outside counsel).

[129] *See* Revenue Act § 530(a)(2)(B); *see also* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1122(a), 110 Stat. 1755 (1996).

[130] *See* Revenue Act § 530(a)(2)(C); Small Business Job Protection Act § 1122(a); Beck v. United States, No. 3:96-3642-19, 1999 U.S. Dist. LEXIS 3511, at *4-6 (D.S.C. Mar. 4, 1999) (holding that an adult entertainment establishment had a reasonable basis for treating its entertainers as independent contractors because of a long-standing practice of a significant segment of the adult entertainment industry treating their entertainers as independent contractors) (internal citation omitted). The SBJPA amended the Revenue Act making the requirement for a significant segment a showing by the taxpayer of more than 25% of the industry. *See* Small Business Job Protection Act § 1122(a). The Act also made it clear that long standing does not require a showing of more than 10 years. *Id.*

[131] *See* Revenue Act § 530(a)(1)(A).

[132] 927 F. Supp. 171 (W.D. Pa. 1996).

[133] *Id.* at 173.

[134] *Id.*

$222,720.45 tax delinquency by the IRS for the 1988 through 1990 tax years.[135] The taxpayer filed suit against the IRS for a refund, and the court concluded that the taxpayer was not permitted protection under the section 530 safe harbor because he had previously treated his son as an employee, and thus, lacked the requirement of substantive consistency.[136]

Third, the taxpayer must show reporting consistency, specifically that all 1099 IRS forms were filed for the worker when it was required.[137] The reporting consistency requirement was illustrated in *Murphy v. United States I.R.S.*,[138] where the taxpayer owned a truck driving business.[139] The taxpayer hired his truck drivers and billing clerk as independent contractors for tax purposes.[140] After an audit, the IRS assessed the taxpayer $203,319.73 for periods during 1981 through 1986, after a determination that the truck drivers and billing clerk were employees, not independent contractors.[141] The taxpayer paid the delinquency assessment and then filed suit against the IRS for a refund.[142] The court held that the taxpayer was not entitled to section 530 safe harbor because the business failed to file any 1099 Forms for the drivers or billing clerk.[143]

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[135] *Id.* at 173-74.

[136] *Id.* at 176; *see also* United States v. Porter, No. 4:05-cv-00464-JEG, 2009 U.S. Dist. LEXIS 82160, at *20-21 (S.D. Iowa July 21, 2009) (holding that a livestock products company met the requirement of substantive consistency despite one salesman being classified as an employee and another as an independent contractor because they had distinguishable responsibilities).

[137] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 530(a)(1)(B), 92 Stat. 2763 (1978).

[138] No. 93-C-156-S, 1993 U.S. Dist. LEXIS 15406 (W.D. Wis. Oct. 22, 1993).

[139] *Id.* at *1.

[140] *Id.*

[141] *Id.* at *2.

[142] *Id.*

[143] *See id.* at *6; *see also* Greco v. United States, 380 F. Supp. 2d 598, 616-17 (M.D. Pa. 2005) (holding that a company with restaurants and bars was not

B. THE IRS TRAINING MANUAL – INDEPENDENT CONTRACTOR OR EMPLOYEE

The IRS developed a training manual and course to provide Employment Tax Specialists and Revenue Office Examiners with the tools to determine whether a worker is classified as an employee or an independent contractor.[144] The objectives of the material, among others, are to: (1) explain the reporting and substantive consistency requirements; (2) explain the reasonable basis test, along with the three safe havens under the test; and (3) determine "whether relief is applicable in a particular situation."[145] It is not necessary for the taxpayer to claim section 530 relief for it to be applicable.[146] With respect to reporting consistency, section 530 requires *timely* filing of all required Forms 1099 for all workers in any given period, [147] but the courts have been unwilling to penalize for this timing requirement.[148] Additionally, businesses that mistakenly, but in *good faith*, file the wrong type of Form 1099, will not lose section 530 protection.[149]

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protected by the section 530 safe harbor because it had failed to file any 1099 Forms for individuals treated as independent contractors prior to 1993).

[144] *See* INTERNAL REVENUE SERV., INDEPENDENT CONTRACTOR OR EMPLOYEE? TRAINING MATERIALS, TRAINING NO. 3320-102 (1996) [hereinafter IRS, TRAINING MATERIALS]. The front cover of this training guide reads, "[t]his material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position." *Id.*

[145] *Id.* at 1-1.

[146] *Id.* at 1-4.

[147] *See* Rev. Rul. 81-224, 1981-2 C.B. 197 (issuing a revenue rule barring a taxpayer from section 530 protection after he had failed to timely file Forms 1099); IRS, TRAINING MATERIALS, *supra* note 144, at 1-6.

[148] *See* Med. Emergency Care Assoc. v. Comm'r, 120 T.C. 436, 445 (2003). While the Tax Court did hold that the IRS could penalize a taxpayer for untimely filing, the penalty could not be disallowance of the safe harbor protection. *Id.* at 444–45.

[149] Rev. Rul. 81-224, 1981-2 C.B. 197 ("Such relief will not be denied [to] taxpayers who mistakenly but in good faith timely file Forms 1099-MISC,

On the requirement of substantive consistency, a determination as to whether different individuals hold *substantially similar* positions requires consideration of the relationship between the taxpayers and those individuals.[150] On the issue of reasonable basis, the IRS provides that "[t]he [industry practice] safe haven [is the] most commonly argued, and the one which causes the most controversy between businesses and the Government[.]"[151] In a classic case, which defined an industry for purposes of section 530, the court held that a significant segment of the industry consisted of small mining businesses located in the county, rather than the IRS's contention that it should include all the mining businesses throughout the country.[152] Furthermore, section 530(e)(2)(B) provides that 25% of the industry is deemed to satisfy a significant segment of the industry, but depending on the facts, a lower percentage may also satisfy.[153] In addition to showing a significant segment of the industry, the taxpayer must also prove that he or she reasonably relied on the industry practice.[154] In showing reasonable reliance, the taxpayer must

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Statement for Recipients of Miscellaneous Income, in lieu of [the required] Forms 1099-NEC."); IRS, TRAINING MATERIALS, *supra* note 144, at 1-7.

[150] *See, e.g.*, Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1122(a), 110 Stat. 1755 (1996) (amending section 530 of the Revenue Act of 1978 by adding a new subsection); *see also* McLaine v. United States, No. 98-832, 1999 U.S. Dist. LEXIS 2168, at *10-15 (W.D. Pa. Feb. 4, 1999) (holding that a freight trucking company was not entitled to section 530 relief because substantive consistency was not met considering those designated as independent contractors and those as employees both hauled freight, received their job assignments from the taxpayer, submitted driver's logs and bills, and used trailers provided by the taxpayer); IRS, TRAINING MATERIALS, *supra* note 144, at 1-9. In analyzing the relationship between the taxpayers and the individuals, the degree of supervision and control is an important factor. *Id.* Furthermore, a determination of *substantially similar* requires an analysis of the individual facts. *Id.*

[151] IRS, TRAINING MATERIALS, *supra* note 144, at 1-26.

[152] Gen. Inv. Corp. v. United States, 823 F.2d 337, 342 (9th Cir. 1987) (holding that a small mining company had misclassified their workers as independent contractors because the company retained "the *right* to control" their workers).

[153] IRS, TRAINING MATERIALS, *supra* note 144, at 1-28.

[154] *Id.* at 1-30.

demonstrate that he or she had known about the industry practice at the time when the taxpayer began to categorize those workers as independent contractors.[155]

Another widely used safe haven under reasonable basis is the reliance on technical advice of an accountant or tax attorney.[156] The Code of Federal Regulations states that "[r]eliance on . . . a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith," but such reliance does satisfy the reasonable cause exception if, "under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."[157] Thus, reliance on an expert's opinion "may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law."[158] The courts usually require only that the taxpayer present: (1) some evidence as to the educational qualifications of the attorney or accountant; (2) evidence that the attorney or accountant issued the advice after reviewing relevant facts; and (3) that the taxpayer reasonably believed that the accountant or attorney was qualified and familiar with business tax issues.[159]

V. CURTAILING THE MISUSE

As more studies and reports continue to shed light on the costly effect of misclassification, various agencies have attempted to cut

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[155] *Id.*

[156] *See, e.g.*, United States v. Porter, 569 F. Supp. 2d 862, 878-79 (S.D. Iowa 2008) (holding that the taxpayer failed to satisfy the reasonable basis requirement necessary to sustain the technical advice safe haven because he was unable to provide testimony to support his reliance argument).

[157] 26 C.F.R. § 1.6664-4(b)(1) (2014).

[158] *Id.* § 1.6664-4(c).

[159] IRS, TRAINING MATERIALS, *supra* note 144, at 1-32 (internal citations omitted).

down on the number of misclassifications.[160] Numerous Congressmen have unsuccessfully tried to pass legislation in attempts to curtail the misclassification.[161] States have also tried different strategies to reduce its effects.[162] Finally, the IRS has instituted information gathering systems and determination programs to better assist with creating uniformity in determining classification.[163]

A. LEGISLATIVE CONTROL

In the 113th session of Congress, one bill has been introduced that should substantially address the misuse of independent contractor classification.[164] The Payroll Fraud Prevention Act of 2014[165] would amend the Fair Labor Standards Act of 1938[166] to

[160] *See* Moran, *supra* note 73, at 125-28 (discussing the New York and the United States Department of Labor's efforts in regulating misclassification).

[161] *See, e.g.*, Independent Contractor Proper Classification Act of 2007, S. 2044, 110th Cong. § 2 (2007) (introducing a bill with procedures for the proper classification of employees and independent contractors, but Senator Barack Obama failed to get the bill passed as it stalled out in committee).

[162] *See* CATHERINE K. RUCKELSHAUS, NAT'L EMP'T LAW PROJECT, SUMMARY OF INDEPENDENT CONTRACTOR REFORM: NEW STATE ACTIVITY 4-5 (2009), *available at* http://www.nelp.org/page/-/Justice/SummaryIndependentContractorReforms July2009.pdf (summarizing various states actions that have been attempted and implemented in trying to stop misclassification).

[163] *See* PHILLIPS, *supra* note 35, at 3-5 (discussing the positive actions that the IRS has taken and plans to take in order to address worker misclassification).

[164] Richard Reibstein et al., With No Fanfare, Congress Re-Introduces the Payroll Fraud Prevention Act of 2014 to Crack Down on Independent Contractor Misclassification, INDEPENDENT CONTRACTOR COMPLIANCE (May 20, 2014), http://independentcontractorcompliance.com/2014/05/20/with-no-fanfare-congress-re-introduces-the-payroll-fraud-prevention-act-of-2014-to-crack-down-on-independent-contractor-misclassification/; see sources cited infra notes 169, 178.

[165] H.R. 4611, 113th Cong. (2014), *available at* https://www.congress.gov/bill/113th-congress/house-bill/4611?q=%7B%22search%22%3A%5B%22H.R.+4611%22%5D%7D.

[166] Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201–219 (2012).

cover misclassification of employees and independent contractors. It would impose additional record keeping requirements on businesses, reminiscent of the 2011 version of the Employee Misclassification Prevention Act.[167] Additionally, it would make misclassification a federal labor law violation with a civil penalty of up to $1,100 per worker, and in cases of repeated or willful misuse, a maximum of $5,000 per worker.[168]

The Payroll Fraud Prevention Act would also create a new definition of workers called "non-employees," and would require that all employees and enterprises provide a classification notice for each employee and non-employee.[169] Each notice would inform all workers that (1) they have been classified as employee or non-employee; (2) the Department of Labor website contains additional information about their rights; and (3) they should contact the Department of Labor if they suspect they have been misclassified.[170] Finally, the Act would also direct the Secretary of Labor to establish a misclassification website, authorize the Department of Labor to report misclassification information to the IRS, and require targeted audits of certain industries "with frequent incidence of misclassifying employees as non-employees."[171]

Another bill that has been introduced in Congress this year is the Fair Playing Field Act of 2014[172] For one, the bill would permit

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[167] Employee Misclassification Prevention Act, S. 3254, 111th Cong. § 2 (2010); *e.g.*, 156 CONG. REC. E 1595, 1596 (daily ed. Sept. 14, 2010).

[168] Payroll Fraud Prevention Act, H.R. 4611 § 2(d).

[169] *Id.* § 2(a), (c).

[170] *Id.* § 2(b)(1).

[171] *Id.* § 6.

[172] Fair Playing Field Act, H.R. 4503, 113th Cong. (2014). According to the findings of Congress:

> Many workers are properly classified as independent contractors. In other instances, workers who are [really] 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

the Secretary of the Treasury to issue regulations, as necessary or appropriate, in order to provide workers and businesses a clear understanding of proper federal tax classification for workers.[173] The bill would prohibit the IRS from retroactive assessments if the employer did not treat an individual as an employee for any period before the reclassification date, and the employer filed all of the necessary 1099 tax forms, relating to the worker, between 1978 and the reclassification date.[174] Additionally, the employer would need to have a reasonable basis for classifying the worker as an independent contractor.[175] Furthermore, the bill would require employers to inform their workers, by written statements, as to their federal tax obligations and rights in seeking reclassification.[176]

On April 28, 2014, the bill was assigned to a congressional committee, but considering it is almost identical to the Fair Playing Act of 2010 and the Fair Playing Act of 2012, it is unlikely to pass.[177]

> purposes, such as denial of unemployment benefits, workplace health and safety protections, and retirement or other benefits or protections available to employees.

Id. § 1(b)(4).

[173] *Id.* § 2(a).

[174] *Id.* § 2(b). An employer's reclassification date shall be the earlier of: (1) the first day of the first calendar quarter beginning more than 180 days after the date of an employee classification determination with respect to such individual; or (2) the effective date of the first applicable final regulation issued by the Secretary of Treasury with respect to such worker. *Id.*

[175] *See id.*

[176] *See id.* § 2(d).

[177] *Compare* Fair Playing Field Act, S. 3786, 111th Cong. § 2 (2010) (striking section 530 of the Revenue Act), *with* Fair Playing Field Act, H.R. 4123, 112th Cong. § 2 (2012) (seeking to strike section 530 of the Revenue Act).

B. STATE REFORM

Despite the fact that Congress has yet to pass an act stopping misclassification, many states have recognized the problem, and have attempted to correct it through various means. For the most part, state action can be generalized into three categories: (1) state Attorney Generals who have targeted employers who misclassify employees; (2) task forces and committees that have been created to study misclassification trends and issue annual reports; and (3) enacting state legislation that targets the misclassification.[178] In 2008, the Attorney General of California filed suit against three trucking companies who were operating at the Ports of Long Beach and Los Angeles.[179] All three trucking companies were charged with unfair competition and violations of the state's Business and Professions Code section 17200 as their misclassification resulted in an unfair competitive business advantage.[180] In 2009, both Indiana and Vermont established task forces through legislation whose sole purpose was to investigate the misclassification trends in their state.[181] In April 2009, Vermont's task force issued a progress report stating that in 2007, an estimated 10–14% of

[178] RUCKELSHAUS, *supra* note 162, at 2–6.

[179] News Release, Office of the Attorney General, Attorney General Brown Sues Three Trucking Companies in Ongoing Worker Abuse Crackdown at Los Angeles and Long Beach Ports (Oct. 27, 2008), *available at* http://ag.ca.gov/newsalerts/release.php?id=1625& (discussing how the Attorney General instituted suits against three companies after a task force, authorized by the Attorney General, issued a report which uncovered numerous state labor law violations).

[180] *See id.*; *see also* CAL. BUS. & PROF. CODE § 17200 (2008) ("[U]nfair competition shall mean and include any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising. . . ."); *accord* Complaint for Injunctive Relief and Civil Penalties, California v. Lira, No. BC-397602, at 3 (Cal. Super. Ct. Sept. 5, 2008), *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1606_complaint.pdf (providing the state of California's complaint against Lira Trucking company).

[181] RUCKELSHAUS, *supra* note 162, at 4–5.

Vermont employers had misclassified their employees as independent contractors.[182]

Unfortunately, the actions of a state attorney general can help only to curtail the misuse through deterrence. Even now, the best available option for a state is passing of legislation, which will directly stop the misuse. Such legislation fits into either two types: (1) acts which create a presumption of employee status for certain fields; or (2) acts which create clear tests for determining classification in very specific fields that have been known to abuse the classification of independent contractors.[183] In Maryland, the Workplace Fraud Act of 2009,[184] which took effect in October 2009, creates a presumption of employee status for those working in construction or landscaping services.[185] It also authorized the Commissioner of Labor and Industry to initiate an investigation under certain circumstances to determine violations and sets forth the method for determining whether an employee-employer relationship exists.[186] The Act also imposes a penalty for lack of timely compliance with section 3-903 and a penalty for knowingly

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[182] *Id.* at 5; MARIA ROYLE & MEREDITH SUMNER, 2008-2009 PROGRESS REPORT OF THE WORKERS' COMPENSATION EMPLOYEE CLASSIFICATION, CODING, AND FRAUD ENFORCEMENT TASK FORCE 2 (2009), *available at* http://www.leg.state.vt.us/reports/09Reports/243987.pdf.

[183] *See* RUCKELSHAUS, *supra* note 162, at 5–6.

[184] MD. CODE ANN., LAB. & EMPL. §§ 3-901–3-920 (West 2012).

[185] *Id.* §§ 3-902, 3-903.

[186] *See id.* § 3-903. The Act creates a presumption that an employee-employer relationship does exist unless the person is either an "exempt person" or, alternatively, the employer can prove the opposite through three factors. *Id.* The employer must prove: (1) the individual is free from control or direction over its performance, both in fact and under contract; (2) the individual normally is engaged in an independent business or occupation of the same nature as the current work; (3) the work being performed is outside the usual course of business or outside the general vicinity of the employer. *Id.* However, an employer does not have to satisfy the three factors if they are an "exempt person" under the Code. *See id.* § 3-901. Furthermore, the act creates a record keeping requirement for all employers who use independent contractors. MD. CODE ANN., LAB. & EMPL. § 3-914.

misclassifying workers.[187] In New York, a law was passed, which established clear rules to determine when cab drivers in New York are considered employees or independent contractors.[188] Even though states have attempted to rectify the problem through independent reforms, it would seem that without legislative action to level the playing field across the country, misclassification would continue to be rampant, with reforms coming in only narrow fields.

C. IRS'S ACTIONS

The IRS has acknowledged the revenue losses resulting from the misclassification of independent contractors and has made numerous efforts to try and reduce the misclassification.[189] From an educational standpoint, the IRS has created informational websites discussing classification issues along with releasing publications such as *(Circular E), Employer's Tax Guide*;[190] *Employer's Supplemental Tax Guide*;[191] *Independent Contractor or Employee . . .* ;[192] *Are You an Employee?*;[193] and *Do you Qualify*

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[187] *Id.* § 3-908 (stating that an employer can receive a civil penalty of up to $1,000 for each employee, for not timely complying with applicable labor laws); *id.* § 3-909 (assessing a penalty on the employer of up to $5,000 for each employee if the employer is found to be knowingly misclassifying).

[188] *See* N.Y. WORKERS' COMP. LAW § 18-c (McKinney 2010). New York law requires that, in order for a cab driver to be classified as an independent contractor, the employer must submit an affirmation sworn under penalty of perjury, which states that the employee satisfies nine listed requirements relating to the job duties of the cab driver. *See id.*

[189] *See* PHILLIPS, *supra* note 35, at 3-5.

[190] *See* IRS PUBLICATION 15, *supra* note 58 (explaining the tax responsibilities of an employer, including the requirements for withholding, depositing, reporting, paying, and correcting employment taxes).

[191] *See* IRS PUBLICATION 15-A, *supra* note 103 (supplementing IRS publication 15 by supplying tables and formulas for withholding on distributions of Indian gaming profits to tribal members).

[192] *See* INTERNAL REVENUE SERV., PUBLICATION 1779: INDEPENDENT CONTRACTOR OR EMPLOYEE? (2012) (informing taxpayers that relevant factors relating to whether a worker is an employee or an independent contractor fall into

for Relief Under Section 530?.[194] The IRS also established the Form SS-8 Worker Status Determination program, which allows a business or worker to request a determination letter from the IRS regarding a worker's federal employment tax status as an employee or an independent contractor.[195]

The IRS has also recognized that most studies underestimate the true scope of misclassification, due to a lack of statistical data.[196] As such, the IRS has established the Questionable Employment Tax Practices program, which is a collaborative effort that seeks to identify employment tax schemes and illegal practices by sharing employment tax compliance information between the IRS and state workforce agencies.[197] The IRS has also implemented the Service Wide Employment Tax Research System, also known as SWERTS, which provides for electronic analysis of numerous databases including information related to special programs, issues, and projects that identify areas of independent contractor misclassification.[198]

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three main categories: behavioral control, financial control, and the relationship of the parties).

193 *See* INTERNAL REVENUE SERV., PUBLICATION 4445-E: ARE YOU AN EMPLOYEE? (2006) (informing taxpayers on the basic tax differences between a worker who is either an employee, self-employed, or considered an independent contractor).

194 *See* INTERNAL REVENUE SERV., PUBLICATION 1976: DO YOU QUALIFY FOR RELIEF UNDER SECTION 530? (2007) (clarifying for employers the section 530 relief requirements: reasonable basis, substantive consistency, and reporting consistency).

195 *See* IRS Form SS-8, *supra* note 91; PHILLIPS, *supra* note 35, at 3.

196 *See* LEBERSTEIN, *supra* note 15, at 3.

197 *See, e.g.*, PHILLIPS, *supra* note 35, at 4; INTERNAL REVENUE SERV., INFORMATION ON THE QUESTIONABLE EMPLOYMENT TAX PRACTICES MEMORANDUM OF UNDERSTANDING (2007), *available at* http://www.irs.gov/uac/Information-on-the-Questionable-Employment-Tax-Practices-Memorandum-of-Understanding.

198 INTERNAL REVENUE SERV., IT MODERNIZATION VISION & STRATEGY 24 (2006), *available at* http://www.irs.gov/pub/irs-news/mvs-10-06.pdf.

Unfortunately, the IRS lacks an agency-wide employment tax program to address worker classification.[199] As such, the different business divisions of the IRS are limited in their ability to communications between themselves.[200] The problem is that these divisions make determinations based on their goals, rather than decisions based on impacting and curtailing misclassification.[201] Thus, the IRS has not been very successful in stopping a large percentage of misclassification because they lack uniformity in their methods of tracking and auditing misclassification cases.[202] The Obama Administration has noticed the problems, which result from the lack of uniformity, and in the 2011 budget, President Obama allocated $25 million to the Department of Labor to add 100 new enforcement personnel and create grants for states to target misclassified workers.[203]

D. JOINT EFFORTS

In September 2011, the IRS and the Department of Labor (the "DOL") decided to join forces by executing a Memorandum of Understanding that allows the two departments to share information in order to reduce the number of misclassified

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[199] PHILLIPS, *supra* note 35, at 5.

[200] *See id.*

[201] *See id.* at 6.

[202] *See id.* The SB/SE Division tracks both employment tax audits and worker misclassification audits. *Id.* The Large and Mid-Size Business Division has the capability to track worker classification issues, however, the division does not because of the recurring nature of many classification audits. *Id.* The Tax Exempt and Government Entities Division only tracks employment tax audits. PHILLIPS, *supra* note 35, at 6.

[203] Ashlee M. Bekish, *United States: Misclassifying Employees as Independent Contractors Can Be Costly*, MONDAQ (April 15, 2010), http://www.mondaq.com/unitedstates/x/98282/Contract+of+Employment/Misclassifying+Employees+as+Independent+Contractors+Can+Be+Costly (summarizing some of the issues involved in worker misclassification and discussing some recent cases regarding misclassification).

employees.[204] In addition, this union has reached out to various states, including Massachusetts, Connecticut, Maryland, Illinois, Colorado, Missouri, Minnesota, Montana, Washington, Utah, California, and Hawaii, in an effort to share information.[205] The agreed upon memorandum states that that parties specific objectives include the following:

- Reduce the employment tax portion of the tax gap
- Increase compliance with federal employment and unemployment tax requirements
- Increase compliance with federal labor laws enforced by the DOL
- Reduce fraudulent filings
- Reduce abusive employment/unemployment tax schemes
- Reduce worker misclassification
- Reduce questionable employment tax practices
- Work together to create educational and outreach materials and guidance for employers and workers.[206]

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[204] *Wage and Hour Division (WHD): Employee Misclassification as Independent Contractors*, U.S. DEPARTMENT OF LABOR, http://www.dol.gov/whd/workers/misclassification/ (last visited Feb. 1, 2015).

[205] Jill M. Benson, *Misclassification of Independent Contractors: Will North Carolina Join Forces with the IRS & DOL?*, 11 STAFFING NOW 4, 12 (March/April 2012), *available at* http://issuu.com/ncasp/docs/2012_marchapril_ncasp_final_hires.

[206] News Release, Dep't of Labor, Labor Secretary, IRS Commissioner Sign Memorandum of Understanding to Improve Agencies' Coordination on Employee

These joint efforts are definitely a step in the right direction. While commissioner clarification on the definition of an employee would ultimately stop the problem of misclassification, combined efforts can still go a long way to stopping this problem until Congress should see fit to free the commissioner in this regard.

IV. CONCLUSION

Regulating worker misclassification is a daunting task from a practical sense as the majority of misclassification is a result of workers' underreporting or non-filing.[207] The Code is an always changing and shifting piece of legislation, which allows the United States to collect tax revenue. Various sections of the Code adjust to the inflation rates on a yearly basis and provide deductions to boost the economy in down times.[208] So why is it that when it comes to misclassification, the Code, a purely statutory creation, is nearly silent on who is an employee and who is an independent contractor? Congress' primary goal in any legislation should be to strike the silencing portion of the section 530 safe harbor so that the Secretary of the Treasury can issue regulations providing clearer tests for determining a worker's status.[209] Moreover, the safe harbor should be limited by only allowing employer's protection from retroactive penalties. The safe harbor should also only provide protection for two years from the point of audit or other classification determination.

Additionally, some of the protections under the employment related Acts should be extended to independent contractors. If unemployment insurance coverage were to be extended to

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Misclassification Compliance and Education (Sept. 19, 2011), *available at* http://www.dol.gov/opa/media/press/whd/WHD20111373.htm.

[207] *See* PHILLIPS, *supra* note 35, at 8.

[208] *See, e.g.*, I.R.C. § 1(i)(C) (2013) (asserting that the phase-out of marriage penalty is adjusted each year by the increased cost-of-living); *id.* § 195(b) (allowing an accelerated deduction for start-up costs associated with beginning a new business).

[209] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 530(b), 92 Stat. 2763 (1978).

independent contractors, under a credit system where the worker would become eligible after a year with the same employer, this would create a motivating benefit for the worker where the worker would have personal interest in making sure they were properly reported. The state and federal taxes, which fund unemployment insurance would be paid by the employer, but the employer would be allowed a business deduction for that amount.[210] By allowing a deduction, this in turn offsets any cost to the employer, while only requiring from the employer a small amount of additional record keeping. From a federal revenue perspective, this is just a small shift in revenue from federal income tax to unemployment insurance funds.

Congress could also amend a portion of the Patient Protection and Affordable Care Act (ACA) pertaining to independent contractors and self-employed workers.[211] Currently, independent contractors are allowed to purchase health insurance through state-based exchange programs because they are not considered employees, and thus they do not count towards the fifty (50) employee threshold.[212] Furthermore, the ACA actually incentivizes employers to hire more independent contractors or misclassify workers.[213] As a solution, the ACA could be amended to require that employers of independent contractors match a small percentage of the compensation paid to independent contractors to healthcare credit funds. Those credits could be used by the independent contractors towards purchasing the health insurance

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[210] *See* I.R.C. § 62(a)(1) (stating that deductions are allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business).

[211] *See* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

[212] *See* Nancy E. Joerg, *Companies Will Increasingly Use Independent Contractors to Avoid Coverage Under the Affordable Care Act/Obamacare!*, WESSELS SHERMAN (March 2013), http://www.w-p.com/Articles/Companies-Will-Increasingly-Use-Independent-Contractors-To-Avoid-Coverage-Under-the-Affordable-Care-Act-ObamaCare.shtml.

[213] *Id.*

from the state-based exchange programs.[214] To offset the amount matched by the employers, the employers would be able to deduct the amount as a business deduction.[215] Understandably, it would be practically impossible to apply these taxes to employers of independent contractors who are used on a more temporary basis, such as lawn care services, various repair men like electricians or plumbers, and even some consulting services. The issue, however, could be remedied by applying a date restriction. For example, an independent contractor must work with one particular employer for at least one-year before the employer is responsible for making payments towards these healthcare funds. Not only would this idea help curtail the incentive to misclassify, it would also provide valuable data, which would show the length of time some of these independent contractors are being employed for.

To conclude, by amending and restricting the section 530 safe harbor, the loophole which has created so much uncertainty will be closed, while still maintaining the underlying goal of protecting businesses from retroactive punishment. Furthermore, by extending certain rights to independent contractors, this would create an incentive, which would in turn motivate proper reporting by employers and workers, thus, lowering the misclassification costs that result from underreporting and non-filing. Outside of extra record keeping, the only costs to business would be offset by the allowable deductions. The federal government would simply be shifting revenue to unemployment and healthcare funds. Overall, these changes will lower the tax gap resulting from misclassification, as it will increase accurate reporting while providing additional clarity in determining whether a worker qualifies as an employee or an independent contractor.

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[214] Jill Jackson & John Nolen, *Health Care Reform Bill Summary: A Look at What's in the Bill*, CBS NEWS (Mar. 21, 2010), http://www.cbsnews.com/news/health-care-reform-bill-summary-a-look-at-whats-in-the-bill/.

[215] *See* I.R.C. § 62(a)(1).