

Independent Contractor vs. Employee:

Why independent contractor misclassification matters and what we can do to stop it

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1. Introduction

Whether companies treat their workers as employees or independent contractors has profound implications for workers' pay and benefits, for employers, and for public revenues. High-profile worker lawsuits against Uber and other on-demand giants seeking fair pay or workers' compensation have recently thrust the business practice of misclassification into the national spotlight again.¹ But for decades, many companies in transportation, janitorial, logistics, home care and domestic work, construction, tech, and other sectors have imposed take-it-or-leave-it non-employee contracts on their workers, putting them outside of the workplace protections and tax requirements that apply only to employees and employers. Under the law, however, these arrangements are permissible only when the worker is running a separate business.

In most instances, an individual performing labor or services for another should be covered as an employee under our employment laws, unless the person operates an independent business, with specialized skill, capital investment, and the ability to engage in arms-length negotiations over the terms of a job. In key industries in our economy, however, independent contractor misclassification is prevalent and has become standard operating practice for companies looking to save on payroll costs, outbid competitors, or avoid workplace regulations.

Here are some high-profile examples:

- FedEx requires its ground-delivery drivers to sign independent contractor agreements, which have been found to be shams in several large cases around the country;²
- Uber drivers are claiming employee status in many suits and agency claims;³
- [Amazon's](#) "last mile" delivery drivers were treated as independent contractors but claim they should be employees;⁴
- Honor, a Hollywood-backed home care agency, [recently switched](#) its workers' status from independent contractor to employee;⁵

- A 2013 study by the Workers Defense Project and the University of Texas found that more than 40 percent of construction workers in Texas are either classified as independent contractors or paid under the table.⁶

Unchecked, independent contractor misclassification can cause long-term damage to the economy and workers, but there are solutions. State reforms already have helped curb abuses, recouping millions of dollars, while the federal government has taken a strong stand against the practice, evident in its multi-agency task force and the [U.S. Department of Labor's July 2015 guidance](#) clarifying that most workers are covered employees.⁷

2. What is independent contractor misclassification and why does it matter?

A true independent contractor is someone who is running a separate business.⁸ Determining whether a worker is an employee or not matters because employers are bound to provide workplace protections and benefits only with respect to their employees.

In addition to pushing on their workers take-it-or-leave-it “agreements” that claim independent contractor status, companies also require workers to form limited liability corporations (LLCs) or individual franchisees to get a job, even when their relationship is clearly one of employment. The nature of the relationship between company and worker, rather than a worker’s label, determines whether the worker is a covered employee, but these practices cause immediate harm that workers may have trouble remedying.

Courts and administrative agencies consider a variety of facts to determine whether the worker is truly running a separate business, and these considerations are given varying weights depending on the worker protection or law.⁹ Common questions include the following:

- Does the company have the right to control the work?
- Does the worker have an opportunity for profit or loss based on a capital investment in the business?
- Does the work require specialized skill and independent initiative?
- Is the work needed on a long-term or permanent basis?
- Is the work an integrated part of the business engaging the worker?

Decision-makers are supposed to consider all relevant factors. No single element of the work relationship determines whether the worker is an employee or independent contractor.

A. Misclassification depresses workers' income and deprives them of essential workplace protections and social-safety-net benefits

As a result of their outsized tax burden, the prevalence of wage and other violations, and unreimbursed businesses expenses, misclassified workers' net income is often significantly less than for similar workers paid as employees. The differences are striking:

Table 1. Worker Protection Laws	
Employee	Independent Contractor
Minimum wage and overtime	None
Workers' compensation	None, or worker pays
Unemployment insurance	None
Anti-harassment ¹⁰ and discrimination	None
Right to form a union and collectively bargain ¹¹	None
Employer-provided retirement benefits	None

Table 2. Costs to Worker	
Employee	Independent Contractor
Employer and worker each pay 7.65% of payroll for FICA and FUTA. Employer generally makes payroll deductions. ¹²	Worker pays entire 15.3% self-employment rate. ¹³ Worker also usually responsible for quarterly tax filings.
Employer pays workers' compensation taxes.	Worker responsible for insurance (or costs arising from workplace injuries).
Employer usually cannot deduct from pay any required work expenses such as uniforms, materials, etc.	Worker responsible for operating costs such as gas, tools, etc.

One government expert calculated that a construction worker earning \$31,200 a year before taxes would be left with an annual net compensation of \$10,660.80 if paid as an independent contractor, compared to \$21,885.20 if paid properly as an employee.¹⁴ A study on port truck drivers found that annual median net earnings before taxes were \$28,783 for drivers paid as contractors as compared with \$35,000 for employees.¹⁵ A side-by-side comparison of FedEx drivers classified as independent contractors and UPS drivers classified as employees found a \$10,000 to \$20,000 annualized difference in earnings.¹⁶ A lead plaintiff in a case against Uber estimated that his unreimbursed costs for gas, carwashes, oil changes, and insurance, for which he might seek reimbursement under California law, topped \$10,000 per year,¹⁷ and a former driver for Uber and Lyft calculated that he netted only \$2.64 per hour, after expenses.¹⁸

B. Independent contractor abuses strain federal, state, and local budgets

Several government studies show that misclassification—also called payroll fraud—drains billions from federal and state revenues annually. A Government Accountability Office report estimated that independent contractor misclassification cost federal revenues \$2.72 billion in 2006. A 2010 study by the Congressional Research Service estimated that a proposed modification to the Internal Revenue Service’s “safe harbor” rules, which currently allow employers significant leeway to treat workers as independent contractors for employment tax purposes, would yield \$8.71 billion for fiscal years 2012 to 2021.¹⁹ The Questionable Employment Tax Practice initiative, a partnership between some states and the IRS, assessed approximately \$50 million in taxes between June 2009 and June 2012.²⁰

States’ unemployment trust funds and workers’ compensation funds lose tens of millions of dollars annually, per state, due to misclassification. States also lose hundreds of millions of dollars in unpaid payroll taxes per year.²¹

C. Independent contractor misclassification unfairly burdens responsible businesses

Employers that correctly classify workers as W-2 employees are often unable to compete with lower-bidding companies that reap the benefits of artificially low labor costs. This is especially a problem in construction, janitorial, home care, delivery services, and other labor-intensive low-wage sectors, where employers can gain competitive advantage by driving down payroll costs. Misclassification, especially when pervasive in an industry, skews markets and can drive responsible employers out of business.

Law-abiding employers also suffer from inflated unemployment insurance and workers’ compensation costs, as “free riding” employers that misclassify employees as independent contractors pass off costs to employers that play by the rules. A 2010 study estimated that misclassifying employers shifts \$831.4 million in unemployment insurance taxes and \$2.54 billion in workers’ compensation premiums to law-abiding businesses annually.²²

D. Independent contractor misclassification is widespread and persists in pockets of the economy

Employers misclassify their employees as independent contractors with alarming persistence, even in industries such as construction, or in companies such as FedEx and others, where investigations have substantiated violations and companies have been made to pay millions of dollars in settlements or judgments. State-level task forces, commissions, and research teams using agency audits along with unemployment insurance and workers’ compensation data have shown that between 10 to 30 percent or more of employers misclassify their employees as independent contractors, meaning that several million workers nationally may be misclassified.²³

State unemployment insurance and other laws that use the so-called “ABC” test are an example of these laws; they create a presumption of employee status and require employers to overcome this presumption by showing three factors:

- (a) an individual is free from control or direction over performance of the work, both under contract and in fact;
- (b) the service provided is outside the usual course of the business for which it is performed; and
- (c) an individual is customarily engaged in an independently established trade, occupation, or business.

There is strong precedent for these laws, as shown in the map above, where 27 states have some version of these provisions.

C. Sector-specific approaches

Some state legislatures have passed “presumption” laws or other new enforcement and coverage mechanisms for particular sectors with rampant independent contractor abuses—mainly the construction industry, for which 10 states have now passed such laws²⁵—but other states are following with laws aimed at the transportation²⁶ and home care industries.²⁷ See map above.

The strongest sector approaches simply designate any worker in a particular job as a covered employee, regardless of what the company calls that worker. Similarly, laws can designate companies operating in particular sectors as “statutory employers” responsible for covering all workers they engage.²⁸

4. Federal reform efforts are ongoing

A. Labor Department reforms on coordination and data collection

The U.S. Department of Labor has recently focused significant attention and resources on misclassification abuses through a robust education and outreach campaign, in-depth research, and a national multi-industry strategic enforcement initiative.²⁹ The agency has signed agreements with the IRS and over half of the states to share data and coordinate enforcement activities.³⁰ Its recently issued Administrator’s Interpretation makes clear the breadth of the Fair Labor Standard’s Act’s definition of “employ,” and provides critical guidance on the factors applied by courts in determining if a worker is indeed an employee, concluding that most workers are employees.³¹

The Labor Department announced in January 2016 that the Bureau of Labor Statistics will work with the Census Bureau to rerun the Contingent Workers Supplement to the Current Population Survey through the Census’s May 2017 Survey,³² providing a valuable supplement to a GAO report³³ on the size and nature of the contingent workforce.

B. Congressional proposals stalled

Congressional attempts to rein in independent contractor abuses have stalled. Current rules under the Internal Revenue Code give employers a “safe harbor” when they misclassify employees, and the IRS is prohibited from issuing guidance on the subject.³⁴ These roadblocks to real reform must be modified, but Congress has resisted doing so.

Senate committees have considered several versions of H.R. 3527, the Payroll Fraud Prevention Act,³⁵ which would amend the recordkeeping provisions of the Fair Labor Standards Act to require employers to notify all workers of their employment status. This law would provide important transparency for workers and their employers, and enable workers to question their designated employment status if the notification appears incorrect or is confusing.

5. Defending against industry carve-outs

Industry groups fighting against independent contractor misclassification enforcement have pushed “clarification” bills, purportedly to clear up confusion and disputes over employee status.³⁶ But most of the labor standards and tax laws have been on the books for decades, and industry proposals to amend the laws often create less objective complex multi-factored tests, or use the common-law tests for employee status that are easy for employers to manipulate (such as the IRS test).³⁷ The effect is to water down more expansive laws that make it harder for employers to misclassify workers. A recent trend has been to create industry-specific carve-outs from unemployment insurance or other workplace laws. These generally aim to create a presumption of independent contractor status for truck drivers, home care workers, or other workers who sign an independent contractor agreement.³⁸

6. Conclusion

A company’s incorrect designation of its employees as “independent contractors” is more than a technical mistake; misclassification strips workers of essential wage and other workplace rights, lowers their income, drains tax revenues, and disadvantages employers that play by the rules. State-level policy reforms, some used successfully for decades, have helped to curb the practice, boosting job standards and filling budget shortfalls. Proposed federal policies would also aid immensely in reining in abuse of the 1099 label. The vast majority of workers need the workplace protections and benefits they are due as employees and, with the help of well-designed strategies, we can ensure they have them.

Endnotes

- ¹ See, Rebecca Smith and Sarah Leberstein, “[Rights on Demand](#): Ensuring Workplace Standards in the On-Demand Economy,” (National Employment Law Project, Sept. 2015), <http://www.nelp.org/content/uploads/Rights-On-Demand-Report.pdf>.
- ² See, e.g., FedEx Settles Independent Contractor Mislabeling Case for \$228 Million, (Forbes, June 2015), chronicling other settlements, <http://www.forbes.com/sites/robertwood/2015/06/16/fedex-settles-driver-mislabeling-case-for-228-million/#2684ad395f5a>.
- ³ A high-profile Uber class action covering MA and CA workers recently settled for money damages, but did not resolve the independent contractor question. See Uber lawsuit website, <http://uberlawsuit.com/>. Other Uber driver claims that they are employees under a variety of state claims, including unemployment insurance, workers compensation, and wage and hour.
- ⁴ Amazon cuts back on price, delivery times by cheating workers, lawsuit says, (Los Angeles Times, April 2016), <http://www.latimes.com/business/la-fi-amazon-contractors-20151030-story.html>.
- ⁵ Tim Mullaney, “Honor to Directly Employ Home Care Workers,” (Home Healthcare News, Jan. 29, 2016), <http://homehealthcarenews.com/2016/01/honor-to-directly-employ-home-care-workers/>.
- ⁶ “Building Austin, Building Injustice: Working Conditions in Austin’s Construction Industry,” Workers Defense Project in collaboration with the Division of Diversity and Community Engagement at the University of Texas at Austin (June 2009), available at http://www.buildaustin.org/Building%20Austin_Report.pdf.
- ⁷ U.S. Department of Labor, Wage and Hour Division, The Application of the Fair Labor Standards Act’s “Suffer or Permit” Standard in the Identification of Employees Who Are Misclassified as Independent Contractors, Administrator’s Interpretation No. 2015-1, (Jul. 15, 2015), http://www.dol.gov/whd/workers/Misclassification/AI-2015_1.htm.
- ⁸ *Id.*, page 4, citing *Hopkins v. Cornerstone Am.*, 545 F.3d 338, 343 (5th Cir. 2008) (“To determine if a worker qualifies as an employee, we focus on whether, as a matter of economic reality, the worker is economically dependent upon the alleged employer or is instead in business for himself.”); *Baker v. Flint Eng’g & Constr. Co.*, 137 F.3d 1436, 1440 (10th Cir. 1998) (the economic realities of the relationship govern, and the focal point is whether the individual is economically dependent on the business to which he renders service or is, as a matter of economic fact, in business for himself); *Brock v. Superior Care, Inc.*, 840 F.2d 1054, 4 (2d Cir. 1988). The number of factors and the exact articulation of the factors may vary some depending on the court. Courts routinely note that they may consider additional factors depending on the circumstances and that no one factor is determinative. *Id.* at 1059.
- ⁹ *Id.*
- ¹⁰ Some harassment protections that prohibit “any person” from harassing another on a worksite could cover independent contractors.
- ¹¹ Some newer legislation and proposed bills permit workers to bargain as independent contractors, outside of the National Labor Relations Act, which only covers “employees”. See, for example, Seattle City Council Press Release, “Giving Drivers a Voice: Council Unanimously Adopts First-of-its-Kind Legislation to Give Drivers Voice on the Job,” (Dec. 12, 2015) <http://www.seattle.gov/council/issues/giving-drivers-a-voice>.
- ¹² FICA is the tax for Social Security and Medicare and FUTA is the Federal Unemployment Tax. Employers generally must withhold part of social security and Medicare taxes from employees’ wages and employees pay a matching amount, while independent contractors pay the entire FICA rate themselves. Employers must report and pay FUTA only for their employees. See the Internal Revenue Service webpage “Understanding Employment Taxes,” <https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Understanding-Employment-Taxes>.
- ¹³ The taxpayer may later claim these payments on her end-of-year tax filings, and may get a partial offset.
- ¹⁴ Tim Crowley, UI Tax Chief, U.S. Department of Labor, “Worker Misclassification – An Update from Constitution Ave.” (Oct. 24, 2012), http://www.naswa.org/assets/utilities/serve.cfm?gid=86824dbe-575c-4edb-9e93-444cef85c837&dsp_meta=0.
- ¹⁵ Rebecca Smith, Paul Alexander Marvy and Jon Zerolnick, “The Big Rig Overhaul: Restoring Middle-Class Jobs at America’s Ports through Labor Law Enforcement” (Feb. 2014), page 12, <http://www.nelp.org/page/-/Justice/2014/Big-Rig-Overhaul-Misclassification-Port-Truck-Drivers-Labor-Law-Enforcement.pdf?nocdn=1>.

- ¹⁶ Erin Johansson, “Fed Up with FedEx: How FedEx Ground Tramples Workers’ Rights and Civil Rights” (American Rights at Work, Oct. 2007), <http://www.americanrightsatwork.org/dmdocuments/ARAWReports/fedupwithfedex.pdf>.
- ¹⁷ Dan Levine and Sarah McBride, “Uber, Lyft Face Crucial Courtroom Test over Driver Benefits,” Reuters (Jan. 28, 2015), <http://www.reuters.com/article/us-uber-lyft-workers-idUSKBNOL11BN20150128>.
- ¹⁸ Seth Sandronsky, “Uber Drivers are Running on Empty,” (Capital and Main, Sept. 23, 2015) http://www.huffingtonpost.com/entry/uber-drivers-are-running-on-empty_us_56031619e4b00310edf9e8a7.
- ¹⁹ A 2010 study by the Congressional Research Service built on earlier national studies to compare the costs and benefits of improved classification if President Obama’s proposed modification of Section 530 of the Revenue Act of 1978 were passed. The modification would permit the IRS to prospectively reclassify workers who are misclassified. The US Treasury estimated that the proposal would yield \$8.71 billion for the period of FY 2012 through 2021. The CRS study acknowledged, however, that the work needed to reduce misclassification “would impose significant costs.” James M. Bickley, “Tax Gap: Misclassification of Employees as Independent Contractors,” (Congressional Research Service, Mar. 10, 2011), [http://op.bna.com/dlrcases.nsf/id/vros-8euvqa/\\$File/taxgap.pdf](http://op.bna.com/dlrcases.nsf/id/vros-8euvqa/$File/taxgap.pdf).
- ²⁰ Crowley, “Worker Misclassification.”
- ²¹ Sarah Leberstein, “Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries,” (National Employment Law Project, July 2015) <http://www.nelp.org/content/uploads/Independent-Contractor-Costs.pdf>.
- ²² Douglas McCarron, “Worker Misclassification in the Construction Industry,” BNA Construction Labor Report (April 7, 2011), https://www.carpenters.org/Libraries/1099_Files/BNA_CLR_20110407_-_McCarron_on_Misclassification_4-7-2011_v4.sflb.ashx.
- ²³ See, for example, Leberstein, “Independent Contractor Misclassification Imposes Huge Costs”; Françoise Carré, “(In)dependent Contactor Misclassification,” Economic Policy Institute Briefing Paper #403 (June 8, 2015), <http://www.epi.org/publication/independent-contractor-misclassification/>.
- ²⁴ CT HB 5113 (Pub. Act 08-105), SB56 (2008); IL HB 1795 (Pub. Act 95-0026) (2008); IN SB 478 (P.L.164-2009); IA Exec. Order No. 8 (2008); ME Exec. Order 23 FY 08/09; MD Workplace Fraud Act of 2009; MA HB 1835 (2008); MI Exec. Order 2008-1 (2008); MN Advisory Taskforce on Employee Misclassification: Report to the 2011-12 Biennium, 87th Legislature; NC Exec. Order 125 (2012); NH SB500 (2008), Exec. Order 2010-3; NJ Governor’s Advisory Comm. on Construction Industry Independent Contractor Reform; NY Exec. Order 17 (2007); NV SCR 26 (BDR R-1297) (2009); OR HB 2815 (2009); RI SB 3099, HB 7907B (2008); UT SB 189 (2008), amended by S11 (2011); VT S.345 (2008), Exec. Order 08-12 (2012); WA SB 5926 (2007).
- ²⁵ At least ten states have passed laws that aim to combat misclassification in the construction industry through adoption of the ABC test for construction workers, enhanced penalties, and other measures: Delaware, Illinois, Maine, Maryland, Minnesota, Nebraska, New Jersey, New Mexico, New York, and Pennsylvania. 19 Del. Code § 3501 (2009); Ill. Compiled. Stat. § 185:10 (2008); 39-A Me. Stat. § 1043 (2011); Md. Code, Labor and Employment § 3-903 (2009); Minn. Stat. § 181.723 (2009); N.J. Stat. § 34:20-4 (2008); Neb. Rev. Stat. § 48-2903 (2010); N.M. Stat. § 60-13-31 (2005); N.Y. Labor Law § 861-c (2010); 43 Pa. Stat. § 933.3 (2011).
- ²⁶ “New York State Commercial Goods Transportation Industry Fair Play Act,” S 4589 (2014), <http://public.leginfo.state.ny.us/navigate.cgi?NVDT0>. Seattle recently passed an ordinance granting organizing and collective bargaining rights to taxi drivers and Transportation Network Company (TNC) drivers; both taxi and TNC companies treat the drivers as independent contractors.
- ²⁷ CT HB 5368 (2016) would create automatic coverage for certain home care employers under key workplace laws by designating certain home care registries as the employer of the home care workers they supply or refer to consumers for the purposes of workers’ compensation benefits, Unemployment Insurance, and wages. <http://search.cga.state.ct.us/r/basic/dtsearch.asp?cmd=getdoc&DocId=5379&Index=I%3a%5czindex%5c2016&HitCount=1&hits=155+&hc=101&req=5368+or+HB+&Item=0>. See also, Testimony of Sarah Leberstein, National Employment Law Project, on H.B. 5368: An Act Concerning Homemaker Services and Homemaker Companion Agencies, Hearing Before the Committee on Labor & Public Employees (Mar. 8, 2016), <https://www.cga.ct.gov/2016/labdata/tmy/2016HB-05368-R000308-Sarah%20Leberstein,%20National%20Employment%20Law%20Project-TMY.PDF>.
- ²⁸ Id.

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- ²⁹ See, for example, Blog Post “Employee or Independent Contractor” (July 15, 2015), <http://blog.dol.gov/2015/07/15/employee-or-independent-contractor/>.
- ³⁰ U.S. Department of Labor Wage & Hour Division, Misclassification of Employees as Independent Contractors, The DOL Misclassification Initiative, <http://www.dol.gov/whd/workers/misclassification/>.
- ³¹ Id.
- ³² U.S. Labor Secretary Tom Perez, “Innovation and the Contingent Workforce,” (Jan. 25, 2016), <http://blog.dol.gov/2016/01/25/innovation-and-the-contingent-workforce/>.
- ³³ Analyzing data from the 2005 Contingent Work Supplements to the Current Population Survey, the report found that 7.4% of the labor force is classified as independent contractors and 4.4% is classified as self-employed. The report noted that contingent workers (a category that also includes temporary workers, staffing agency workers, on-call workers and day laborers) have lower weekly and annual earnings than standard workers, are less likely to have work-provided benefits, and are more likely to receive public assistance. The GAO acknowledged that the data is outdated and may not capture the same level of detail as other, more focused studies. U.S. Government Accountability Office, *Contingent Workforce*, GAO-15-168R (April 2015), <http://www.gao.gov/assets/670/669766.pdf>.
- ³⁴ See, e.g., Fair Playing Field Act of 2013, S1706 (2013), <https://www.congress.gov/bill/113th-congress/senate-bill/1706>. The IRS could also extend 1099 transaction reporting requirements to any payments made to incorporated businesses, to help the IRS track down the companies who received those payments but did not pay taxes. [Closing the Safe Harbor could save as much as \\$9 billion a year. See, Françoise Carre, Independent Contractor Misclassification, Economic Policy Institute, \(2015\), http://www.epi.org/publication/independent-contractor-misclassification/](#)
- ³⁵ Available at <https://www.congress.gov/bill/114th-congress/house-bill/3427?q=%7B%22search%22%3A%5B%22%5C%22hr3427%5C%22%22%5D%7D>.
- ³⁶ See, for example, <https://www.abc.org/EducationTraining/AcademyPages/tabid/340/entryid/645/Default>.
- ³⁷ See recent Vermont proposal, <http://legislature.vermont.gov/assets/Documents/2016/Docs/BILLS/H-0867/H-0867%20As%20Introduced.pdf>. See <https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-Self-Employed-or-Employee>. The IRS test includes a number of factors that are entirely or almost entirely within the employer’s control and which are poor indicators of an employment relationship. For example, the test directs decision-makers to consider whether the employer provides the worker with benefits, reimburses the worker for business expenses, and pays an hourly or daily rate rather than a flat fee. A business that wanted to avoid a finding that it employed a worker could easily alter its practices in these regards. Furthermore, employers often fail to provide benefits, do not reimburse workers for business expenses, and pay workers a flat fee not because the worker is an independent business person able to shoulder such burdens and negotiate over the details, but out of a desire to shift the costs of doing business to workers. Also see the American Legislative Exchange Council’s materials proposing a “Model Independent Contractor Definition Act,” at <https://www.alec.org/model-policy/independent-contractor-definition-act/>.
- ³⁸ See, for example, CT Public Act No. 13-168 (2013) (truck drivers); IL S 1661 (2014) (drivers); MD HB 1341 (2010) (messenger service drivers); MD SB 303 (2010) (home care workers); AZ HB 2114 (2016) (all workers).