

Employee Misclassification as Independent Contractors

Question: What is employee misclassification?

Answer: Participation in many statutory employment laws is governed by an individual's status as an "employee." A wide range of laws conditioned upon formal employment status includes federal and state anti-discrimination laws, wage and hour laws (including minimum wage and overtime), and social insurance programs (including Social Security, unemployment insurance, and workers' compensation). "Misclassification" involves purposefully treating individuals providing services to businesses as non-employees in order to avoid coverage of workplace laws (Bauer, 2015). The most common method of employee misclassification is to treat individuals as independent contractors; although, in reality, they are employees.

Mechanisms commonly used in employee misclassification include boilerplate contracts disclaiming an employment relationship, requiring individuals to create a limited liability corporation as a condition of payment for work, and paying individuals "off the books" (NELP, 2015). In addition, the growing "on-demand economy" has developed new mechanisms to avoid creating employee relationships with those providing services to customers (NELP, 2015b). By whatever means, employers engage in employee misclassification to avoid liability for employee conduct as well as Federal Insurance Contributions Act (FICA) and other payroll taxes, insurance premiums, and other costs.

The excluded employee, if self-employed, becomes responsible for the employer portion of FICA taxes and loses coverage under UI laws in the event of job loss. In addition, if the employee operates "off the books," he or she will lose quarters of FICA coverage toward Social Security eligibility, with potentially deleterious impact upon retirement or if disability occurs. In addition, workers treated as independent contractors usually lose coverage under otherwise applicable workers' compensation laws. Misclassification not only impacts the affected individuals, but law-abiding employers are undercut by misclassifying competitors.

Question: How does employee misclassification affect UI?

Answer: As a social insurance program financed by payroll taxes, UI experiences significant revenue losses from employee misclassification. This impact is well documented. A 2000 federal USDOL study conducted by Planmatics focused specifically upon UI rules. Many of state-level studies of misclassification have relied upon state UI agency auditing data as well. A 2015 fact sheet by NELP, "Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries," summarizes federal studies and state-level task forces and commissions that have studied misclassification. These studies have consistently found that significant percentages of employers engage in misclassification. Currently, New Hampshire and Georgia have study committees on misclassification issues, which will add two newer studies in the next year or so and may result in UI legislation.

Question: What legal rules apply to employee misclassification in UI?

Answer: Our federal-state UI programs have two layers of rules for determining who is subject to UI payroll taxes. As explained earlier, the Federal Unemployment Tax Act (FUTA) imposes a federal excise tax on wages of employees. FUTA revenues are used to pay both federal and state UI agency administrative costs and finance benefit extensions.

FUTA determines coverage of workers through its definition of “employee.” FUTA explicitly adopts the common-law definition of “employee” under FICA, which governs contributions to Social Security. These two related federal provisions read:

For purposes of this chapter [FUTA], the term “employee” has the meaning assigned to such term by section 3121(d), except that subparagraphs (B) and (C) of paragraph (3) shall not apply. (26 U.S.C. § 3306(i).)

For purposes of this chapter [FICA], the term “employee” means—(2) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. (26 U.S.C. §3121(d)(2).)

The “common law” test for employment is also known as the 20-factor test, or the IRS test. It involves applying a list of factors to the facts of each potential employment relationship. These factors revolve around the question of who controls what work will be done and how that work is done (IRS, 2015.)

In addition to satisfying FUTA’s definition of employee, FUTA has a threshold definition of “employer” that includes employing units who have paid wages of \$1,500 in a calendar quarter OR employing units with at least one employee on each of 20 days during the past calendar year. A separate definition applies to employers of agricultural or domestic labor. For agricultural employment, an employing unit that pays \$20,000 or more for agricultural labor in any calendar quarter in the current or preceding calendar year, or who employed 10 or more workers on at least one day in each of 20 different weeks in the current or immediately preceding calendar year meets the agricultural employer test under FUTA. Domestic employers are defined as an employing unit paying \$1,000 in wages for domestic service during any calendar quarter in the current or preceding calendar year. While a majority of states use all three of the FUTA standards, they are not required to do so and several states have more inclusive standards for employers (23 states, USDOL, 2015: Table 1-1), agricultural labor (10 states, id., Table 1-2), and domestic services (six states, id., Table 1-3).

In summary, the common law test is generally considered the strictest legal test for employment relationships; that is, the common law test enables employers to more easily escape a finding of an employment relationship and treat potential employees under some different classification than employee. In recent years, employer groups have asked states to move toward the common law test under their UI laws, and Michigan has recently done so. Nonetheless, only a minority of states use the common law test of employment for state UI coverage.

Question: How do states determine employee status under their UI laws?

Answer: States are free to adopt their own statutory standards defining covered employment. While Congress has adopted a common law test for the employment relationship under FUTA, the states use a number of other statutory tests to determine employer-employee relationships under their UI laws (USDOL, 2015: Table 1-4). About one dozen states use the common law test for UI coverage.

Most states currently use the so-called “ABC test” to define employment or a variant of the test with two of its three subtests (Labor Department, 2015: Table 1-4). The test is called the ABC test because its three paragraphs, each containing one element of the test for exclusion from employment, are typically numbered A,B, and C. The ABC test was developed in Wisconsin’s UI law (which pre-dated the adoption of the federal law in 1935) and was proposed to the states by the Social Security Board in its model state UI legislation. As a result, its use became prevalent in the first decade of the UI program (Asia, 1945).

Here is the typical definition of employment under the ABC test as found in current Massachusetts UI law:

Service performed by an individual, except in such cases as the context of this chapter otherwise requires, shall be deemed to be employment subject to this chapter irrespective of whether the common-law relationship of master and servant exists, unless and until it is shown to the satisfaction of the commissioner that—

- (a) such individual has been and will continue to be free from control or direction over the performance of such service, both under his contract of service and in fact; and
- (b) such service is either outside the usual course of the business for which such service is performed or that such service is performed outside of all the places of business of the enterprise for which such service is performed; and
- (c) such individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.

Mass. General Laws, Chp. 151A §2.

As can be seen from its text, the approach taken under the ABC test is a presumption of employment for any personal services contract that is only rebutted when all three of its subtests are found inapplicable. As a result, the test is more difficult to manipulate than the common law test and is generally considered more likely to result in a finding of employment by agencies and courts assessing a potential employment relationship. Because the ABC test accurately distinguishes between independent contractors and employees, NELP recommends that states retain this test or consider its adoption.

Resources:

- Benjamin S. Asia, "Employment Relation: Common-Law Concept and Legislative Definition," Yale L.J. v. 55, p. 76 (1945).
- David Bauer, "The Misclassification of Independent Contractors: The Fifty-Four Billion Dollar Problem," Rutgers J. of Law & Policy, v. 12, p. 138 (Spring 2015).
- Internal Revenue Service, "Employers Supplemental Tax Guide," IRS Publication 15-A (2015).
- National Employment Law Project, "Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries," Fact Sheet (July 2015a).
- National Employment Law Project, "Rights On Demand: Ensuring Workplace Standards and Worker Security in the On-Demand Economy" (2015b), available at <http://www.nelp.org/publication/rights-on-demand/>.
- Planmatics, Inc., Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs. U.S. Department of Labor (UI Occasional Paper 2000-05)(February 2000), http://workforcesecurity.doleta.gov/dmstree/op/op2k/op_05-00.pdf.
- U.S. Department of Labor, Comparison of State Unemployment Insurance Laws, Chapter 1: "Coverage." (2015), <http://workforcesecurity.doleta.gov/unemploy/pdf/uilawcompar/2015/coverage.pdf>.