



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

EVALUATION REPORT

Misclassification of Employees as Independent Contractors

NOVEMBER 2007

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

November 2007

Members of the Legislative Audit Commission:

In response to your request, the Office of the Legislative Auditor (OLA) examined the extent to which employers misclassify employees as independent contractors. We also evaluated state government's efforts to enforce laws related to worker classification.

We found that misclassification is a problem in Minnesota, which negatively affects employees, government, and employers that correctly classify their workers. We also found that state government's enforcement efforts are limited and uncoordinated. In addition to recommending a coordinated approach to enforcement, we also recommend greater standardization of the criteria used to determine the status of workers.

This report was researched and written by Deborah Parker Junod (project manager) and Carrie Meyerhoff. Staff in the departments of Employment and Economic Development, Labor and Industry, and Revenue cooperated fully with our evaluation, and we thank them for their assistance.

Sincerely,

James Nobles
Legislative Auditor

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Summary

Misclassification of employees as independent contractors is a problem in Minnesota, and state government needs to establish a coordinated response.

Major Findings:

- Using independent contractors instead of employees can significantly reduce an organization's labor costs. However, when employers misclassify employees as independent contractors, the misclassified workers are denied benefits and protections that should be available to them ([pp. 8-11](#)).
- An estimated 14 percent of Minnesota employers subject to unemployment insurance taxes—or 1 in 7—misclassified at least one worker in 2005. This estimate is conservative because it excludes employers that fail to register with the unemployment system ([pp. 14-17](#)).
- The departments of Employment and Economic Development (DEED), Labor and Industry (DLI), and Revenue (DOR) administer and enforce laws that require them to determine whether workers have been properly classified ([p. 24](#)).
- These agencies' efforts to detect and deter misclassification range from very limited to modest, and they are not well coordinated ([pp. 24-31](#)).
- Because of limits in state law, employers are normally not penalized specifically for misclassifying workers; rather, they may be penalized for related failures to obtain workers' compensation insurance or withhold income taxes from employees' wages ([pp. 28-30](#)).

Recommendations:

- To the extent possible, DEED, DLI, and DOR should work with the Legislature to standardize the criteria in state law and rule that determine worker status ([p. 33](#)).
- DEED, DLI, and DOR should better coordinate their audit and investigation activities related to worker classification ([p. 35](#)).
- DEED, DLI, and DOR should establish procedures to routinely share information about identified instances of misclassification and work with the Legislature to resolve any statutory barriers to doing so ([p. 34](#)).
- The Legislature should modify state law to authorize a penalty for repeated misclassification by an employer ([p. 36](#)).

Our estimate—that 1 in 7 employers misclassified at least one employee in 2005—is likely conservative.

Report Summary

To comply with various state laws, organizations and individuals must determine whether the workers they hire should be classified as employees. This classification has important implications. For example, employees are covered by the unemployment insurance program, and their employers must carry workers' compensation insurance, pay employment-related taxes, and withhold income taxes from wages. If a worker is an independent contractor, the organization avoids many of these obligations.

Three state agencies in Minnesota administer and enforce state laws that require them to determine whether workers are properly classified. The Department of Employment and Economic Development (DEED) enforces worker classification requirements as part of its authority to administer the unemployment insurance program, and the Department of Labor and Industry (DLI) does so for the workers' compensation program and as administrator of various workplace protection laws. The Department of Revenue (DOR) is involved in worker classification as it pertains to tax law compliance.

We estimated the extent to which employers misclassify workers in Minnesota. We also evaluated the state's approach to enforcing proper classification. Our evaluation focused on misclassification of employees as independent contractors.

The criteria for determining a worker's classification are open to interpretation.

A worker's classification is determined by the nature of the work performed in a specific situation. In general, classification rests on interpreting the degree of control an organization has over a worker. If a worker must follow the organization's instructions on when, where, and how to do the work, he or she is more likely to be an employee. In contrast, independent contractors retain control over how the tasks are accomplished. Neither an organization nor a worker can simply choose which classification to use.

State authority over classification is fragmented.

Different state laws and rules, along with related judicial case law, establish DEED, DLI, and DOR's obligations regarding worker classification and the factors that each should consider when determining a worker's status. The principles regarding worker classification that are contained in Minnesota laws and rules derive from Internal Revenue Service (IRS) guidance, and as a result, there are more similarities than differences among them. However, agencies' worker classification determinations can differ.

Misclassification of employees as independent contractors is a problem in Minnesota.

An estimated 14 percent of Minnesota employers subject to unemployment insurance taxes—or 1 in 7—misclassified at least one worker in 2005. This estimate,

The state's compliance activities related to worker classification are limited and uncoordinated.

based on the results of DEED unemployment insurance audits, is likely conservative because it does not capture employers who conduct all of their business using workers classified as independent contractors or employers that operate in the “hidden” or “cash” economy. Misclassification is also found during DOR audits, DEED investigations of applications for unemployment benefits, and DLI investigations of claims for workers’ compensation benefits.

Audits of Minnesota employers in the unemployment insurance program show that misclassification occurs in many industries. The estimated percentage of audited employers that misclassified workers in 2005 ranked from a low of 3 percent of employers in transportation and warehousing to a high of 33 percent in real estate, rental and leasing. An estimated 15 percent of employers in the construction industry misclassified at least one employee, but misclassification appeared to be higher among certain subgroups, such as roofing, drywall, and residential remodeling. According to agency staff, industries prone to misclassification are those that use unskilled labor, minimal capital investment requirements, and seasonal business cycles.

Misclassifying employees as independent contractors can significantly reduce an employer’s cost of doing business.

To illustrate the impact of misclassification on labor costs, we developed a hypothetical scenario involving drywall installation. The base pay for drywall installers in Minnesota is about \$30 per hour.

We estimated that mandatory costs, including federal employment taxes, workers’ compensation insurance premiums, and state unemployment insurance taxes add another \$7.82 per hour for employees. The resulting hourly rate (\$37.82) is 26 percent higher than the employer’s cost if the employee were misclassified as an independent contractor.

State agency efforts to detect and correct misclassification vary from minimal to modest.

Officials at DEED, DLI, and DOR told us that their compliance activities related to misclassification generally arise as a by-product of administrative or enforcement activities with other primary purposes, such as ensuring workers’ compensation coverage.

Overall, we found that DEED most systematically addresses possible misclassification of workers through its unemployment insurance audits and investigations. DEED audits about 2 percent of employers per year to ensure unemployment insurance compliance. Auditors routinely look for evidence of workers whose wages should have been reported to the unemployment system, but were not.

Efforts at DOR and DLI are more limited. DOR implemented a new audit program in late 2006 that targets organizations that may have misclassified employees and failed to withhold income tax from the wages paid. As of July 2007, DOR had completed about 40 audits. DLI does not have an ongoing audit program or other means of systematically identifying misclassified workers. Rather,

State agencies need to coordinate enforcement activities and routinely share information about employers that misclassify employees.

misclassification may be identified during investigations of worker complaints—for example, when a worker is denied workers’ compensation benefits because the hiring organization asserts that the worker is an independent contractor.

State agencies’ enforcement activities are not well coordinated.

State law currently authorizes DEED, DLI, and DOR to share information related to investigations of possible misclassification.

However, the three agencies do not routinely exchange information about employees that were misclassified or their employers. Agency staff told us that, as a result of differing legal authorities and criteria, each agency must make its own determination regarding a worker’s status rather than relying on a judgment made by another agency. Officials were also concerned that some data practice barriers may still limit effective sharing of information. We recommend that the three agencies (1) work with the Legislature to minimize or remove these barriers, (2) establish information-sharing procedures, and (3) coordinate their enforcement activities.

Because of limits in state law, employers cannot be penalized specifically for misclassification of employees.

When DEED, DLI, and DOR identify misclassification, they require the employer to take corrective action and provide, if appropriate, any benefits due the misclassified workers. However, state laws do not authorize penalties linked specifically to misclassification. Rather, an

employer can only be penalized for misclassifying workers if the misclassification caused a program or tax law violation, such as failing to pay all unemployment insurance taxes due or failing to carry required workers’ compensation insurance coverage. To address misclassification that is persistent and more likely intentional, we recommend that the Legislature authorize a penalty linked specifically to repeated misclassification of employees.

Introduction

The U.S. Department of Labor estimated in 2005 that about 7 percent of employed individuals worked as independent contractors.¹ Working as an independent contractor is a legitimate alternative to being an employee, and using independent contractors is a legal means of doing business. However, in Minnesota and nationally, there has been growing concern about the number of workers who are, in fact, employees but are being treated as independent contractors.

Classification has important implications for employers, workers, and governments because employee status engenders very different obligations and rights than does classification as an independent contractor. For example, Minnesota's unemployment insurance and workers' compensation programs, occupational safety and health laws, and labor standards generally apply to employees, not independent contractors. Also, employers must withhold state and federal income taxes from wages paid to employees, but not payments to independent contractors.

In Minnesota, three state agencies have obligations related to worker classification. They are the Department of Labor and Industry, which administers the workers' compensation system, the occupational safety and health program, and labor standards; the Department of Employment and Economic Development, which administers the unemployment insurance program; and the Department of Revenue.

In April 2007, the Legislative Audit Commission directed the Office of the Legislative Auditor to evaluate the issue of misclassification in Minnesota. In this report, we address the following questions:

- **What factors determine whether a worker is an employee or independent contractor, and what are the implications of misclassifying an employee as an independent contractor?**
- **To what extent do employers misclassify Minnesota employees?**
- **Does Minnesota have an adequate, coordinated approach to enforcing laws and rules regarding the proper classification of workers?**

¹ U.S. Department of Labor, "[Contingent and Alternative Employment Arrangements, February 2005](#)" (Washington, DC, July 27, 2005), 4.

To understand how worker classification is determined and the implications of misclassification, we reviewed state laws and rules, federal guidance, and publications issued by Minnesota state agencies that describe how workers should be classified. We also interviewed representatives from the Minnesota departments of Employment and Economic Development, Labor and Industry, and Revenue.

To estimate the extent of employee misclassification in Minnesota, we analyzed data from unemployment insurance audits conducted by the Department of Employment and Economic Development. We supplemented data gleaned from unemployment insurance audits with data on misclassification available from audits conducted by the Department of Revenue and investigations of unemployment insurance benefit applications.

To evaluate how well Minnesota state government as a whole ensures that workers are properly classified, we interviewed officials from the departments of Employment and Economic Development, Labor and Industry, and Revenue. We also interviewed individuals representing labor unions and construction contractors. In addition, we analyzed available data on the results of audit and enforcement activities from the three state agencies.

Our efforts to estimate the extent and impact of misclassification in Minnesota were limited by the availability of relevant data. For example, we did not have data from recent unemployment insurance audits on the amount of unreported wages associated with misclassified employees; as a result, we could not estimate unpaid unemployment insurance taxes. Also, the Department of Labor and Industry did not maintain any systematic data on its discovery or resolution of worker misclassification, so we were not able to measure the extent of misclassification found through administration of the workers' compensation program.

Concerns regarding the misclassification of employees as independent contractors go hand-in-hand with concerns over the impact of the "hidden" or "cash" economy. Nearly all of the officials interviewed for this evaluation pointed out that many employers and workers in Minnesota—regardless of classification—operate "off book" to avoid state and federal tax, employment, and immigration laws. Although likely a problem of significant magnitude, Minnesota's cash economy was not within the scope of this evaluation.

This report is divided into three chapters. In Chapter 1, we provide an overview of the factors used to distinguish between employee and independent contractor classifications, the implications of misclassification, and state and federal oversight responsibilities. In Chapter 2, we present our estimates of the extent to which Minnesota employers misclassify employees as independent contractors. Chapter 3 describes how well Minnesota ensures that workers are properly classified, including the adequacy of state laws and rules, state agency activities to ensure compliance, and coordination among state agencies.

Background

SUMMARY

Worker classification refers to the designation of a worker as an employee, independent contractor, consultant, or another type of worker. Classifying workers as employees has important implications. Workers who are employees are protected by labor standards such as minimum wage and overtime requirements. In addition, their employers pay unemployment insurance and other payroll taxes, carry workers' compensation insurance, comply with workplace safety and health requirements, and withhold state and federal income taxes from wages. If a worker is an independent contractor, the hiring organization avoids many of these obligations. Neither organizations nor workers can simply choose one status over another. Rather, various conditions and criteria for determining worker status are contained in federal and state laws and rules, and these factors are applied to the facts and circumstances of a specific relationship between a worker and organization. Under state law, three Minnesota agencies have obligations related to worker classification because they administer laws that apply to employees. These agencies are the departments of Employment and Economic Development, Labor and Industry, and Revenue.

In Minnesota, there is growing concern about the number of employees who are being improperly treated as independent contractors.

Whether a worker is classified as an employee or an independent contractor is an important public policy concern because classification affects the legal rights and obligations of both workers and employers. In addition, misclassification of workers imposes costs on government, primarily through lost tax revenue. Working as an independent contractor is a legitimate alternative to being an employee, and using independent contractors is a legal means of doing business. However, in Minnesota and nationally, there has been growing concern about the number of workers who are, in fact, employees but are being treated as independent contractors.

As background for our evaluation of worker classification in Minnesota, this chapter addresses the following questions:

- **What factors determine whether a worker is an employee?**
- **What are the implications of misclassifying an employee as an independent contractor?**
- **How are state and federal agencies involved in ensuring proper classification of workers?**

To answer these questions, we reviewed state laws and rules, federal guidance, and publications issued by Minnesota state agencies that describe how workers should be classified. We also interviewed representatives from the Minnesota departments of Employment and Economic Development (DEED), Labor and Industry (DLI), and Revenue (DOR).

A worker's classification as an employee or independent contractor is regulated by law.

Classification rests on the degree of control the employer has over the nature and method of the work performed.

CLASSIFYING WORKERS

Worker classification refers to the designation of a worker as an employee, independent contractor, consultant, or some other type of worker.¹ In general, classification rests on interpreting the degree of control the hiring organization (such as a business, government agency, or nonprofit organization) has over a worker.² If a worker must follow the organization's instructions on when, where, and how to do the work, he or she is more likely to be an employee. In contrast, an independent contractor is engaged in a business of his or her own and retains control over how the work is accomplished. Misclassification occurs when a worker acting as an employee is classified by his or her employer as an independent contractor, consultant, or another type of worker.³ In this report, we are most concerned about the distinction between employees and independent contractors.

Various conditions and criteria for determining worker status are contained in federal and state laws and rules, which are generally applied according to the facts and circumstances of a specific relationship between a worker and organization. Neither an organization nor a worker can insist upon designation as an independent contractor; rather, a worker's classification is determined by the circumstances under which he or she performs the work.

For the most part, the factors to be considered when determining worker status derive from principles developed by the U.S. Internal Revenue Service (IRS). According to IRS guidance, "all information that provides evidence of the degree of control and the degree of independence must be considered."⁴ As shown in Table 1.1, in its instructions to employers, the IRS categorizes facts that provide evidence relevant to worker classification into three categories. They are: behavioral control, financial control, and the type of relationship between the worker and employer. None of the factors, standing alone, determine

¹ Other classifications may include day laborers; "temps" (workers hired through temporary employment agencies); or on-call workers, such as substitute teachers.

² Under various state laws, "employer" is often defined as an organization that has at least one worker that meets the legal definition of "employee." Technically, then, a business, sole-proprietor, nonprofit, or other type of organization that uses only independent contractors is not an "employer." In these instances, we use the term "organization" to refer to the entity engaging a worker's services.

³ Employers sometimes exclude certain types of workers from employee status, including temporary workers, casual labor, and part-time workers. In some circumstances, such as failing to report a part-time worker's wages for unemployment insurance purposes, the term "misclassification" can be broadly applied to these types of mistakes. Unless otherwise noted in the report, we use the term "misclassification" more narrowly to refer to instances in which a worker who should be classified as an employee is instead considered to be an independent contractor.

⁴ Internal Revenue Service, *Publication 15-A: Employer's Supplemental Tax Guide* (Washington, DC, January 2007), 6. The IRS and others also often refer to the IRS' 20 "common law factors" that may be considered in determining whether an employee-employer relationship exists. These 20 factors are consolidated in the published guidance referenced here and in Table 1.1.

Minnesota's approach to determining worker status derives from criteria developed by the U.S. Internal Revenue Service.

Table 1.1: Internal Revenue Service Criteria for Determining Worker Status

Behavioral Control: Facts that show whether the employer has the right to direct and control how the worker does the task for which the worker is hired. This includes instructions for how the work is to be done and training given to the worker.

- An employee is generally subject to the employer's instructions about when, where, and how to work. This includes: (1) when and where to do the work, the tools and equipment to use, and/or the workers to hire or to assist with the work; (2) where to purchase supplies and services; and (3) what work must be performed by a specified individual or the order or sequence to follow.
- An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial Control: Facts that show whether the employer has a right to control the business aspects of the worker's job.

- A key aspect is the extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than are employees.
- An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- An independent contractor is generally free to seek out other business opportunities.
- An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- An independent contractor can make a profit or loss.

Type of Relationship: Facts that show the parties' understanding of the type of relationship.

- Written contracts that describe the relationship the parties intended to create.
- Whether the employer provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.
- The permanency of the relationship. If the employer engages a worker with an expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-employee relationship.
- The extent to which services performed by the worker are a key aspect of the employing organization's primary function or purpose. If a worker provides services that are a key aspect of a regular business activity, it is more likely that the employer has a right to direct and control the worker's activities.

SOURCE: Internal Revenue Service, *Publication 15A: Employer's Supplemental Tax Guide* (Washington, DC, January 2007), 6-7.

independent contractor or employee status; ultimately, classification rests on weighing various factors within a particular set of circumstances. The examples shown in Table 1.2 illustrate distinctions between an employee and an independent contractor.

Table 1.2: Examples of Worker Classification

Independent Contractor	Employee
<p>Bill Plum contracted with Elm Corporation to complete the tile work for a housing complex. A signed contract established a flat amount for the services rendered by Bill. Bill is a licensed tile setter and carries workers' compensation and liability insurance under the business name Plum Tiling. He hires his own tile setters who are treated as employees for federal employment tax purposes. If there is a problem with the tile work, Plum Tiling is responsible for paying for any repairs.</p>	<p>Milton Manning, an experienced tile setter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation pays him on a piecework basis and carries workers' compensation insurance for him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time.</p>
<p>The Smith Company hired individuals on a short-term basis to conduct interviews and to fill in questionnaire forms reporting the interview results. The interviewers are free from supervision and control, and the company is interested only in the results reported in the completed questionnaires. Interviewers are paid either hourly or by interview, and they may be reimbursed for expenses. Dealings between the company and the interviewers are generally by mail. Interviewers are free to refuse any assignment, and to work whenever they please subject to the specifications of a particular job.</p>	<p>The Jones Company paid interviewers on an hourly basis to conduct market research surveys. The company hires the interviewers from a list of people who want to conduct interviews on a permanent basis, issues specific instructions for conducting the interviews, may select the interview site, sets quotas and deadlines for completion, does not permit the interviewers to hire assistants or substitutes, and requires daily reports.</p>

NOTES: These examples are from various Internal Revenue Service documents and are relevant to determining worker status for the purpose of various federal laws. Determinations of worker status for other programs could differ. Examples have been modified and edited by the Office of the Legislative Auditor and are for illustrative purposes only.

SOURCES: Internal Revenue Service, *Construction Industry Audit Technique Guide* (October 2004), 11-4 and 11-5, <http://www.irs.gov/pub/irs-mssp/build.pdf>, accessed October 19, 2007; IRS Revenue Ruling 65-188, <http://www.taxlinks.com/rulings/1965/revrul65-188.htm>, accessed October 23, 2007; and IRS Revenue Ruling 75-243, <http://www.taxlinks.com/rulings/1975/revrul75-243.htm>, accessed October 23, 2007.

Minnesota has special criteria for classifying construction workers.

Minnesota laws and rules also establish criteria for classifying workers. For example, as shown in Table 1.3, Minnesota's workers' compensation and unemployment insurance laws spell out nine criteria, all of which must be met, for a construction worker to be classified as an independent contractor.⁵ More generally, *Minnesota Rules* for DEED and DLI set forth general standards for the classification of workers.

Table 1.3: Minnesota Criteria for Determining the Classification Status of Construction Workers in the Unemployment Insurance and Workers' Compensation Programs

To be considered an independent contractor, a residential or commercial construction worker must meet all nine of the following criteria:

1. maintains a separate business with the independent contractor's own office, equipment, materials, and other facilities;
2. holds or has applied for a federal employer identification number or has filed business or self-employment income tax returns with the federal Internal Revenue Service based on that work or service in the previous year;
3. operates under contracts to perform specific services or work for specific amounts of money and under which the independent contractor controls the means of performing the services or work;
4. incurs the main expenses related to the service or work that the independent contractor performs under contract;
5. is responsible for the satisfactory completion of work or services that the independent contractor contracts to perform and is liable for a failure to complete the work or service;
6. receives compensation for work or service performed under a contract on a commission or per-job or competitive bid basis and not on any other basis;
7. may realize a profit or suffer a loss under contracts to perform work or service;
8. has continuing or recurring business liabilities or obligations; and
9. the success or failure of the independent contractor's business depends on the relationship of business receipts to expenditures.

NOTE: In 2007, the Legislature enacted an independent contractor certification program for workers in the residential and commercial construction industries. When the new law becomes effective on January 1, 2009, codification of the nine criteria will shift to the new law under [Minnesota Statutes 2007, 181.723, subd. 6](#).

SOURCES: [Minnesota Statutes 2007, 176.042, subd. 2, and 268.035, subd. 9](#); [Laws of Minnesota 2007, chapter 135, art. 3, sec. 15 and 42](#).

⁵ [Minnesota Statutes 2007, 176.042, subd. 2, and 268.035, subd. 9](#). These provisions apply to construction workers doing commercial or residential building construction or improvements in the public or private sector.

Misclassification negatively affects employees, government, and employers that comply with the law.

Like the IRS common law factors, Minnesota's laws and rules focus on the extent to which the organization controls the method and manner in which the work is performed. For example, rules governing Minnesota's unemployment insurance program specify that five essential factors must be considered and weighed. They are: (1) the organization's right to control the means and manner of performance, (2) the ability to discharge the worker without incurring liability, (3) mode of payment, (4) furnishing of materials and tools, and (5) control over the premises where the services are performed.⁶ The first two of these factors are considered most important.

IMPLICATIONS OF MISCLASSIFICATION

Misclassification has important implications for organizations, workers, and governments because employee status engenders very different obligations and rights. As shown in Table 1.4, misclassification can affect the extent to which workers are covered by various laws' provisions. If workers are employees, their employers must withhold and remit state and federal income taxes from wages, withhold and pay Social Security and Medicare taxes, pay unemployment insurance taxes, provide workers' compensation insurance, adhere to minimum wage and overtime standards, comply with workplace safety and health requirements, and include them in benefit plans. Organizations generally avoid these obligations if they use independent contractors. In addition, some workers might prefer to be considered independent contractors. As independent contractors, their take-home pay might be higher, and their earnings might be hidden from government programs, such as income tax collections and child support enforcement.

Employers can cut labor costs by treating employees as independent contractors. As noted above, employers incur direct costs for their share of federal Social Security and Medicare taxes, unemployment insurance taxes, workers' compensation insurance premiums, and minimum wage and overtime pay. Rising medical costs and workers' compensation premiums are particularly costly in more injury-prone industries such as construction. Because of these costs, many employers find the risk of penalties associated with misclassifying employees to be outweighed by the competitive advantage that arises from doing so.

To illustrate, we developed a scenario showing how labor costs for drywall installation can vary based on the installer's classification. According to DEED labor market data, the median hourly wage for drywall installers in Minnesota is about \$30 per hour.⁷ But as shown in Table 1.5, hourly costs increase significantly when the drywall installers are employees. We estimated that mandatory costs, including federal employment taxes, state unemployment insurance taxes, and workers' compensation insurance premiums, add another \$7.82 per hour for employees. The resulting hourly rate (\$37.82) is 26 percent higher than the employer's cost if the employee were misclassified as an

⁶ *Minnesota Rules* 2007, 3315.0555, subpart 1.

⁷ This median rate is based on data for the second quarter of 2007.

Table 1.4: Key Employer Obligations Toward Employees

	Federal Law	State Law	Employer Obligation
Unemployment insurance	✓	✓	Pay unemployment insurance taxes and comply with other unemployment insurance program requirements
Workers' compensation	^a	✓	Insure liability for benefits paid to employees who are injured on the job
Fair labor standards	✓	✓	Comply with minimum wage, overtime, and child labor provisions
Collective bargaining	✓	✓	Allow employees to organize unions and bargain collectively
Family and medical leave	✓	✓	Provide job-protection and unpaid leave provisions for family and medical leave
Occupational safety and health	✓	✓	Meet workplace safety and health standards
Civil rights	✓	✓	Comply with laws prohibiting employment discrimination based on (1) race, color, religion, gender, and national origin, (2) disabilities, and (3) age
Tax laws	✓	✓	Meet federal and state income and employment tax requirements and employer tax withholding
Social Security and Medicare	✓		Pay employer share of federal taxes funding retirement, disability, and health care benefits
Employer-provided benefits	✓	^b	Comply with laws safeguarding private pension, health, and other employee benefit plans

^a State laws govern most aspects of workers' compensation programs, but the U.S. Department of Labor administers four special workers' compensation funds (the Federal Employees' Compensation Program, Energy Employees Occupational Illness Compensation Program, Longshore and Harbor Workers' Compensation Program, and Black Lung Benefits Program).

^b Federal law governs most aspects of employer-provided benefits, but Minnesota laws include provisions regarding the continuation of health and life insurance benefits after an employee-employer relationship is terminated (*Minnesota Statutes* 2007, 62A.17 and 61A.092).

SOURCES: U.S. Government Accountability Office, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification* (Washington, DC, July 2006), 8; and *Minnesota Statutes* 2007, chapters 175, 176, 179, 181, 182, 268, 290, and 363A.

Employers that misclassify have an unfair economic advantage.

Table 1.5: Hypothetical Impact of Misclassifying a Drywall Installation Employee as an Independent Contractor

	Employee	Employee Misclassified as an Independent Contractor
Hourly Base Rate	\$30.00	\$30.00
MN Unemployment Insurance Tax ^a	\$ 1.11	\$ 0.00
U.S. Unemployment Insurance Tax ^b	0.21	0.00
Social Security and Medicaid Taxes ^c	2.30	0.00
Workers' Compensation Insurance ^d	4.21	0.00
Subtotal Mandatory Costs	\$ 7.82	\$ 0.00
Total Base Rate and Mandatory Costs	\$37.82	\$30.00

NOTES: Unemployment insurance tax rates and workers' compensation insurance costs can vary considerably among industries. As a result, we linked our example to a single occupation and chose drywall installation because it is an occupation prone to misclassification. According to DEED labor market data, the median hourly wage for drywall installers in Minnesota during the second quarter of 2007 was \$30.46. For illustrative purposes, we assumed that an employer would pay the same base rate to an employee misclassified as an independent contractor.

^a According to DEED, a new employer in the drywall industry would be subject to an unemployment insurance tax of 9.6 percent on the first \$24,000 in annual wages paid.

^b The federal unemployment insurance tax rate for 2007 is 6.2 percent on the first \$7,000 of wages paid. Because Minnesota unemployment insurance laws conform to certain federal standards, Minnesota employers are eligible for a 5.4 percent tax credit (resulting in a net tax rate of 0.8 percent).

^c For 2007, employers pay a combined tax rate of 7.65 percent on annual wages up to \$97,500.

^d According to the Minnesota Workers' Compensation Insurance Association, a new employer in the drywall industry would pay a workers' compensation insurance premium averaging 14.03 percent of annual wages.

SOURCE: Office of the Legislative Auditor analysis.

independent contractor. If the employer provided benefits, such as health insurance and retirement contributions, the cost of employee classification would be even higher.⁸ We extrapolated these hourly estimates to a project taking 175 hours (about how long it would take to install drywall in a new, 3,500 square foot house). A builder misclassifying employees as independent contractors would incur labor costs of roughly \$5,200 compared to about \$6,600 for a builder appropriately classifying its employees.

⁸ According to U.S. Department of Labor data for the construction industry as of March 2007, employer-provided benefits (paid leave, insurance, and retirement) totaled 22.2 percent of the average hourly wage for construction employees. In our example, this would total \$6.67 per hour.

Employees misclassified as independent contractors may inappropriately take work-related tax deductions.

Misclassification also affects governments and taxpayers, in large part because of lost tax revenue. For example, both the state and federal governments lose unemployment tax revenue when employers misclassify their workers as independent contractors, and these costs are borne by compliant employers. Similarly, employers that misclassify employees as independent contractors underpay Social Security and Medicaid taxes.

DOR and the IRS collect income taxes from both employees (through employer withholding) and independent contractors (through estimated tax payments or payments submitted with income tax returns). However, employees who are misclassified as independent contractors may take work-related tax deductions that they would not be entitled to if they were properly classified. In addition, federal and state income tax compliance is far higher among employees than the self-employed. According to recent IRS data, for example, employees accurately report on their income tax returns about 99 percent of their wage, salary, and tip income. In contrast, individuals who are self-employed (excluding farmers) accurately report only about 43 percent of their income.⁹ Better tax compliance among employees with wage and salary income arises largely because employers are required to withhold income tax from employees' wages.

According to the U.S. Government Accountability Office, the IRS last estimated the federal tax impact of misclassification in 1984. The IRS estimated that 15 percent of employers misclassified 3.4 million workers as independent contractors, resulting in an estimated federal tax loss of \$1.6 billion in Social Security, unemployment tax, and income tax (or \$2.72 billion in inflation-adjusted 2006 dollars).¹⁰ Neither DOR nor DEED have made similar estimates of Minnesota income tax and unemployment insurance tax losses resulting from misclassification of employees as independent contractors.

STATE AND FEDERAL RESPONSIBILITIES

Responsibility for enforcing laws that are dependent on worker classification is shared by the state and federal governments, as shown in Table 1.6. Within Minnesota, DEED, DLI, and DOR have obligations related to worker classification. DLI administers state and federal laws related to workers' compensation, occupational safety and health, and labor standards. DEED administers state and federal laws governing the unemployment insurance program. For the most part, the laws administered and enforced by these two departments apply to employers. Thus, establishing an employee-employer relationship makes the laws applicable. At the federal level, the U.S. Department

⁹ U.S. Internal Revenue Service, *IRS Updates Tax Gap Estimates*, Publication IR-2006-28 (Washington, DC, February 14, 2006).

¹⁰ U.S. Government Accountability Office, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification* (Washington, DC, 2006), 2. According to the report, "The \$2.72 billion is intended to be an estimate of the magnitude of tax loss due to misclassification in 2006 dollars—not an updated estimate. The actual tax loss due to misclassification in 2006 may be higher or lower based on the tax rates, the level of independent contractors used in various sectors of the economy, and the types and levels of misclassification observed in 2006."

In Minnesota, three state agencies administer and enforce laws related to worker classification.

Table 1.6: State and Federal Agencies Administering Laws that Apply to Employers

Minnesota Department of Labor and Industry	Workers' compensation insurance program Occupational safety and health Labor standards
Minnesota Department of Employment and Economic Development	Unemployment insurance program
Minnesota Department of Revenue	State income tax and income tax withholding
U.S. Department of Labor	Implementation of federal laws regarding: <ul style="list-style-type: none"> • Unemployment insurance • Workers' compensation insurance • Occupational safety and health • Labor standards
U.S. Internal Revenue Service	Federal income tax and income tax withholding Social Security and Medicaid taxes Federal unemployment insurance tax

SOURCE: Office of the Legislative Auditor.

of Labor has jurisdiction over these program areas. It provides implementation guidance to states through federal regulations, manuals, and other directives; oversees the activities of the relevant state agencies; and does some direct enforcement of federal laws. According to DLI and DEED officials, however, most investigation and enforcement is done by the state.

Similarly, DOR and the IRS have an interest in worker classification as it relates to the administration of state and federal tax laws. Because Minnesota's income tax is based directly on the federal income tax, IRS determinations of worker status and its enforcement actions resulting from misclassification are highly relevant to Minnesota tax administration, and vice versa. As a standard practice, the IRS shares with DOR information on federal determinations of worker status and changes to federal tax obligations that result from enforcement activity.

Employee Misclassification

SUMMARY

Misclassification is a problem in Minnesota. An estimated 1 in 7 employers subject to Minnesota unemployment insurance taxes misclassified at least one employee in 2005. Overall, randomly audited employers in the unemployment insurance system misclassified a relatively small percentage of their employees. The majority of misclassification involved employers that misclassified one or two employees, but some employers misclassified dozens of workers. Unemployment insurance auditors found misclassification by employers in many industries. Some misclassification was likely deliberate, while in other cases, it was more likely the result of misunderstanding.

National literature suggests that employee misclassification is a growing problem, with a significant, negative impact on government tax revenues and workers' access to employee protections, such as unemployment insurance. To provide a clearer understanding of whether misclassification is a problem in Minnesota, this chapter addresses the following question:

- **To what extent do employers misclassify Minnesota employees?**

To estimate the extent of employee misclassification, we relied primarily on data from unemployment insurance (UI) audits conducted by the Minnesota Department of Employment and Economic Development (DEED). UI auditors examine the books and records of covered employers to ensure that they are appropriately reporting their payroll and paying the correct amount of unemployment insurance taxes.¹ For example, auditors review a business's cash disbursements, general ledger, Internal Revenue Service (IRS) 1099 information returns, and income tax returns looking for misclassified workers and hidden wages.² Unemployment insurance audit findings of misclassification cover a range of employment circumstances, not just those in which an employee was

¹ The U.S. Department of Labor requires states to audit at least 2 percent of employers covered by the UI program every year. (U.S. Department of Labor, [Employment Security Manual, Appendix E, Field Audits](#) [1999], 3677.) Not all businesses are liable for Minnesota unemployment insurance taxes. For example, Minnesota businesses with no employees do not have to pay unemployment insurance taxes, and government and nonprofit employers can elect to reimburse the unemployment insurance system instead of paying taxes. In addition, some categories of employers, such as churches and church-sponsored private schools, are exempt from UI obligations and would not be subject to audit.

² Payers use an IRS [Form 1099-MISC](#) to report "miscellaneous income" payments, such as rents, royalties, or other payments. If an employer compensates a worker (who is not an employee) \$600 or more, the employer must report the payment as "nonemployee compensation" to the IRS and the worker on a Form 1099.

We used unemployment insurance audit data from the Department of Employment and Economic Development to estimate the extent of misclassification.

erroneously classified as a self-employed independent contractor. For example, an auditor might make a finding of misclassification if an employer failed to report employee wages paid to part-time, temporary, or other types of contingent workers. As such, DEED's UI audits define misclassification more broadly than is sometimes done in discussion of the issue. Commonly, "misclassification" is used in reference only to instances in which workers are treated as self-employed independent contractors when they should be employees. Nonetheless, the UI audits conducted by DEED provide the richest source of information on the extent of employee misclassification in Minnesota.

We supplemented data gleaned from UI audits with data on misclassification available from audits conducted by the Minnesota Department of Revenue (DOR) and investigations of unemployment insurance benefit applications. Although these sources of information do not provide the same level of detail, we think that they contribute different perspectives on the issue than those provided through the UI audits.

MISCLASSIFICATION IN MINNESOTA

Whether misclassification should be an important public policy concern in Minnesota depends on how often misclassification occurs and how detrimental the effects of misclassification are. In Chapter 1 we discussed the impact of employee misclassification on workers, employers, and government revenue. With that in mind, we found that:

- **Misclassification is a problem in Minnesota.**

As discussed in detail below, the percentage of Minnesota employers who misclassify workers and the percentage of employees who are misclassified are modest, but the impact of the misclassification is felt broadly. Misclassification is a problem in Minnesota because it can negatively affect the thousands of employees who are misclassified, the large majority of employers who appropriately classify workers, and state tax revenues. It is found during unemployment insurance audits, DOR audits, and investigations of UI benefit applications. In addition, some misclassification appears to be a deliberate attempt to evade employment-related responsibilities and costs.

Estimates of Extent

We measured the extent of misclassification in Minnesota in terms of both the percentage of employers that misclassified employees and the percentage of employees who were misclassified. We also analyzed the extent of misclassification by industry.

Employers that Misclassify

We used the most recent UI audit data available to estimate the percentage of employers in the state that misclassified at least one worker. We found that:

- **An estimated 14 percent of employers subject to Minnesota unemployment insurance taxes—or 1 in 7—misclassified at least one worker in 2005.**

Since approximately 125,000 employers were liable for unemployment insurance taxes in 2005, this means that about 17,500 employers misclassified at least one worker.³

Our estimate—that 1 in 7 employers misclassified—is conservative because it excludes employers who operate in the “cash” economy or fail to register in the unemployment program.

Our estimate of the number of employers who misclassified at least one worker in 2005 is likely conservative because it generally does not account for businesses that do not treat any workers as employees. For the most part, DEED audits employers who report at least one employee to the unemployment insurance system. Thus, employers who conduct all of their business using workers classified as independent contractors or operate in the “hidden” or “cash economy” are not very likely to be audited by DEED and, consequently, our estimate of the number of employers that misclassify employees in Minnesota will be low.⁴

Audits completed by DOR’s Withholding Division support the conclusion that misclassification is a problem in Minnesota. In keeping with IRS priorities at the federal level, the department implemented a new audit program in late 2006 that specifically targets worker classification. Under this program, the Withholding Division selects employers for audit using various indicators of possible misclassification. Of the 37 audits completed by the division through July 2007, 24 (65 percent) resulted in reclassification of at least one worker to employee status.⁵ In all but one of these cases, workers had been treated as self-employed independent contractors when they should have been classified as employees.⁶ Misclassification had a substantial impact on accurate reporting of employer

³ The 95-percent confidence interval around the estimate is 12 to 16 percent. (A 95-percent confidence interval means that if samples of the same size were drawn repeatedly from the same population of employers and 95-percent confidence intervals were calculated, 95 percent of the intervals would contain the true percentage of employers that misclassified employees.) The 14-percent estimate is based on UI audits of 2005 employer records generalized to the population of tax-liable employers that were eligible for random audit in October 2006. When we applied the 14-percent estimate to the full population of 125,000 tax-liable employers (not just those eligible for random audit), we assumed that the liable employers who were not eligible for random audit were not different, in the degree to which they misclassified workers in 2005, from employers that were eligible. UI auditors found misclassified workers in 18 percent of 2,274 audits of employers’ 2005 records. This includes two types of audits – random and targeted. Employers subject to random audits are selected through a stratified random sampling process, and the generalization took this process into account. Employers subject to targeted audits are selected based on tips or other indications of possible problems. Considered separately, DEED found misclassified employees in about 17 percent of the 1,802 random audits, and 21 percent of the 472 targeted audits.

⁴ There are circumstances under which employers who are not in the UI system are audited. For example, an employer might be the subject of a targeted audit, or an audit of a construction contractor might lead to audits of subcontractors that are not registered employers in the UI system.

⁵ Each audit generally covered multiple tax years.

⁶ In the remaining case, the business owner’s spouse (who did not formally own any part of the business) had been working without pay. In these circumstances, the spouse was an employee and the owner was required to pay a reasonable wage for the work performed.

payroll and the amount of income tax withholding remitted to the state. Among the 24 audited employers that misclassified workers, the amount of taxable payroll associated with the reclassified employees (\$10.0 million) was nearly twice the payroll originally reported to DOR (\$5.7 million). Further, these employers should have withheld almost \$600,000 in income taxes from these employees' wages.⁷

Worker classification was also an issue in unemployment insurance application investigations. Most applications for UI benefits are processed routinely, but DEED initiates investigations when it has no record of wages paid to the applicant or if the amount of wages paid is in dispute. One reason for unreported (or underreported) wages is that the employer has been treating the worker as an independent contractor rather than as an employee. We estimated that in about one-fourth of almost 400 UI investigations closed in 2006, the applicant's worker classification was in dispute.⁸ In nearly all of the cases we reviewed, the applicant was an employee whose wages should have been reported to the UI program.⁹

Number of Employees Misclassified

Most employers that misclassified employees misclassified a small number of them.

We also measured misclassification in terms of the numbers of employees who were misclassified. To look at misclassification this way, we used the UI auditors' counts of additional employees found in random audits of employers' records for 2001-03.¹⁰ We found that:

- **Overall, randomly audited employers in the unemployment insurance system misclassified a relatively small percentage of their employees.**

The additional employees found among misclassifying employers constituted about 1 percent of the employees of all employers subject to random audits. Auditors found over 5,097 additional employees among employers who had misclassified workers, while all randomly audited employers had around 354,000

⁷ DOR did not bill employers for the full \$600,000 in taxes that should have been withheld from wages. When reclassified workers accurately reported the misclassified income on their individual tax returns and paid the income tax due, their employers' assessments were reduced to reflect the taxes paid. In total, the audits resulted in additional assessments of \$496,000.

⁸ The 95-percent confidence interval around the estimate is 18 to 32 percent. A 95-percent confidence interval means that if samples of the same size were drawn repeatedly from the same population of application investigations and 95-percent confidence intervals were calculated, 95 percent of the intervals would contain the true percentage of application investigations in which worker classification was an issue. Our estimate is based on review of investigation reports for about one-third of the almost 400 UI investigations closed in 2006.

⁹ Individuals who should have been paid as employees but were compensated as independent contractors might not even apply for benefits, or might not pursue benefits through the investigation process.

¹⁰ UI auditors began using a new data system in mid-2005. In the new system, auditors no longer record the number of additional employees they identify during audits. Therefore, data on numbers of additional employees are available only for the 2001-03 audits. The audits covered employers' records for a single year between 2001 and 2003, not all three years.

employees. The additional employees constituted about 6 percent of the workforce of employers that had misclassified workers.¹¹

Unemployment insurance audits showed that most employers that misclassified workers misclassified a small number of them, but some misclassification was more extreme. As shown in Table 2.1, over half the time auditors found misclassified workers, they identified one or two additional employees. However, in 4 percent of the cases, auditors found 21 or more additional workers who should have been classified as employees.¹²

Table 2.1: Additional Employees Found Through Minnesota Unemployment Insurance Random Audits, 2001-03

Number of Added Employees ^a	Audits with Misclassification Found ^b	Percentage of Audits with Misclassification Found
1 to 2	512	54%
3 to 5	214	23
6 to 10	104	11
11 to 20	74	8
21 to 50	25	3
51 or more	13	1

^a Although only random audits with a finding of misclassified workers are included, the numbers of additional employees might include additional employees resulting from audit findings other than misclassification. Overall, auditors found 5,151 additional employees in random audits with misclassification found.

^b Auditors indicated the number of additional workers found for 942 random audits with misclassification found. Not included are 131 random audits with a finding of misclassified workers, but no additional workers noted.

SOURCE: Office of the Legislative Auditor analysis of Department of Employment and Economic Development unemployment insurance audits of 2001, 2002, or 2003 employer data.

¹¹ The percentage of random audits with misclassification identified is based on 1,073 audits with misclassification identified. The number and percentage of additional employees is based only on 940 random audits with misclassification found. Auditors did not indicate the number of additional employees for 131 of the audits. In these cases, we accepted the finding of misclassification and counted the lack of employee information as an oversight. In addition, we excluded the audit results for two employers that misclassified 54 employees, but for which a total number of employees was not available. The number of additional employees might include workers added for a reason other than misclassification (such as a finding of “casual labor”).

¹² These figures are based on 942 random audits in which auditors found misclassified workers and indicated the number of additional workers. The number of additional employees might include workers added for a reason other than misclassification. Misclassification was found in 1,073 random audits, but auditors did not indicate additional employees for 131 of them.

Misclassification in the construction industry has been a particular concern, but misclassification occurs in many industries.

Misclassification by Industry

Knowledgeable staff at DEED told us that worker misclassification is more common in some industries than others. According to these staff, some characteristics of industries more prone to misclassification include: use of unskilled labor, minimal capital investment requirements, and seasonal business cycles. In theory, businesses that rely on unskilled labor will find it easier to use “independent contractors” as business needs increase instead of employing the labor permanently. In addition, workers that can be easily replaced may have less ability to negotiate for employee status. The capital investment required to do a particular type of work will affect the ease with which individuals can create the impression that they are self-employed independent contractors. Seasonality increases unemployment insurance tax rates and creates an incentive to misclassify employees. In addition, industries with higher injury rates have higher workers’ compensation premiums and an incentive to misclassify workers.

We looked at misclassification by industry and found that:

- **Audits of Minnesota employers in the unemployment insurance program show that misclassification occurs in many industries.**

As Table 2.2 shows, the estimated percentage of audited employers that misclassified workers in 2005 varied among industries, from a low of 3 percent of employers in the transportation and warehousing industry to a high of 33 percent in the real estate and rental and leasing industry.¹³ The estimated percentage of employers in the construction industry that misclassified at least one worker in 2005 (15 percent) was in line with the estimated percentage of all employers that misclassified at least one worker (14 percent).

We looked more closely at the construction industry because of legislative interest and because some construction subindustries have qualities that DEED staff said characterize industries with more employee misclassification. Although employers in the construction industry did not appear to misclassify workers in 2005 more often than employers overall, some subindustries within the construction industry stand out. As Table 2.3 shows, in auditing the 2004 or 2005 records of employers, UI auditors found misclassified workers among 28 to 38 percent of employers in the roofing, drywall and insulation, residential remodeling, and commercial and industrial building construction industries. In contrast, one-tenth of audited employers in highway, street, and bridge construction and one-twentieth of audited employers in the site preparation industry misclassified workers. Although we cannot draw firm conclusions about differences in misclassification among subindustries, the results suggest that the impressions of DEED staff and others who mentioned specific industries as being problematic are reasonable.¹⁴

¹³ Industry groups are based on the [North American Industry Classification System](#).

¹⁴ For the analysis of subindustries, we looked at all 2004 and 2005 audits, including both random and targeted audits. The audit results are not generalized to the population, and the number of audits in some subindustries is low.

Table 2.2: Estimated Employee Misclassification in Minnesota by Industry, 2005

Industry	Estimated Percentage of Employers Misclassifying Employees	Precision of Estimate (Confidence Interval ^a)
Real Estate and Rental and Leasing	33%	20-50%
Arts, Entertainment, and Recreation	23	9-45
Professional, Scientific, and Technical Services	18	12-26
Health Care and Social Assistance	16	10-24
Manufacturing	16	11-23
Construction	15	11-21
Retail Trade	14	9-20
Administrative Support, Waste Management, and Remediation Services	12	7-21
Wholesale Trade	11	7-18
Accommodation and Food Services	8	4-16
Finance and Insurance	6	3-13
Transportation and Warehousing	3	1-8
All Industries	14	12-16

NOTES: Industry groups are based on the [North American Industry Classification System](#) (NAICS). Industries with fewer than 40 audited employers and the "Other Services" industry are not shown but are included in "All Industries." Audits of employers with no NAICS code or an invalid code are also included in "All Industries."

^a Calculated at the 95-percent confidence level. Calculating an interval at the 95-percent confidence level means that if samples of the same size were drawn repeatedly from the same population of employers and 95-percent confidence intervals were calculated, 95 percent of the intervals would contain the true percentage of employers that misclassified employees.

SOURCE: Office of the Legislative Auditor analysis of Department of Employment and Economic Development unemployment insurance audits of 2005 employer data.

Finally, workers in the construction industry accounted for a disproportionate share of the misclassified employees found in UI audits of employers' 2001, 2002, or 2003 records. Employees in the construction industry accounted for about 6 percent of the employees of all randomly audited employers, but accounted for 11 percent of the misclassified employees.¹⁵

As discussed above, the percentages of employees who were misclassified by their employers was relatively small, overall. However, for the most part, only employers who report at least one employee to the unemployment insurance system are audited by DEED. Thus, organizations that conduct all of their

¹⁵ The industry groups during this time period were based on the [Standard Industrial Classification system](#).

business using workers classified as independent contractors or operate in the “hidden” or “cash” economy are not very likely to be audited. The misclassified employees that they may be using would not be captured in the UI audit data.

Table 2.3: Employee Misclassification Found in the Construction Industry, Minnesota Unemployment Insurance Audits, 2004-05

Industry	Employers Audited	Audits with Misclassification Found	Percentage
Construction	601	119	20%
Roofing contractors	29	11	38
Drywall and insulation contractors	16	5	31
Residential remodelers	42	12	29
Commercial and institutional building construction	29	8	28
Poured foundation and structure contractors	16	4	25
Finish carpentry contractors	19	4	21
Painting and wall covering contractors	20	4	20
New single family housing construction	64	12	19
Plumbing, heating, and air conditioning contractors	83	13	16
Masonry contractors	39	6	15
Electrical contractors	62	9	15
Water and sewer line and related structures construction	21	3	14
Highway, street, and bridge construction	20	2	10
Site preparation contractors	38	2	5
All other industries ^a	3,088	501	16
All industries ^a	3,689	620	17

NOTES: Construction subindustries with fewer than 15 audited employers and the “other specialty contractors” industry are not shown. Industry groups are based on the North American Industry Classification System. The table includes both random and targeted audits, and the results have not been generalized to the population. Therefore, one cannot draw firm conclusions about the differences in misclassification among industries.

^a These rows include audits of employers that did not have a [North American Industry Classification System](#) code or had an invalid code.

SOURCE: Office of the Legislative Auditor analysis of Department of Employment and Economic Development unemployment insurance audits of 2004 or 2005 employer records.

In some cases, misclassification was likely a deliberate attempt to avoid labor and tax laws.

Intent

Misclassification of workers sometimes reflects employer and worker misunderstanding of the employee classification issue. For example, one study found that there was “a perception among employers and workers, especially those in medium to high wage occupations, that the designation of employee or independent contractor status was an option to be agreed upon by both parties.”¹⁶ However, misclassification might also reflect employer or worker efforts to avoid wage-related tax provisions.

The reasons behind employee classification errors are an important consideration in deciding how to address misclassification. Although making determinations of intent is difficult, we reviewed narrative comments in DEED’s 2005 UI audit reports and found that:

- **Some worker misclassification found in 2005 unemployment insurance audits was likely deliberate, while in other cases, misclassification was more likely the result of misunderstanding.**

In some cases, misclassification was likely a deliberate attempt by the employer and/or worker to avoid compliance with labor and tax laws that apply to employees. Misclassification may have been deliberate when the amount of money the misclassified worker was paid was just under \$600. If an employer compensates a worker (who is not an employee) \$600 or more, the employer must report the payment on a 1099 information return, which then creates a government paper trail to that worker. If a misclassified worker’s compensation is just under \$600, it is reasonable to conclude that the employer and/or worker is trying to keep the payment from government scrutiny. We found several instances of this. For example, one business reported three employees to the unemployment insurance system, but the auditor found “several individuals listed as labor, most [of whom] had earned \$590, just under the 1099 issuing limit.” Similarly, another business reported one employee and paid three additional workers \$599.

Contractor and union representatives we spoke with provided other examples of intentional misclassification. For example, construction contractors spoke to us about losing bids to contractors known to avoid employment-related taxes by misclassifying employees or paying workers “off the books.” In another case, according to union officials, a Twin Cities builder had employed construction crews consisting of a supervisor and several carpenters, then “spun off” the employees as independent contractors even though they continued to do the same work under the same degree of control by the builder. Others we interviewed noted that some employees supplement their wages by intentionally taking side jobs for which they are compensated in cash or erroneously as independent contractors.

¹⁶ Planmatics, for the U.S. Department of Labor, *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs* (Washington, DC, 2000), 91.

UI auditors' notes suggest that some misclassification is likely a result of a misunderstanding. For example, in a few cases, UI auditors noted that the business owner thought he needed to report workers' wages only if they exceeded \$600, the cut off for issuing a 1099 information return to workers. In other words, the employer was applying the monetary requirement for issuing a 1099 return to other government programs. Another employer, who did not understand that there is a meaningful distinction between worker statuses, simply chose to reclassify all of her employees to independent contractor status, presumably for the cost-savings or convenience. Some employers improperly classified temporary or other contingent workers. For example, one employer paid some relatives to do a small amount of work, not realizing that they should have been paid as employees.

Enforcement

SUMMARY

Minnesota has neither an adequate nor coordinated approach for ensuring that Minnesota workers are properly classified. No single state or federal agency has jurisdiction over worker classification. In practice, the three Minnesota agencies involved—the departments of Labor and Industry, Employment and Economic Development, and Revenue—make limited to modest efforts to detect and correct misclassification, and they do not effectively share information among themselves about instances of misclassification. In addition, because of limits in state law, employers are generally not penalized specifically for misclassifying workers. A new Minnesota law targets misclassification in the construction industry, but with a 2009 implementation date, it is too soon to estimate how it will affect the extent of misclassification.

As discussed in Chapters 1 and 2, misclassification of workers is a problem in Minnesota, and jurisdiction for enforcing relevant laws and rules is divided among three Minnesota state agencies. In this chapter, we discuss the extent to which these agencies attempt to detect and deter misclassification of workers. Specifically, this chapter addresses the following questions:

- **Does Minnesota have an adequate, coordinated approach to enforcing laws and rules regarding the proper classification of workers?**
- **How might recent Minnesota legislation requiring certification of construction industry independent contractors influence the proper classification of workers?**

To answer these questions, we reviewed state laws and rules, federal guidance, and publications issued by Minnesota state agencies that describe how workers should be classified and the enforcement-related roles and responsibilities of state agencies. We interviewed officials from the Minnesota Department of Employment and Economic Development (DEED), the Department of Labor and Industry (DLI), and the Department of Revenue (DOR) as well as individuals representing labor unions and construction contractors. In addition, we analyzed available data on the results of audit and enforcement activities from DLI, DEED, and DOR.

ENFORCEMENT

To assess how well Minnesota state government as a whole ensures that workers are properly classified, we looked at several key elements of the state's approach, including: (1) legal authorities established in state law and rule, (2) state agency activities to ensure compliance, and (3) coordination among state agencies. Overall, we found that:

- **Minnesota has neither an adequate nor coordinated approach for ensuring that Minnesota workers are properly classified.**

More specifically, we found that legal jurisdiction and authorities related to worker classification are fragmented, agencies make varying levels of efforts to detect misclassification, state law does not provide for penalties specific to misclassification, and agencies do not sufficiently coordinate their efforts or share information about instances of misclassification. We discuss each of these concerns in turn.

Legal Authority

Based on our review of Minnesota laws and rules, we found that:

- **Authority for ensuring the proper classification of workers is fragmented.**

As stated previously, DEED, DLI, and DOR have an interest in worker classification, but different sections of state laws and rules authorize each agency's obligations. As discussed in Chapter 1, the principles regarding worker classification that are contained in Minnesota laws and rules derive from Internal Revenue Service (IRS) guidance (see Table 1.1), and as a result, there are more similarities than differences among them. Nonetheless, DLI, DEED, and DOR have authority to make decisions regarding worker classification only within their areas of jurisdiction and, as discussed in Chapter 1, classification is determined according to the specific circumstances surrounding the relationship between a worker and hiring organization. Table 3.1 illustrates some of the differences in legal authority for DEED and DLI classification determinations. In our opinion, the differences between them are subtle.

Officials at all three agencies told us that, as a result of differing legal authorities, each agency must make its own determination regarding a worker's status rather than relying on a judgment made by another agency in a different program context. As we discuss later in the chapter, this contributes to limited sharing of information among the agencies on employers found to have misclassified workers.

Compliance Activities

In evaluating agency efforts to ensure proper classification of workers in Minnesota, we considered the extent to which the agencies help hiring organizations and workers make correct classification determinations up front and how they systematically identify and investigate instances of misclassification. Because penalties are an important aspect of administrative enforcement, we also assessed the extent to which penalties related specifically to misclassification are authorized in law and used by the agencies.

The departments of Employment and Economic Development (DEED), Labor and Industry (DLI), and Revenue (DOR) apply different laws in evaluating worker classification issues.

Nevertheless, the criteria DEED, DLI, and DOR use to determine a worker's classification are more similar than different.

Table 3.1: Laws and Rules Regarding Worker Classification for Workers' Compensation and Unemployment Insurance, 2007

Workers' Compensation (DLI)

Minnesota Statutes 2007, chapter 176

Defines an employee generally as someone "who performs services for another for hire" and includes numerous categorical definitions of employees, such as minors, elected officials, and volunteer ambulance drivers (176.011, subd. 9).

Defines numerous categories of employment relationships specifically excluded from covered employment, including independent contractors as defined in DLI rules (176.041, subd. 1).

Establishes criteria for determining construction workers' classification that are identical to those in Chapter 268 (176.042, subd. 2).

Minnesota Rules 2007, chapters 5200 and 5224

For the purposes of workers' compensation, establishes specific standards for classifying workers in over 30 occupations, such as barbers, musicians, nurses, and door-to-door sales people (5244.0020-0312).

For occupations without specific standards, describes general factors that must be considered in determining whether an employment relationship exists and states that all factors must be weighed to determine whether the worker is economically dependent upon the business to which the worker provides services (5200.0221).

Factors to be weighed include the employer's degree of control over the method and manner of performing the work and eight other factors relating to the method of payment, the worker's investment in equipment needed to do the work, and the employer's right to terminate the working relationship (5224.0330 and 5224.0340).

Unemployment Insurance (DEED)

Minnesota Statutes 2007, chapter 268

Defines an employee as one "who performs services for an employer in employment," and further as "an individual who is considered an employee under the common law of employer-employee and is not considered an independent contractor" (268.035, subd. 13 and subd. 15).

Establishes criteria for determining construction workers' classification that are identical to those in Chapter 176 (268.035, subd. 9).

Minnesota Rules 2007, chapter 3315

Defines certain factors that must be considered when determining whether an individual is an employee or independent contractor for the purposes of unemployment insurance (3315.0555).

States that two of the factors are the most important: (1) the employer's right to control the means and manner of performance and (2) the employer's right to discharge the worker without liability. Other factors to be considered are substantially the same as the general factors stated in DLI rules for workers' compensation (3315.0555).

NOTE: The key factors to be considered when classifying workers in the context of state and federal tax law are included in Chapter 1, Table 1.1.

SOURCES: *Minnesota Statutes* 2007, chapters 176 and 268; *Minnesota Rules* 2007, chapters 3315, 5200, and 5224.

Prevention and Detection of Misclassification

To prevent misclassification when new workers are hired, all three agencies: (1) make available written guidance regarding the proper classification of workers, (2) include the topic in training sessions for employers, and (3) make staff available to answer questions from employers and workers. While these educational activities are important, we looked more extensively at the proactive efforts agencies make to enforce proper classification of workers, and we found that:

- **State agency efforts to prevent and detect misclassification range from very limited to modest.**

The state does not have an enforcement program aimed specifically at worker classification.

Officials at all three agencies told us that their compliance activities related to misclassification generally arise as a by-product of administrative or enforcement activities with other primary purposes, such as ensuring workers' compensation coverage. Overall, we found that DEED most systematically addresses possible misclassification of workers through its unemployment insurance audits and investigations. Efforts at DOR and DLI are more limited.

Key training guidance for Minnesota employers says that DEED, DLI, and DOR will provide up-front opinions to organizations regarding a worker's status, and it encourages organizations to obtain determinations from all three agencies.¹ Doing so is intended to ensure that workers are properly classified at the time of hire. However, only DEED makes such determinations in practice. If an organization formally requests a determination, DEED will evaluate information submitted by the organization and provide an opinion on a worker's status for the purposes of unemployment insurance. More commonly, organizations contact DEED informally for assistance, and DEED refers them to the state's unemployment insurance manual and other guidance. Similarly, when an organization contacts DLI about a worker's proper classification, staff refer the organization to available guidance on classification criteria and suggest that the organization consult its attorney for further guidance.² DOR refers employers to

¹ Business Education Tax Partnership, *Introduction to Employment Taxes and Employer Issues and Responsibilities Guide* (St. Paul, 2007), 9, http://www.taxes.state.mn.us/business_taxpayers/business_education/mbeguide.shtml, accessed June 5, 2007. The Business Education Tax Partnership is a cooperative partnership between the Minnesota departments of Revenue, Employment and Economic Development, Labor and Industry, and Human Services; the Internal Revenue Service; the Social Security Administration; the U.S. Department of Labor; and the U.S. Citizenship and Naturalization Services.

² DLI staff will make preliminary classification determinations only when misclassification may be an issue in enforcement of the department's administrative responsibilities—such as a claim for workers' compensation benefits. According to DLI officials, only a judge can make official determinations of worker status for the programs under the department's purview.

DEED identifies misclassification through its unemployment insurance audits.

the IRS' process for a determination of worker status, and the department abides by the IRS' decision.³

According to DEED officials, the agency does not have a specific compliance program aimed at identifying misclassification. However, the department discovers misclassified workers through two primary means: (1) processing applications for unemployment benefits and (2) audits of employers registered in the unemployment insurance system. When a worker applies for unemployment benefits, DEED determines whether the applicant's employer has reported and paid taxes on his or her wages. If the department finds no wages reported, it will investigate whether the applicant has been treated as an independent contractor but should be a covered employee. As described in Chapter 2, DEED also audits about 2 percent of employers per year to ensure unemployment insurance compliance.⁴ This audit program is the state's most systematic means of identifying misclassified workers. Auditors routinely look for evidence of workers whose wages should have been reported to the unemployment system, but were not. DEED randomly selects most of the employers to be audited, but the agency targets some audits at employers in particular industries, such as roofing and drywall. Audits targeting specific industries are sometimes aimed specifically at identifying misclassification. DEED also initiates some audits based on tips.

DOR identifies employers who misclassify and fail to withhold income tax from wages.

DOR does a limited amount of auditing directed at worker classification.⁵ In keeping with an Internal Revenue Service priority, the department implemented a new Withholding Division audit program in late 2006 that specifically targets worker classification. Under this program, the division selects employers for audit using various indicators of possible misclassification. If auditors find evidence of misclassification, they send a questionnaire to workers asking about various aspects of the employment relationship. Auditors use questionnaire results and other information to determine workers' proper classification. However, according to the division director, with only four field auditors in the Withholding Division, the department lets the Internal Revenue Service and DEED take the lead on misclassification.

³ Employers or workers may file [IRS Form SS-8](#) to request an IRS determination of a worker's status for the purpose of federal employment taxes and income tax withholding. A Form SS-8 determination can only be requested in order to resolve actual tax matters. The IRS does not issue SS-8 determinations for proposed transactions or hypothetical situations.

⁴ U.S. Department of Labor, *Employment Security Manual, Appendix E, Field Audits* (1999), 3677.

⁵ Two Department of Revenue divisions have a related interest in employee misclassification. The Withholding Division oversees employer withholding of state income tax from employees' wages. As a result, this division has a key interest in misclassification because the withholding requirement applies only to employees. Although classification as an employee has important implications for income tax compliance, misclassification is not a distinct audit issue for the department's Individual Income Tax Division. If an individual taxpayer is designated as an independent contractor, income tax audits focus on proper reporting of the self-employment income and associated deductions for business expenses; income tax auditors generally do not question the underlying assumption that the taxpayer is an independent contractor.

DLI finds misclassification when it investigates complaints regarding labor standards, workplace safety, or workers' compensation.

One resource that neither DEED nor DOR have been able to use to its full advantage to identify possible misclassification is the IRS Form 1099.⁶ The U.S. Department of Labor has suggested that states' unemployment insurance agencies use 1099 information return data from the IRS as a tool for identifying individuals who are misclassified as independent contractors. DEED currently receives 1099 information from the IRS but does not use it for its unemployment insurance audit program, largely because of logistical problems. The data provided by the IRS is over a year old by the time it reaches DEED, and the IRS conveys it in an archaic electronic format. DOR has long received 1099 data from the IRS, but the transmittal problems are the same. To make 1099 data more timely and useful to the state agencies, the 2007 Minnesota Legislature passed a bill requiring Minnesota employers to send 1099 information returns directly to DOR at the same time they are submitted to the IRS, but this provision was lost when the Governor vetoed the 2007 tax bill. The Department of Revenue could use the electronically-submitted 1099 data for a variety of tax compliance purposes, but more timely, electronically-formatted data could be a useful tool for DOR and DEED to identify misclassified workers as well.

DLI does not have an ongoing audit program or other means of systematically identifying misclassified workers. Rather, misclassification may be identified during investigations of worker complaints—most often through the workers' compensation claims process. There are two scenarios in which this can occur. First, a worker may submit a claim for workers' compensation benefits that is denied by the insurer because the employer treats the worker as an independent contractor. The worker may appeal the denial (and underlying classification) to DLI, and the department will determine whether the worker is an employee or an independent contractor. Second, a worker may make a claim for workers' compensation benefits, but DLI records indicate that the employer does not carry mandatory workers' compensation coverage. During the course of investigating the employer's coverage status, DLI may discover that the employer has misclassified all of its workers as independent contractors rather than employees. In addition, DLI may identify misclassified workers through its enforcement activities related to occupational safety and health, fair labor standards, and other workplace rules, most of which apply to employees but not independent contractors. DLI does not maintain systematic data on its discovery or resolution of worker misclassification.

Corrective Action and Penalties

Penalties are an important aspect of administrative enforcement, but we found that:

- **Because of limits in state law, employers are generally not penalized specifically for misclassification of workers.**

⁶ Payers use an IRS [Form 1099-MISC](#) to report "miscellaneous income" payments, such as rents, royalties, or other payments. If an employer compensates a worker (who is not an employee) \$600 or more, the employer must report the payment as "nonemployee compensation" to the IRS and the worker on a Form 1099.

With one exception, state laws do not authorize penalties linked directly to misclassification of workers. Rather, as shown in Table 3.2, penalties available to DLI, DEED, and DOR are linked to program violations, such as failing to pay all unemployment insurance taxes due or failing to carry required workers' compensation insurance coverage. In general, an employer can only be penalized for misclassifying workers if the misclassification caused a program or tax law violation.

Table 3.2: Penalties that May Apply if Employers Misclassify Employees

Workers' Compensation

Failure to carry mandatory insurance coverage	Used if an employer fails to insure workers' compensation liability through an authorized insurance carrier or self-insurance of the liability. The penalty amount is up to \$1,000 per employee per week for the duration of noncompliance.
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Unemployment Insurance

Missing or erroneous wage information	Used if an employer files a wage detail report with DEED that includes missing, incomplete, or erroneous wage information for an employee. The penalty amount is \$25 for each employee for whom the information is partially missing or erroneous or 2 percent of the total wages for each employee for whom the information is completely missing.
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Income Tax Withholding

Late filing of a return	Used if an employer did not file a quarterly withholding report at all and DOR auditors later reclassify at least one worker to employee status. ^a The penalty amount is 5 percent of the amount of withholding tax due.
Negligence	Used if the withholding tax assessment is due to negligence or intentional disregard of the provisions of the applicable tax laws or rules relating to proper classification of workers, but without intent to defraud. The penalty amount is 10 percent of the additional tax assessed.

NOTE: The list of relevant penalties is not exhaustive. The table includes those penalties that agency staff indicated were most likely to be used in instances of misclassification.

^a The penalty cannot be used if the employer filed a timely quarterly withholding report for at least one employee.

SOURCES: [Minnesota Statutes](#) 2007, 176.181, subd. 3; 268.044, subd. 3; and 289A.60, subd. 2, 5.

When, through an investigation or audit, DEED identifies an employee who was erroneously classified as an independent contractor, DEED notifies the employer of the determination and directs the employer to correctly classify similarly employed workers. Also, if the reclassified worker is eligible for unemployment benefits, those benefits are paid. Employers that have misclassified workers are

When they identify misclassification, all three agencies direct the employer to correctly classify similarly employed workers.

assessed unpaid unemployment insurance taxes, penalties, and interest. DEED may assess back taxes for up to four prior years.⁷

Like DEED, DLI does not directly penalize employers for misclassification. If an employer incorrectly classified all of its workers as independent contractors and did not carry workers' compensation insurance, then the employer can be penalized for failing to have mandatory coverage. If an employer has a workers' compensation policy, misclassified employees are covered by it. In these cases, the issue that the employer may not be paying a sufficient premium to cover all actual employees is between the insurer and the employer. Finally, if the Labor Standards division finds that a worker was misclassified as an independent contractor and the payment to the worker did not meet minimum wage standards, the division may assess penalties for labor standards violations.

According to DOR officials, Withholding Division audits focus on bringing employers into compliance going forward so that, in the future, the employers properly classify workers who are employees and withhold income taxes from their wages. If an audit finds misclassification, the department sends an assessment to the employer for the amount of income tax that should have been withheld (minus the amount of income tax that the misclassified employees actually paid), penalties, and interest.⁸ According to DOR officials, the most applicable penalty is for late reporting of withholding obligations. The department may also assess a negligence penalty if the employer did not exercise "due diligence" in properly classifying its workers.

In addition to the agency-initiated penalties just described, *Minnesota Statutes* 2007, 181.722, gives individual workers standing to file a civil action in district court against an employer that misrepresents the nature of their employment relationship (in the context of workers' compensation).⁹ This remedy is available only to construction workers (although the prohibition itself is stated generally). The court may award attorney fees, costs, and disbursements to a construction worker recovering under this section. Also, if a court finds that an employer violated this section of the law, the court must transmit the findings to DLI, and DLI is required to share the information with DEED, DOR, Commerce, the IRS, and the U.S. Department of Labor. According to DLI officials, the agency has never received this type of referral from the courts.

Coordination Among Agencies

Since three state agencies have an interest in classification of workers, we assessed the extent to which the agencies shared information on their findings of worker misclassification in order to maximize the benefit of each agency's individual work. We found that:

⁷ *Minnesota Statutes* 2007, 268.043(b).

⁸ The employer is not responsible for past payments to misclassified employees who fully declared the income on their tax returns.

⁹ *Minnesota Statutes* 2007, 181.722, subd. 1 and 2. This provision was enacted in 2005. *Laws of Minnesota* First Special Session 2005, chapter 1, art. 4, sec. 41.

- **State agencies do not make effective use of opportunities to coordinate their efforts and share information about employers that misclassify employees.**

DEED, DLI, and DOR do not routinely exchange information about misclassified employees or their employers.

State law generally allows the three agencies to share information on individuals and employers for the purpose of determining a worker's status.¹⁰ Although the language differs somewhat among statutes specific to each agency, in general, DEED, DLI, and DOR may exchange information on individuals and employers if the receiving agency uses the data consistent with its administrative duties.

According to the managers and supervisors we interviewed at DEED, DLI, and DOR, the three agencies do not routinely share information about misclassified employees or their employers. For example, although DEED has the most systematic data on misclassified employees, neither DOR nor DLI routinely receives and uses the data to determine whether there may be implications for income tax withholding by employers, proper reporting of income by individuals, or appropriate coverage for workers' compensation.¹¹ Similarly, DOR does not share its withholding audit findings with the other agencies, nor does DLI share data on individuals who were initially denied workers' compensation benefits because of an erroneous classification as an independent contractor. A DOR Withholding Division manager described the division's relationship with DLI as "nonexistent."

Data sharing within DLI (the agency with multiple divisions having an interest in worker classification) is also incomplete. For example, misclassification can be an important issue for workers' compensation, occupational safety and health, and labor standards enforcement. However, various DLI officials said that they rarely share information with other DLI divisions on misclassified employees and their employers.

Agency officials told us that differing criteria for classifying workers are a significant barrier to sharing data among state agencies. As discussed in Chapter 1, DEED and DLI share specific, statutory classification criteria for construction workers but have somewhat different criteria in *Minnesota Rules* for other types of workers. Because of the close interrelationship between DOR and the IRS, DOR officials find it prudent to follow IRS criteria for classifying all types of workers (including construction workers), even though these criteria may differ from DLI and DEED criteria contained in state law and rule. Overall, one agency's determination regarding an employee or group of employees may not apply to programs administered by the other agencies. Our recommendations to address these barriers are discussed later in the chapter.

¹⁰ *Minnesota Statutes* 2007, 270B.14, subd. 2 and 8; 268.19, subd. 1; and 176.181, subd. 8.

¹¹ DEED routinely provides the IRS with data on UI audits that resulted in a change to recorded wages or a worker's classification. If the IRS subsequently makes a corresponding change to federal tax obligations, the IRS transmits the federal tax changes to DOR.

CERTIFICATION OF INDEPENDENT CONTRACTOR STATUS

Misclassification of workers is a difficult problem to address, but during the 2007 legislative session, the Minnesota Legislature acted to improve enforcement of classification rules. More specifically:

- **A new Minnesota law targets misclassification in the construction industry, but with a 2009 implementation date, its impact is unknown.**

Beginning in 2009, construction workers will need a certificate from DLI before they can work as independent contractors.

The new law applies to individuals who provide public or private sector commercial or residential construction or improvement services, when providing such services is their trade, business, profession, or occupation.¹² Under the new law, individuals who are performing construction services covered by the law may not be classified as independent contractors unless they (1) have a current independent contractor exemption certificate issued by DLI and (2) are performing the services in a manner that meets the law's nine factor independent contractor test (see Table 1.3 for these factors). Consequently, if a construction worker does not have a current independent contractor exemption certificate, then the classification is clear—the worker is an employee. If a construction worker has an independent contractor exemption certificate, then the worker may be either an employee or an independent contractor depending on whether the specific work situation meets the nine-factor test.

The new law applies to classification determinations in the context of workers' compensation, minimum wage, overtime, and other fair labor standards; child labor; occupational safety and health; and unemployment insurance. When misclassification occurs, the law gives DLI authority to penalize workers and the organizations or individuals who hire them. DLI will begin taking applications for independent contractor exemption certificates beginning July 1, 2008, and the law goes into effect January 1, 2009. By 2010, DLI expects to have an additional 14 staff in place to process certification applications and enforce the law.

It is too early to say how big an impact the law will have on reducing misclassification in the construction industry. Under the law, independent contractor certification means only that the individual has the capacity to function as an independent contractor. Certified independent contractors and employers will still need to determine, on a case-by-case basis, whether the actual terms of work support independent contractor status. However, the law promotes coordinated action by DLI, DOR, and DEED in cases of noncompliance with the certification process. DLI is required to notify DEED and DOR if an individual holding a certificate fails to meet the requirements of the certification law. DOR is then required to determine whether the individual

¹² *Laws of Minnesota* 2007, chapter 135, art. 1, sec. 15.

may also have failed to comply with tax laws when reporting income from the certification-related work being questioned.¹³

Although Minnesota's certification law was modeled after a similar law in Montana, Montana's experience to date provides limited insight regarding what Minnesota should expect. Montana's current certification process for construction industry independent contractors is about two years old. According to Montana officials, the state uses a 15-point test with the determination criteria focusing on whether the individual has an independently established business. Unlike Minnesota, the extent of the employer's control and direction of the work performed is not part of the independent contractor determination process. Montana's Department of Labor and Industry issues certificates of independent contract status, and these determinations apply to all relevant state programs, including workers' compensation, labor standards, and state tax compliance. Montana has not done any research on the impact of its certification law.

RECOMMENDATIONS

As stated at the beginning of this chapter, Minnesota's strategy for addressing worker misclassification is fragmented and inadequate. Our recommendations—to the Legislature, DEED, DLI, and DOR—are designed to improve the state's overall approach to the issue.

Increase Coordination Among Agencies

RECOMMENDATION

The departments of Employment and Economic Development, Labor and Industry, and Revenue should work with the Minnesota Legislature to (1) establish common definitions of employee, employer, and independent contractor and, (2) to the extent possible, enact common rules for determining worker status.

The Legislature needs to work with DEED, DLI, and DOR to streamline the rules and criteria used to classify workers.

Currently, DEED, DOR, and DLI are not taking full advantage of opportunities to share information about employers who misclassify workers, and officials at all three agencies told us that definitional differences contribute to this disconnect. Although judgment in determining worker classification will still be required, we encourage all reasonable efforts to align decision-making processes and classification criteria among the three departments.¹⁴ Doing so would increase the likelihood that different agencies would reach the same conclusion about a worker's classification and the confidence with which they could rely on each other's decisions. Common definitions would facilitate the coordination of work among agencies and simplify classification-related interactions with the

¹³ *Minnesota Statutes* 2007, 181.723, subd. 15.

¹⁴ Efforts to align classification criteria need to take relevant federal standards into account, along with state policy goals and program requirements.

agencies for employers and workers. In implementing this recommendation, we encourage the three agencies and the Legislature to consider the merits of adopting a single decision-making framework, such as the IRS' common law factors.

Aligning the decision-making criteria in Minnesota law and rule is a first step toward an integrated state approach to dealing with misclassification. The three state agencies also need to routinely share specific information about instances of misclassification and coordinate their enforcement efforts.

RECOMMENDATIONS

The departments of Employment and Economic Development, Labor and Industry, and Revenue should:

- *Identify the minimum information necessary for them to effectively share and use the results of each other's enforcement efforts,*
 - *Recommend to the Legislature by January 2009 any changes to the Minnesota Data Practices Act needed to facilitate the sharing of information on employers that misclassify, and*
 - *Implement procedures to routinely share information on employers that misclassify workers.*
-

The three agencies need to routinely share the results of their enforcement efforts.

DEED, DOR, and DLI should consult among themselves to determine the minimum information that should be shared to effectively use the results of each other's enforcement efforts related to employee misclassification. For example, agencies might be less interested in employers that were found to misclassify one or two workers, but they might be very interested in cases resulting in reclassification of several workers. State law currently authorizes the three agencies to share information related to investigations of possible misclassification. However, state officials (particularly those at DLI) were concerned that some data practice barriers may still limit effective sharing of information. If necessary, DEED, DLI, and DOR should work in consultation with the data practices policy group in the Department of Administration to determine and craft needed changes to state law that would allow sharing of the information.

Once legal concerns have been addressed, the agencies should put in place procedures to routinely share information so that one agency's reclassification determinations can be acted upon by the others. Currently, agencies sometimes alert each other to instances of misclassification. This *ad hoc* process, however, is not sufficient. DEED has the most systematic approach for identifying misclassified employees, but because the other two agencies do not routinely obtain audit data, they do not sufficiently capitalize on DEED's work. Each agency's routine sharing of investigation results would provide good leads for investigations by the others.

Enhance Efforts to Prevent and Detect Misclassification

RECOMMENDATIONS

The departments of Employment and Economic Development, Labor and Industry, and Revenue should explore opportunities to coordinate targeted audit and investigation activities pertaining to worker classification.

The Legislature should amend state law to require Minnesota employers to file copies of 1099 information returns directly to the Minnesota Department of Revenue.

The departments of Employment and Economic Development, Labor and Industry, and Revenue should revise their educational materials, as needed, to reflect actual agency practices for providing up-front determinations of worker status.

More broadly, DEED, DLI, and DOR should develop and implement coordinated enforcement strategies.

To expand the reach of each agency's individual efforts, we think DEED, DLI, and DOR need to explore opportunities to coordinate their enforcement activities. In part, this would be achieved by the information sharing recommended above, but we also think the agencies need to coordinate specific enforcement activities. For example, both DOR and DEED select employers for targeted audits based on various indicators of likely misclassification. The agencies could share these criteria, develop mutually beneficial audit programs, or perhaps divide responsibility for auditing a set of identified employers. The agencies could also coordinate education and audit activities within certain industries prone to misclassifying workers. With the anticipated addition of up to 14 new staff at DLI for administration of the independent contractor certification program, we expect that the department could increase its overall level of enforcement activity and coordination with the other agencies, particularly with regard to misclassification in the construction industry.

IRS 1099 information returns can be used to help identify instances of misclassification if the income and employment data are not too dated. Currently, there is a significant time lag between when 1099 information returns are submitted to the IRS and when the data are supplied to Minnesota agencies. To facilitate use of 1099 data to identify misclassification and for other tax compliance purposes, the Legislature should require employers to submit 1099s to DOR when they are submitted to the IRS. DOR should then be authorized to provide the data to DEED.¹⁵

Finally, the state agencies should make sure that informational materials that are used to educate employers about employee classification accurately reflect the activities of each agency.

¹⁵ DEED officials told us that the department would need to do some additional work to determine how to make the most cost-effective use of 1099 information in its audit selection process.

Increase Penalties for Misclassification of Employees

RECOMMENDATIONS

The Legislature should amend state law to establish a penalty for repeated misclassification by an employer.

The Legislature should amend Minnesota Statutes, 181.722, subd. 4, to allow civil action by workers in all industries when an employer intentionally misrepresents an employee's status.

The Legislature should authorize a penalty for repeated misclassification by an employer.

Agencies can issue program-specific penalties to employers that misclassify, and workers in the construction industry can pursue civil action against an employer that intentionally misrepresents the employment relationship. However, we think the Legislature should authorize a penalty linked specifically to employers that repeatedly misclassify employees. The penalty would give DOR, DEED, and DLI an additional means of enforcement, and might emphasize for employers that the reason underlying their program noncompliance (i.e., employee misclassification) is, by itself, an important issue. We suggest that the penalty be restricted to repeated misclassification. Worker classification is not always clear cut, and as we discussed in Chapter 2, misclassification can result from misunderstanding. However, repeated misclassification more likely reflects intentional action and should be penalized beyond what can already be done.

Current Minnesota law prohibits employers from intentionally misrepresenting the nature of the employment relationship, and as written, this prohibition applies to all workers. However, the remedy for violating this law—the right to take legal action in court—is restricted to workers in the construction industry. Our analysis shows that misclassification occurs in many industries, and we think all workers should have access to the remedy.

List of Recommendations

- The departments of Employment and Economic Development, Labor and Industry, and Revenue should work with the Minnesota Legislature to (1) establish common definitions of employee, employer, and independent contractor and, (2) to the extent possible, enact common rules for determining worker status ([p. 33](#)).
- The departments of Employment and Economic Development, Labor and Industry, and Revenue should:
 - Identify the minimum information necessary for them to effectively share and use the results of each other’s enforcement efforts,
 - Recommend to the Legislature by January 2009 any changes to the Minnesota Data Practices Act needed to facilitate the sharing of information on employers that misclassify, and
 - Implement procedures to routinely share information on employers that misclassify workers ([p. 34](#)).
- The departments of Employment and Economic Development, Labor and Industry, and Revenue should explore opportunities to coordinate targeted audit and investigation activities pertaining to worker classification ([p. 35](#)).
- The Legislature should amend state law to require Minnesota employers to file copies of 1099 information returns directly to the Minnesota Department of Revenue ([p. 35](#)).
- The departments of Employment and Economic Development, Labor and Industry, and Revenue should revise their educational materials, as needed, to reflect actual agency practices for providing up-front determinations of worker status ([p. 35](#)).
- The Legislature should amend state law to establish a penalty for repeated misclassification by an employer ([p. 36](#)).
- The Legislature should amend *Minnesota Statutes*, 181.722, subd. 4, to allow civil action by workers in all industries when an employer intentionally misrepresents an employee’s status ([p. 36](#)).

November 14, 2007

James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
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St. Paul, Minnesota 55155-1603

Dear Mr. Nobles:

This letter is a three-agency response to your final report on the Misclassification of Employees as Independent Contractors, dated November 9, 2007.

The report highlights the public policy implications of misclassification—its unfairness to workers and employers, the cost it imposes on government, the resulting loss of tax revenue, and the need for more coordination among the three agencies whose programs are affected by the classification of Minnesota workers.

Our agencies do not disagree with findings of the report. We think it's important to note, however, that the characterization of our efforts to detect and correct misclassification as “minimal to modest” and our enforcement activities as being “not well coordinated” reflect the resource challenges each of our agencies face.

We appreciate the thoroughness of the report and pledge to work together to improve the classification of employees and contractors as our resources allow.

What follows is our joint response to the report's four recommendations.

Recommendations:

- (1) To the extent possible, DEED, DLI, and DOR should work with the Legislature to standardize the criteria in state law and rule that determine worker status.**

Response:

We agree that a more uniform set of criteria for determining worker classification would be ideal. Over the next 12 months, the Department of Revenue (DOR), the Department of Labor and Industry (DLI), and the Department of Employment and Economic Development (DEED) will define the core set of criteria that could be

applied uniformly by each agency in making a determination. This core set would be supplemented by those few criteria that are specific to the requirements for each agency.

(2) DEED, DLI, and DOR should better coordinate their audit and investigation activities related to worker classification, and

(3) DEED, DLI, and DOR should establish procedures to routinely share information about identified instances of misclassification and work with the Legislature to resolve any statutory barriers to doing so.

Response:

The three agencies agree that better coordination of audits and investigations, as well as more sharing of information about misclassification would improve classification decisions. At this point, however, we do not think new legislation is needed for two reasons: (1) we are currently working to implement recently enacted legislation pertaining to independent contractor certifications. The implementation of this new law could serve as a pilot project for future legislation (see our response to recommendation (4); and (2) our plan to study classification criteria referenced in our response to recommendation (1) will identify existing statutory barriers, if any, to sharing information among our agencies.

Currently M.S. 270B.14, subd. 8 specifically authorizes DOR and DLI to exchange the following data: (1) data used in determining whether a business is an employer or a contracting agent; (2) taxpayer identity information relating to employers and employees for purposes of supporting tax administration, Chapter 176 (workers compensation), Chapter 177 (labor standards and wages), and Chapter 181 (employment); and (3) data to the extent provided in and for the purpose set out in section M.S. 176.181 subd. 8.

M.S. 176.181, subd. 8 specifically authorizes DOR, DEED, and DLI to share information regarding "...the employment or employer status of individuals, partnerships, limited liability companies, corporations, or employers, including, but not limited to, contractors, intermediate contractors, and subcontractors."

Both DEED and DOR believe that M.S. 270B.14, subd. 2 (b) provides sufficient statutory authority to share information and coordinate their audit and investigation activities related to worker classification determinations. It provides that data pertaining to corporations or other employing units may be disclosed to the DEED to the extent necessary for the proper enforcement of Chapter 268 (unemployment insurance).

Our agencies believe these statutes provide implied authority for sharing data regarding independent contractor and employer/employee determinations. We will

consider this issue in the course of our proposed study of classification criteria and recommend legislation for more specific authority to share this data if needed.

DOR, DEED and DLI will explore and pilot methods to coordinate audit and investigation activities related to determinations of worker classifications including the development of processes to routinely share the results of those efforts. We will also identify the information needed by each agency for them to act on the results of determinations made by the other agencies and implement processes to share that required information.

(4) The Legislature should modify state law to authorize a penalty for repeated misclassification by an employer.

Response:

The OLA report recommends that the legislature enact penalties for an organization's repeated act of misclassifying employees as independent contractors.

Under existing law, when DEED, DOR or DLI find that an organization has misclassified its workers and, as a result of that misclassification, violated one or more of the laws they are responsible for enforcing, DEED, DOR and DLI have the authority to order the organization to comply with its laws and to issue penalties for the organization's non-compliance. Penalties for non-compliance include administrative, civil and criminal penalties.

For example, if an organization has not purchased workers' compensation insurance to cover its workers because it claims its workers are independent contractors and therefore exempt from the states' workers' compensation law, DLI has authority to investigate and to determine whether or not its workers are in fact exempt. To make this determination, DLI uses criteria established in workers' compensation statutes, rules and case law. If DLI determines the workers are not exempt, then DLI has the authority to issue an order requiring the organization to obtain workers' compensation insurance and to assess penalties for the organization's failure to have workers' compensation insurance for the workers it misclassified. In addition, under the state's workers compensation statute, an organization's failure to have workers' compensation insurance coverage for its employees is a gross misdemeanor.

DEED and DOR have similar enforcement and penalty authority in their respective laws. The classification of workers as either employees or independent contractors is relevant primarily because state laws require organizations to take or not take certain action depending on a worker's status. Consequently, if the misclassification of a worker results in an organization taking or not taking certain action in violation of a state law, arguably the state law violated provides for an appropriate remedy.

DOR faces slightly different enforcement challenges and may find it helpful to have the authority to impose additional consequences upon organizations that purposefully misclassify workers.

Whether enactment of additional penalties for the act of misclassifying workers will provide a greater or more effective deterrence is currently uncharted ground.

Therefore, in response to this recommendation, DEED, DOR and DLI recommend that the independent contractor certification law, which authorizes DLI to assess penalties for the knowing misclassification of workers in the construction industry, be used as a pilot for purposes of evaluating the effectiveness of such a penalty. DEED, DOR and DLI believe using the independent contractor certification law as a pilot is particularly appropriate because it standardizes the criteria for classifying workers in the construction industry for those laws enforced by DEED and DLI.

Our agencies will recommend new penalties if warranted after DLI's pilot effort on construction workers has been evaluated and a care set of criteria for making employee/independent contractor determinations has been established. We think establishing new penalties prior to completing this work is premature. A common set of criteria will help organizations understand what is expected of them and encourage their voluntary compliance. If they continue to be out of compliance, assessing penalties would be appropriate.

We are confident that, working together, we can improve the quality of employee/contractor determinations and increase compliance with Minnesota Law.

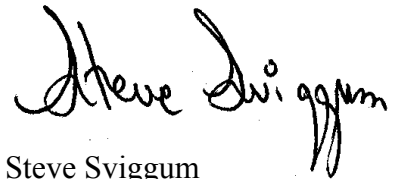
Sincerely,



Ward Einess
Commissioner of Revenue



Dan McElroy
Commissioner of Employment
and Economic Development



Steve Sviggum
Commissioner of Labor
and Industry

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