



# Misclassification of Employees as Independent Contractors

## 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.
- 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.
- 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.
- These agencies' efforts to detect and deter misclassification range from very limited to modest, and they are not well coordinated.
- 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.

## 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.
- DEED, DLI, and DOR should better coordinate their audit and investigation activities related to worker classification.
- 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.
- The Legislature should modify state law to authorize a penalty for repeated misclassification by an employer.

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

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**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, based on the results of DEED unemployment insurance audits, is likely conservative

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

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, 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 need to coordinate enforcement activities and routinely share information about employers that misclassify employees.**

**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.

## Summary of Agency Response

*In a joint letter dated November 14, 2007, Commissioner of Revenue Ward Einess, Commissioner of Employment and Economic Development Dan McElroy, and Commissioner of Labor and Industry Steve Sviggum wrote: "Our agencies do not disagree with the findings of the report." However, they added that limitations in the agencies' enforcement activities "reflect the resource challenges each of our agencies face." The commissioners agreed that "a more uniform set of criteria for determining worker classification would be ideal" and said their agencies will develop a core set of criteria over the next 12 months. In addition, the three agencies 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." They found the recommendation to establish a new penalty directed specifically at misclassification to be premature, suggesting that "the independent contractor certification law, which authorizes the Department of Labor and Industry 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."*

The full evaluation report, *Misclassification of Employees as Independent Contractors*, is available at 651-296-4708 or:

[www.auditor.leg.state.mn.us/ped/2007/misclass.htm](http://www.auditor.leg.state.mn.us/ped/2007/misclass.htm)