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U.S. Cracks Down on 'Contractors' as a Tax Dodge

By [STEVEN GREENHOUSE](#)

Federal and state officials, many facing record budget deficits, are starting to aggressively pursue companies that try to pass off regular employees as independent contractors.

[President Obama's](#) 2010 budget assumes that the federal crackdown will yield at least \$7 billion over 10 years. More than two dozen states also have stepped up enforcement, often by enacting stricter penalties for misclassifying workers.

Many workplace experts say a growing number of companies have maneuvered to cut costs by wrongly classifying regular employees as independent contractors, though they often are given desks, phone lines and assignments just like regular employees. Moreover, the experts say, workers have become more reluctant to challenge such practices, given the tough job market.

Companies that pass off employees as independent contractors avoid paying [Social Security](#), [Medicare](#) and unemployment insurance taxes for those workers. Companies do not withhold income taxes from contractors' paychecks, and several studies have indicated that, on average, misclassified independent workers do not report 30 percent of their income.

One federal study concluded that employers illegally passed off 3.4 million regular workers as contractors, while the Labor Department estimates that up to 30 percent of companies misclassify employees. Ohio's attorney general estimates that his state has 92,500 misclassified workers, which has cost the state up to \$35 million a year in unemployment insurance taxes, up to \$103 million in workers' compensation premiums and up to \$223 million in income tax revenue.

"It's a very significant problem," said the attorney general, Richard Cordray. "Misclassification is bad for business, government and labor. Law-abiding businesses are in many ways the biggest fans of increased enforcement. Misclassifying can mean a 20 or 30 percent cost difference per worker."

Employers deny misclassifying workers deliberately. The businesses say the lines are unclear between employee and independent contractor.

Workers are generally considered employees when someone else controls how and when they perform their work. In contrast, independent contractors are generally in business for themselves, obtain customers on their own and control how they perform services.

Many businesses are dismayed about the tougher federal and state scrutiny.

"The goal of raising money is not a proper rationale for reclassifying who falls on what side of the line," said Randel K. Johnson, senior vice president with the United States Chamber of Commerce. "The laws are unclear in this area, and legitimate clarification is one thing. But if it's just a way to justify enforcing very unclear laws against employers who can have a legitimate disagreement with the Labor Department or I.R.S., then we're concerned."

Among the most often misclassified workers are truck drivers, construction workers, home health aides and high-tech engineers.

Portraying regular workers as contractors allows companies to circumvent minimum wage, overtime and antidiscrimination laws. Workers classified as contractors do not receive unemployment insurance if laid off or workers' compensation if injured, and they rarely receive the health insurance or other fringe benefits regular employees do.

"This denies many workers their basic rights and protections and means less revenues to the [Treasury](#) and a competitive advantage for employers who misclassify," said [Jared Bernstein](#), who as executive director of Vice President [Joseph R. Biden Jr.](#)'s [Middle Class Task Force](#) has helped orchestrate the administration's campaign against misclassification. "The last thing you want is to give a competitive advantage to employers who are breaking the rules."

Organized labor, a strong supporter of Mr. Obama, has long complained about the practice. No administration has undertaken as big a crackdown as Mr. Obama's, although administration and state officials deny they are doing it as a favor to labor.

California's attorney general, [Jerry Brown](#), is seeking \$4.3 million from a construction firm he accused of misclassifying employees. Last April, he won a \$13 million judgment when a court ruled that two companies had misclassified 300 janitors, cheated the state out of payroll taxes and not paid minimum wage and overtime.

Last November, the Illinois Department of Labor imposed \$328,500 in penalties on a home improvement company for misclassifying 18 workers, saying it had pressed them to incorporate as separate business entities.

The Obama administration plans to expand investigations by hiring 100 more enforcement personnel. The I.R.S. has begun auditing 6,000 companies to see whether they are in compliance with the law.

The administration also plans to rewrite a three-decade-old I.R.S. rule that lets companies indefinitely classify employees as independent contractors — even when the government knows they are misclassified — so long as the company once had a reasonable belief that the workers were contractors.

One worker who welcomes stricter enforcement is Fritz Elienberg, who spent five years installing cable and Internet service for [RCN](#) in Boston.

Mr. Elienberg said he and a dozen other installers reported to an RCN office six mornings a week, shortly after 6:30, where they received their daily assignments and the equipment to do installations. He said he typically worked 10 to 14 hours a day and never received time-and-a-half pay for overtime.

"I didn't feel like an independent contractor. I didn't feel like my own boss," Mr. Elienberg said. "I always believed I was an employee. It's a win-win situation for them and a lose-lose for us. We didn't get overtime, sick days, vacations, health insurance or pensions."

Mr. Elienberg said his foot was seriously injured when a ladder fell on it, but workers' compensation did not cover his medical bills because he was considered a contractor. He is suing RCN for overtime pay and the value of lost benefits.

Michele Murphy, an RCN spokeswoman, said the company often contracted with outside service providers but did not misclassify workers.

A Harvard study found that 4.5 percent of Massachusetts workers were misclassified, while a [Cornell](#) study concluded that 10 percent of New York's private-sector workers were.

Last October, the attorneys general of New York, New Jersey and Montana threatened to sue [FedEx](#) Ground, asserting it had misclassified its drivers. The [Teamsters](#) union has long pressed officials to pursue

the company. The Teamsters hope to unionize these drivers, but independent contractors, unlike regular employees, cannot form unions.

FedEx argues that these drivers are contractors because they own their trucks and can sell their routes.

One factor in the push for more aggressive enforcement is the Labor Department's new top law enforcement official, M. Patricia Smith. As New York's labor commissioner the past three years, she was known for cracking down on misclassification.

Ms. Smith oversaw a task force comprising various state agencies that conducted 2,413 misclassification investigations and 65 joint sweeps in which teams descended on companies' offices to examine payroll records.

In a Feb. 1 report to New York's governor, Ms. Smith noted that since late 2007, the task force had identified more than 31,000 instances of misclassification and assessed \$11 million in unpaid unemployment taxes and \$14.5 million in unpaid wages.

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