



Worker Misclassification in Indiana

Joint Report of the Indiana Departments of
Workforce Development, Labor, Revenue, and the
Workers' Compensation Board

November 8, 2010

I. Introduction

On March 13, 2010, a joint house and senate Conference Committee adopted Senate Bill 23. On March 25, 2010, Governor Daniels signed Senate Enrolled Act 23 which required the Indiana Department of Labor (“IDOL”) to develop guidelines and procedures for investigating questions and complaints concerning employee classification and a plan for implementation of those guidelines and procedures. There was no requirement that IDOL estimate the revenue lost due to misclassification. SEA 23 required IDOL to make a presentation to the Pension Management Oversight Commission (“PMOC”) not later than October 1, 2010, and to make recommendations to the legislative council concerning any required legislative changes by November 1, 2010. IDOL was required to implement any adopted rule by August 1, 2011.

On September 29, 2010, the Department of Labor presented their findings and a report to PMOC. The report (referred to throughout this report as the “*Labor* report”) contained four recommendations which can be summarized as: (1) undertake an interagency initiative to address misclassification comprised of relevant state agencies, (2) improve communications among agencies, (3) develop meaningful penalties to enhance the Workers’ Compensation Board’s ability to require coverage on employees, and (4) expand outreach to educate employers and employees about classification rules.

Also, on September 29, 2010, Michael P. Kelsay, Ph.D, presented the a report, financed by the Indiana Building Trades and Construction Council and The Indiana, Illinois, Iowa Foundation for Fair Contracting, titled, “The Economic Costs of Employee Misclassification in the State of Indiana.”¹ That report (referred to throughout this report as the “*Building Trades* report” or “*Building Trades* study”) estimated that Indiana could be losing up to \$400 million annually in tax revenue due to misclassification.

At the following PMOC meeting on October 14, 2010, the Commission adopted a recommendation that the Department of Revenue, the Department of Labor, Department of Workforce Development, and the Workers’ Compensation Board submit, by November 1, 2010, a joint report in an electronic format under IC 5-14-6 to the Legislative Council concerning the following:

- (1) An estimate of the potential revenue recoverable annually by the state through the enforcement of existing statutory provisions concerning worker misclassification;
- (2) An estimate of the annual costs of enforcement to recover the revenue estimate provided in (1);
- (3) An estimate of the amount of additional potential expenditures for state benefits, such as unemployment insurance and workers’ compensation benefits, resulting from the reclassification of workers as employees as the result of the enforcement efforts described in (1); and

¹ Michael P. Kelsay and James I. Sturgeon, *The Economic Costs of Employee Misclassification in the State of Indiana*. A Report by the Department of Economics University of Missouri – Kansas City. (September 16, 2010).

- (4) Recommendations concerning the funding of the estimated annual enforcement costs provided in (2), including a mechanism for paying for the additional costs of enforcement and compliance.

This report represents the agencies joint effort to follow the recommendation of the Commission.

II. Estimate of Revenue Recoverable

Partially because of the limited time available to comply with the Commission's request, our review adopts the methodology, but revises the estimates provided in the *Building Trades* report. The *Building Trades* report is, to our knowledge, the most comprehensive study of the issue in Indiana, and provides a roadmap for estimating the financial impact of misclassification.

Our review concludes that the impact to general fund revenues and the unemployment insurance trust fund are far below the *Building Trades* report estimates. Estimating the impact on Workers' Compensation premiums is much more difficult, and is not attempted in this report. Although some states Workers' Compensation agencies receive premiums, deposit them into state held funds, and pay claims, in Indiana, those services and functions are performed through private insurers or self insured employers. While the authors of this report acknowledge that an argument could be made that the failure to correctly identify workers as employees and provide coverage has an impact on the cost of Workers' Compensation premiums, the impact is not to state funds.

A. Methodology

As in the *Building Trades* study, a logical first step in estimating the impact of misclassification in this report was to calculate the extent of employee misclassification. Or, in other words, estimate the percentage of the workforce that is misclassified. Professor Kelsay's methodology was to:

Calculat[e] the percentage of all audited employers who were found to be misclassifying, and appl[y] that rate to the total number of UI-covered employees in Indiana. Thus, *we assumed that the sample of employers selected for auditing was representative of all UI-covered employers in Indiana.*²

However, this method of calculating includes not only the randomly audited employers, but also targeted employers. We feel that doing so skews the sample numbers higher in two ways.

- 1) Skewed by industry – Because target audits, by definition, seek industries likely to have high levels of misclassification, to use a sample size which is over representative of industries likely to misclassify would result in an overestimation of the percentage of the total workforce which is misclassified.³

² Ibid page 39, emphasis added.

³ For example, in 2008, construction, often regarded as the industry with the highest misclassification rate, made up approximately 17.3% audit of the sample size, yet only approximately 5.25% of the total workforce.

- 2) Skewed by employer – Because target audits are performed on employers likely to misclassify, to assume that the rate of misclassification at targeted employers is likely to hold up across all employers would conflict with the studies own recommendation to continue a high percentage of targeted audits.⁴

Including the target audit numbers as part of the representative sample is an integral part of the *Building Trades* report estimates as the resulting “misclassification rate” is used in nearly every estimate included in the report.⁵

We think the more reliable method is to exclude the target audit numbers and look only to random audit findings. Doing so ensures that the sample is truly random. Second, because some industries are more likely to misclassify than others, instead of simply applying the rate of misclassification for the entire sample to the entire workforce, we used the industry classifications in the audit sample and applied the misclassification by the industry specific workforce.⁶

B. Volume of misclassified workers:

The *Building Trades* report suggests that as many as 15.3% of employees in Indiana were misclassified as independent contractors in 2008. This finding is based on audit results performed by the Indiana Department of Workforce Development (“DWD”) where 2,740 employer audits in 2008 resulted in 10,493 misclassified workers identified. These figures were reported per United States Department of Labor (“USDOL”) standards.

However, further review of the data determined that while 10,493 misclassified workers were found as a result of these audits, only 6,925 were unique to 2008. In other words, 3,568 employees were found to be misclassified in multiple years by the same employer. Using only the unique workers ensures that the rate is truly reflective of the employees misclassified in a given year. Further review of these misclassified workers and the industries in which they work concluded that a more reasonable number of misclassified workers equates to 8.06% of all employees reported.

⁴ Kelsay page 36, “As a result [of using target audits], IDWD is allocating the department’s scarce resources toward those industries and/or employers where the problem of misclassification has been shown to be most acute.” See also page 37, “(1) the State of Indiana should continue to perform a high degree of “targeted” audits on problem employers like those done in other states.” See also footnote page 48.

⁵ *Ibid.* Page 39. II. Calculating the Severity of the Impact of Employee Misclassification, “we assume that the audited employers found to be misclassifying can represent all misclassifying employers in Indiana.” See also page 39, III. Calculating the Extent of Worker Misclassification, “we calculated the percentage of workers misclassified as a percentage of all workers at the audited firms. We applied this percentage to the total number of UI-covered workers in Indiana.” see also page 39-40, IV Calculating Economic Loss in Unemployment Insurance Taxes, “We calculated an estimated average tax loss per worker as a result of misclassification in the audit results and assumed that these workers could stand as a proxy for all workers in Indiana,” see also page 40, V Calculating the Loss in Indiana Income Tax, “For workers statewide, we estimated the number of misclassified workers . . . and multiplied that by the estimated annual earnings for worker [sic] in Indiana.”

⁶ *Ibid.* Page 4.

C. Impact to General Fund Revenues:

1. Unreported Income

The *Building Trades* report's estimate of the percentage of income that is unreported by workers misclassified as independent contractors has been stated by report to be as high as 30-50%, which in turn results in as much as \$245.8 million in lost revenue to Indiana's general fund each year. We find this number to be extremely hard to justify.

Employers are required by federal law to report any individual to whom they have paid over \$600 for services as a non-employee. These informational returns are filed with the IRS. Second, income reported at the federal level is then cross matched with income reported at the state level. If there is a difference between income reported at the state and federal level, the state would issue a discrepancy.

Therefore, income paid to independent contractors is accounted for in the overwhelming majority of cases. Only in instances where both the employer and the worker fail to report this information are the wages paid completely unaccounted for.⁷

Our estimate is that approximately 5-7% of income is underreported each year and results in lost revenue of \$14-20 million annually, of which DOR could be expected to recover a substantial portion. This assessment is based on an estimate of the actual number of misclassified workers in each industry and the fact that the Indiana Department of Revenue ("DOR") works in cooperation with the Internal Revenue Service in matching 1099-MISC reports filed by employers to income tax return filed by individuals. Individuals who fail to report income that is reported on the 1099-MISC form are identified through this matching effort.

DOR can determine the amount of wages that are underreported when informational returns are filed. For calendar year 2006, the most recent year for which discrepancies have been billed, the total dollar amount was \$12.9 million. This amount includes all discrepancies between state and federal reporting, and is not limited to only 1099 reporting.⁸ These actual numbers are clearly more consistent with the methodology employed by this report than those of the *Building Trades* report.

Further, the *Building Trades* report treats "underreported income" as if it is the same thing as lost revenue. The report seems to suggest that no underreported income is recoverable by the state. In reality, DOR does pursue situations where a discrepancy exists, and in 2006 collected from about 65% of the filers that were determined to have underreported.

⁷ Neither this report nor the *Building Trades* report attempts to estimate the amount of revenue lost due to tax evasion.

⁸ For example, a discrepancy would be issued if an individual reported \$43,000 in adjusted gross income on their federal return, but transposed the numbers and reported \$34,000 on their state return.

2. Differing Definitions of “Employee”

In estimating lost income tax revenue, there is one further inadequacy in using the DWD audit numbers. As was discussed in the *Labor* report, DWD and DOR use different standards to determine who is an “employee.”

Services performed by an individual for remuneration shall be deemed to be employment . . . *unless and until all the following conditions are shown* to the satisfaction of the department:

(1) The individual has been and will continue to be free from control and direction in connection with the performance of such service, both under the individual's contract of service and in fact.

(2) The service is performed outside the usual course of the business for which the service is performed.

(3) The individual:

(A) is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed. . . .⁹

While under the DWD test, the individual is an employee if *only one* of the three conditions is met, the IRS test is somewhat less likely to result in a worker being an employee. Under the IRS “20 factor” test:

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. *There is no “magic” or set number of factors that “makes” the worker an employee or an independent contractor, and no one factor stands alone in making this determination.* Also, factors which are relevant in one situation may not be relevant in another.¹⁰

While the DWD audit results do not contain sufficient information to apply the DOR standard to each audit result, it is clear that some reduction from DWD misclassification rates would be appropriate to determine the rate of misclassification for DOR purposes.^{11:12} This report does not suggest a specific amount or apply any reduction to its estimates. However, readers should be aware that the differing definitions are relevant to estimates of revenue loss.

⁹ IC 22-4-8-1(b), emphasis added.

¹⁰ Department of the Treasury. Internal Revenue Service. *Independent Contractor (Self-Employed) or Employee?* Available at <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>, emphasis added. Accessed October 30, 2010.

¹¹ For example, an emerging trend is to employ workers to do phone and internet based customer service type functions from their own home. While the IRS has generally treated these workers as Independent Contractors, these individuals would in many cases be considered employees for DWD purposes.

¹² Our analysis finds that while any worker determined to be an employee for DOR, DOL, or WCB purposes should also be an employee by DWD standards, a worker determined to be an employee by DWD standards would not necessarily be an employee for DOR, DOL or WCB purposes.

D. Impact to Local Tax Revenues

Applying consistent methodology but adjusting for the average local tax rate of 1.16%, the resulting estimate of lost local tax revenue would equal approximately \$4.7 – \$6.7 million annually.¹³

E. Department of Labor¹⁴

The Indiana Department of Labor has reviewed whether there is potential revenue recoverable through existing statutory provisions concerning employee classification. There is no revenue recoverable by the Indiana Department of Labor as the result of any increased emphasis or enforcement of worker misclassification from this agency or another agency. Any and all wages found to be due would be paid directly to the employee. Furthermore, the Indiana Department of Labor investigates such matters on a complaint made basis, and makes an independent review of the workers' classification, whether as an employee or an independent contractor. This is true whether the investigation is undertaken by its Wage and Hour division or its Indiana Occupational Safety and Health division. Accordingly there is no state revenue to be gained by the Indiana Department of Labor.

F. Workers' Compensation Board

As was stated above, because the Workers Compensation Board does not hold the premiums paid or directly pay claims, the impact to the system is much more difficult to project and would require expertise and research not available for this report.

The Workers Compensation Board does have a newly created position, titled Director of Enforcement. That position seeks out employers who are not meeting their statutorily mandated obligation to provide coverage for their employees. This includes situations where the employer is claiming workers are independent contractors incorrectly. However, there are few tools available to the Board to ensure compliance, even when the failure is clear. The original *Labor* report recommended enhancing the tools available to the Workers Compensation Board to require employers to cover their employees. We reaffirm that recommendation.

III. Estimate Cost of Enforcement

DWD's field auditing unit employs 33 staff to enforce the provisions of Indiana law that govern the unemployment insurance premium system. The execution of employer audits that are intended to identify misclassified workers has not historically generated sufficient increased contributions to justify the cost of the enforcement activities. DWD's auditing unit relies on

¹³ Kail M. Padgitt, Tax Foundation, *2011 State Business Tax Climate Index*. (October 2010). Available at <http://www.taxfoundation.org/files/bp60.pdf>. Accessed November 8, 2010. Compare with 1.86% used to estimate local tax revenue loss in the Building Trades study.

¹⁴ The role of the Indiana Department of Labor under existing statutes is minimal given the organization and structure of the executive agencies in Indiana. Labor departments across the country that have been tasked with these goals typically have both workers compensation and workforce development/unemployment insurance within those agencies. In Indiana, all three of these agencies are separate, independent executive branch agencies.

gains from other areas of enforcement, such as SUTA dumping investigations to financially justify their work.¹⁵ While the agency will continue investigating employer misclassification, per USDOL standards, any additional effort should be focused on investigating areas that prove to have the greatest return for the Unemployment Insurance Trust Fund.

Similarly, DOR finds that the return on investment for additional auditing would be in the sales tax area. During Fiscal Year 2010 the average assessment per auditor for individual income tax was \$5,146. Assuming the average auditor would cost approximately \$50,000 in wages and benefits, a positive return on investment is unlikely.

IV. Additional Benefits Payable

The *Building Trades* report estimated a \$36 million loss in revenue to the Unemployment Insurance Trust Fund in 2008. Our analysis of the data has found that while there may be additional revenue from auditing worker classification, the report failed to recognize the cost of further enforcement as well as the cost of providing UI benefits to the misclassified employees who would have collected benefits.

The results of employer audits performed by the Department of Workforce Development in 2008 resulted in 10,493 employees being identified as misclassified as independent contractors. The *Building Trades* report used this number as a starting point for determining lost revenue. However, of these employees found, 6,925 were unique to 2008 with the remainder being employees that were also misclassified in prior years. In order to properly analyze the impact on an annual basis the unique number of misclassified workers should be used.

The cost of providing unemployment insurance benefits to misclassified employees must be considered when determining the true impact on the unemployment insurance trust fund on an annual basis. The chart below summarizes the premiums and expenses to the unemployment insurance system in 2008 and has been derived based on methodology employed by Planmatics, Inc. in their comprehensive report of the impact of employee misclassification.^{16:17} Planmatics, Inc method assumes that employee misclassification is 1% of the total covered workforce. Indiana's misclassification percentage in 2008 was 8.06% and the calculation has been adjusted accordingly. The net result shows that the additional benefits paid from correct classification would exceed the additional revenues by approximately \$35.5 million for 2008.

¹⁵ State Unemployment Tax Act dumping is a process where employers, to avoid higher tax rates, get multiple account numbers with a state unemployment insurance agency, and shuffle employees around to the account number with the lowest unemployment insurance rate each year. Another common scheme is to buy a business with a lower unemployment insurance rate and shuffle employees to that other business to pay the lower tax rate.

¹⁶ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. (February, 2000).

¹⁷ 2008 proves to be an appropriate year for analysis using this method as Indiana had not yet realized the impact of the current economic downturn but was a period where sustained growth had slowed, thus 2008 was neither a recessionary or recovery period.

TABLE 1

Tax Calculation		2008
1	Average Monthly covered employment	2,863,000
2	Contributions for the year	\$545,386,000
3= (2/1)	Annual contributions per covered worker per year	\$190
4= (8.06% of 1)	Number of misclassified workers	230,758
5= (4x3)	UI contributions not paid by employers	\$43,958,112

Benefit Calculation		
6	Number of first payments	229,933
7	Benefits paid for the year	\$986,000,000
8= (7/6)	Average benefits paid per first payment	\$4,288
9= (6/1)	First payment recipients/covered employment	8.0%
10= (4x9)x8	Estimated payments not made to claimants due to misclassification	\$79,471,600
11= (5-10)	Net potential effect on UI Trust Fund	\$(35,513,488)

Furthermore, an analysis performed assuming the premium structures established in HEA 1379 found that the gap between revenues and benefits paid would likely be reduced, the impact on the trust fund remained negative. Therefore, if the analysis were strictly financial, the conclusion would necessarily be that eliminating misclassification would have a negative impact on the unemployment insurance trust fund.

V. Recommendations for additional funding

As was stated in the original *Labor* report, though there are some expected costs expected from carrying out the activities recommended therein, given the financial realities facing the state's budget, the agencies are prepared to absorb the cost of those functions without additional funding.

VI. Conclusion

Our report estimates that the impact to state and local income tax revenue and the unemployment insurance trust fund is far below those of the *Building Trades* report. We estimate that Indiana may lose between \$14 and \$20 million annually in state general fund revenue, of which a substantial portion could be expected to be recovered by DOR, and approximately another \$5 - \$7 million in local income tax revenue annually. In addition, while it is our view that unemployed workers who meet the eligibility requirements for unemployment benefits should receive them, there is no net negative impact to the trust fund from misclassification. Indeed, our estimates, based on a report for the USDOL, indicate that the additional benefits payable from the trust fund would exceed the revenues to the trust fund should all workers be classified correctly.

Further, the Department of Revenue and the Department of Workforce Development have determined that auditing in other areas of their respective agencies would yield higher return on investment than would strictly auditing worker classification.

While our estimates of the revenue loss from misclassification differ greatly from the *Building Trades* report, it is our shared belief that implementing cost effective strategies to reduce misclassification can only be positive for law abiding employers, workers, and government revenue. While the estimates of economic impact differ, the recommendations contained in both studies are strikingly similar.¹⁸ We think it especially important to point out that neither report recommends additional auditors.

Additionally, the authors of this report think it is important to express our joint belief that many employers who misclassify employees do so innocently, and without the intent to avoid tax obligations or stifle worker rights. Indeed, in many situations, both the employer and employee may willingly enter into the arrangement, thinking the consent of the two parties is the only relevant consideration. Heavy handed penalties will have little impact on these employers.

While the agencies would be prepared to carry out any statutory directive from the legislature, we do not recommend any legislative action, other than what was suggested by the *Labor* report. Though there will be minimal cost associated with adopting the recommendations, our agencies are prepared to absorb the cost of these additional functions.

¹⁸ Kelsay. Page 47. “As a beginning, we recommend the following steps for consideration by policy makers and public officials in Indiana: (1) the State of Indiana should continue to perform a high degree of “targeted” audits on problem employers like those done in other states, (2) develop meaningful penalties to deter those employers who intentionally and/or repeatedly violate state laws on misclassification, (3) review current authorities and procedures for the collaboration among revenue, labor, and enforcement agencies so that violations of state statutes will receive a comprehensive and coordinated response with the intent of recovering all payroll-related funds that are due and of deterring future willful violations, and (4) expand outreach to educate employers and employees about classification rules.” Compare with the *Labor* report recommendations on page 1 of this report.