

**Iowa**  
**Misclassification**  
**Task Force**  
**2<sup>nd</sup> Report**

**December 30, 2010**



## TABLE OF CONTENTS

|   | <b>Page</b> |
|---|-------------|
| <b>Executive Summary .....</b>                                | <b>1</b>    |
| <b>I. Background and Purpose .....</b>                        | <b>2</b>    |
| <b>II. Misclassification Unit Accomplishments .....</b>       | <b>3</b>    |
| <b>III. Ongoing Unemployment Insurance Unit Efforts .....</b> | <b>6</b>    |
| <b>IV. Federal/Intra-State Efforts .....</b>                  | <b>9</b>    |
| <b>V. Conclusion .....</b>                                    | <b>10</b>   |

## EXECUTIVE SUMMARY

An interagency Misclassification Task Force was created in July of 2008 to study the problem of worker misclassification in Iowa. The Task Force's work culminated in a December 2008 report presenting several recommendations, including: a budget commitment to enhanced enforcement; educating Iowa's workers and businesses about the problems associated with misclassification; and improved sharing of information between state agencies.

The Iowa Legislature awarded \$500,000 in state general appropriations and potential use of \$250,000 from the penalty and interest fund to fund enhanced enforcement efforts for the 2010 and 2011 fiscal years. The funds were used to set up a special Misclassification Unit within Iowa Workforce Development (IWD) to carry out the Task Force's recommendations.

What the Task Force learned over the last 18 months (July 1, 2009 through December 30, 2010) is that the impact of misclassification is broad and deep. Thousands of Iowa workers have been denied the benefits accorded "employees," including unemployment benefits and workers' compensation protection, among others. The more than 72,000 law-abiding Iowa employers that report wages quarterly and pay unemployment insurance and other taxes owed, have been put at a competitive disadvantage by some 230 employers who have skirted the law by misclassifying workers as "independent contractors." Specific details on these finds and the accomplishments of the Misclassification Unit and the Task Force are set forth below.

**Outreach/Education Efforts:** The Misclassification Unit within Iowa Workforce Development has reached thousands of businesses and workers to educate them about misclassification. The Unit set up a misclassification web site to assist in that education effort. Other state agencies have set up links to that home page, which has been accessed by thousands of users. Similarly, hundreds of Iowans have attended 53 seminars around the state to educate businesses and workers about the problems associated with misclassification.

**Unreported Wages, Unpaid Unemployment Insurance Taxes, Penalties & Interest:** Because of the record high unemployment rate facing Iowa, and the corresponding need to ensure all employers were paying their obligated unemployment insurance taxes in order to protect the Unemployment Insurance Trust Fund and keep unemployment tax rates as low as possible -- the initial focus of misclassification enforcement efforts was on unemployment tax obligations. For the first 18 months of operation (July 2009 through December 2010), it was discovered that 230 employers failed to report more than \$61 million in wages for unemployment insurance tax purposes, resulting in assessments of almost \$2.5 million in unpaid employment insurance taxes, penalties and interest.

**Referrals, Information-Sharing Between Other State Divisions, Agencies:** After the Misclassification Unit finalizes their investigations, they refer cases to the Division of Labor's Contractor Registration program, the Iowa Workers' Compensation Division, and the Iowa Department of Revenue to determine what obligations are owed under those laws and programs. Similarly, those entities share information with the Misclassification Unit. IWD also signed an agreement with the Internal Revenue Service that also allows for the transfer of information related to misclassification.

**Coordination with National, Other State Officials:** Iowa has been asked to share misclassification information and enforcement strategies with federal labor officials and numerous states interested in establishing their own misclassification units.

## **I. BACKGROUND AND PURPOSE OF THE TASK FORCE**

A. **Employee Misclassification Defined:** Employee misclassification occurs when a worker is improperly denied the benefits and protections provided to “employees,” as that term is defined by state and federal law. Workers who are classified as employees receive a wide range of legal protections, including eligibility for unemployment insurance benefits if they are laid off, workers’ compensation protection if they are injured on the job, and the right to be paid minimum wage and overtime pay. Employees have the benefits of other employment and labor laws, such as family medical leave and protection under discrimination laws. Employers with employees are required to obtain workers’ compensation insurance, report wages and pay corresponding unemployment insurance taxes, social security, and withhold state and federal income taxes.

There are two primary forms of worker misclassification – characterizing someone as an “independent contractor,” or paying a worker “off-the-books” for work performed.

1. **Misclassification as an independent contractor.** The first form of misclassification occurs when a worker who meets the legal standards for classification as an “employee” under state and federal law is instead misclassified as an “independent contractor.” Iowa uses the “common law test” to determine who is an employee and who is an independent contractor. The common law test focuses primarily on how much “direction and control” an employer has over the worker. Many of the relevant factors used to assess “direction and control” for unemployment insurance, workers’ compensation, OSHA, wage and contractor registration purposes are similar to the 20 factors used by the federal Internal Revenue Service and relied upon by the Iowa Department of Revenue. Employers issue their employees a W-2 form at the end of the year. By contrast, workers who are classified as “independent contractors,” are issued a “Form 1099” for tax reporting purposes and the employer is not responsible for unemployment insurance, social security and income taxes, or providing workers’ compensation insurance.
2. **Unreported or “off-the-books” work.** This form of misclassification occurs when employees are paid “off-the-books,” or “under-the-table,” and there is no reporting for social security, income tax, and unemployment insurance purposes. These workers may be employed by employers that do not register with state and federal taxing agencies and do not purchase workers’ compensation insurance. Others may work for employers that register with state and federal taxing authorities, but underreport the number of workers they employ.

The Misclassification Unit found that the attraction for desperate workers in these tough economic times to get paid “off the books” or take “cash under the table” wears

off when the worker discovers they cannot get unemployment insurance benefits when laid off, or workers' compensation benefits when they are injured on the job, or owe a large income tax bill at the end of the year. Similarly, Iowa's law-abiding employers have grown increasingly frustrated by being underbid by unscrupulous employers that are not paying their share of unemployment insurance, income taxes and providing workers' compensation and other benefits to their employees.

B. Governor's Executive Order No. 8 Creating Iowa's Misclassification Task Force: Iowa Governor Chet Culver's July 2008 Executive Order created the Misclassification Task Force. Its members included:

- Elisabeth Buck, Director, Iowa Workforce Development – Chair
- Mark Schuling, Director, Iowa Department of Revenue
- David Neil, Labor Commissioner, Iowa Workforce Development
- Thom Hart, Iowa Department of Economic Development
- James C. Larew, General Counsel, Office of the Governor and Lt. Governor

The Task Force was charged with: reviewing Iowa's laws and regulations, assessing existing methods of dealing with misclassification, recommending regulatory/statutory changes, and developing a plan to address and prevent misclassification in Iowa. Three sub-committees were formed: research, legal, and education/communication. The Task Force conducted five meetings and one public hearing before issuing its first report on December 17, 2008. That report included six recommendations to the Governor:

1. Budgetary commitment to enhanced enforcement.
2. Critical public education, communication and employee training.
3. Regulatory review for state agency information sharing.
4. Data sharing agreement with the IRS.
5. Research potential statutory definition changes.
6. Reconvene the Task Force to review outcomes.

## **II. MISCLASSIFICATION UNIT ACCOMPLISHMENTS**

A. Consultations, Outreach and Education: One of the charges of the Misclassification Unit is to conduct outreach and provide educational information about worker misclassification to the public, inclusive of employers and workers. Educational materials have been developed and are widely distributed. A total of 53 of presentations have been given since July 2009. Participants at these presentations included attorneys, accountants, payroll processors, human resource professionals, employers in various industries, workers and workers' organizations. This outreach has been achieved through contact with the local Employer Council of Iowa (ECI) groups, professional organizations, chambers of commerce, and others.

Attendance at these presentations has ranged as high as 200 participants per presentation. Each presentation encourages questions and reports of possible

misclassification, which were provided during the public presentation or privately afterwards. Very positive feedback has been received from these presentations, and has included invitations to speak to organizations at future events. The word is spreading far and wide that Iowa takes misclassification seriously and the message is being received.

- B. Brochures: The Misclassification Unit created a brochure which includes basic information on the topic as well as contact information for reporting misclassification of workers. These brochures, along with the IRS brochure on the same subject and the Contractor Registration brochure, were provided at all misclassification presentations this past year. The brochure is also posted as a link on the IWD website.
- C. Misclassification Report Form: The Misclassification Report Form (<http://www.iowaworkforce.org/misclassification/69-0009.pdf>) was established in September 2009. It allows anyone to report the misclassification of workers. The form can be submitted electronically, faxed, or mailed to the Misclassification Unit. The individual or entity completing the report has the option of remaining anonymous. The forms ask for information about the location where worker misclassification may be taking place, the alleged employer and the statement of facts regarding the alleged violations.
- D. Website: The Misclassification Unit website within IWD includes general information (<http://www.iowaworkforce.org/misclassification>), frequently asked questions (FAQs), and the reporting form. Contact information is also clearly provided so that interested persons can easily reach the Misclassification Unit with information regarding possible misclassification or other concerns. Presentations that are open to the general public are also listed on the website, as are the brochures. Also included on the misclassification website are links to contractor registration, workers' compensation, the Iowa Department of Revenue and the Internal Revenue Service. These are all sources of information that may be useful to individuals in gaining clarification on the worker misclassification issue.

The Misclassification Unit home page also includes copies of court decisions under the title "Misclassification Appeal Decisions." The website link is (<http://www.iowaworkforce.org/misclassification/decisions.htm>). There are several types of decisions on the website. The first section contains decisions of administrative law judges hearing appeals of IWD determinations on employer/employee relationships and/or independent contractor issues. These administrative law judge decisions become the final action unless an employer or worker appeals to Iowa District Court. The website includes administrative law judge decisions on misclassification issues for the years 2008-2010.

Also posted are other selected court cases which addressed employer-employee relationships or involved misclassification of workers. Some are in the context of workers' compensation or wage payment law. These administrative law and court decisions can be readily accessed by lawyers and others as needed. They provide timely education and insight to guide employers and their advisors.

- E. Initiation of Misclassification Cases: The Misclassification Unit, comprised of a manager, an attorney, three field auditors, two investigators and an administrative

assistant, was created in the summer of 2009 after the general fund appropriation was received. Since its creation, the Misclassification Unit has received 1,016 worker misclassification tips, leads and referrals from workers, businesses and government agencies. Since establishing a hotline and an online misclassification reporting form, the Unit has received 342 emails, phone calls, faxes and walk-in's reporting potential worker misclassification.

Field auditors and investigators in the Unit created 611 leads from random worksite visits and the financial statements of employers who were found to be misclassifying workers. Many times employers found to be misclassifying workers provide the names of other employers who are engaged in the same illegal practice. Tips often come from businesses frustrated when they are underbid on projects by companies engaged in unlawful misclassification.

Iowa's contractor registration law and related application process yielded 31 cases for the Misclassification Unit through December 30, 2010. Iowa's contractor registration law requires that eligible contractors provide proof of workers' compensation insurance and compliance with Iowa's unemployment insurance law before a contractor registration number is issued. The Misclassification Unit checks for compliance with unemployment insurance law. The 31 cases were initiated when the contractor applying for a contractor registration supplied inaccurate or incomplete information. In most instances, misclassification auditors and investigators were able to educate the employer before they began their business and get them correctly reporting wages and paying related unemployment taxes before any worker misclassification occurred – a laudable goal.

In addition, the Misclassification Unit received 32 referrals from the Iowa Department of Revenue, IWD's Workers' Compensation, OSHA, Wage and Hour, and Contractor Registration divisions when investigators and inspectors in those areas became suspicious after being advised by employers that they did not have any employees or only used independent contractors.

- F. Misclassification Unit Processes and Unemployment Insurance Tax Results: The initial focus of the Misclassification Unit is to determine if workers are being appropriately classified as "employees" or "independent contractors," and if there are related unemployment insurance tax obligations. With a record high unemployment rate and a need to protect Iowa's unemployment insurance trust fund, a decision was made to focus on unemployment insurance tax issues first, with referrals then made to income tax, worker's compensation, wage and other agencies as appropriate.

A misclassification investigation is initiated when workers, businesses, or government agencies provide the Unit with a tip, referral, or lead. The Misclassification Unit creates and assigns a file to the appropriate field auditor or investigator within the Misclassification Unit for every tip, referral, and lead received. Assigned files are not prioritized and their completion depends upon the complexity of the issues, the level of evidence gathered, and the cooperation of the worker and employer. The auditor or investigator will base his or her determination on all available evidence. The employer ultimately receives a determination letter in the

mail advising them if workers have been misclassified and if any unemployment insurance taxes, related penalties and interest are owed.

The Unit has 607 active worker misclassification investigations. Some of the industries included in the active cases are construction, agriculture, transportation, and retail.

Of the investigations completed from July 1, 2009 through December 30, 2010, the Misclassification Unit found 96 employers misclassified 2,058 workers. These employers failed to report \$55,381,313 in employee wages to Iowa Workforce Development for unemployment insurance tax purposes. The employers owe a total of \$2,427,413 for unpaid unemployment insurance tax, penalty and interest. The Collections Unit of the IWD Unemployment Insurance Division works with employers to collect the unpaid taxes and setting up payment plans as appropriate. While conducting investigations, the Misclassification Unit assisted contractor registration by securing 230 contractor registration applications, equaling \$11,500 in individual \$50 contractor registration fees.

The Unit believes those numbers will remain constant, if not increase, as it continues its second year of operation.

- G. Misclassification Unit Successful Appeal Outcomes: Of the 230 misclassification decisions issued in the last 18 months, only 23 cases were appealed to the Department of Inspections and Appeals for review by administrative law judges. As of December 30, 2010, decisions have been issued in 18 cases, all confirming the Misclassification Unit's decisions in whole or in part, or resulting in settlements that follow the Unit's analysis. Decisions are pending in four cases and one hearing is set for early January.

The success of these cases on appeal is grounded in the careful, detailed investigation and audit process of the Misclassification Unit staff. The investigators are thorough in their observations at the work site, including their interviews with workers and management. Field auditors are diligent in their review of often voluminous and complex financial records. The goal is to gather evidence from all interested parties to ensure a complete picture of the business operation and relationships between the employer and workers. The investigators and field auditors utilize their experience and expertise to build a comprehensive case that the unit's attorney can successfully defend if appealed.

### **III. ONGOING COLLABORATION WITH OTHER STATE AND FEDERAL DIVISIONS, AGENCIES**

The Misclassification Unit works cooperatively with other divisions within Iowa Workforce Development, including the Unemployment Insurance Tax Bureau, Contractor Registration, Occupational Safety and Health, Wage Payment and Workers' Compensation. The Unit has also established collaboration with the Iowa Department of Revenue, the federal Internal Revenue Service, and the U.S. Department of Labor.

Over the past 18 months, much progress has been made in overcoming the barriers that have prevented a coordinated enforcement effort. On a daily basis, the Unit plays an integral role in processing contractor registration forms to ensure that contractors understand their wage

reporting and unemployment insurance tax obligations. Wage payment and OSHA officials also confer as needed when there is a report of a misclassification concern in those programs.

After passage of a statute in the spring of 2010 that allowed for the sharing of misclassification-related information, Iowa Workforce Development and Iowa Department of Revenue executed a Memorandum of Understanding that allows both agencies to share information with each other about completed cases where misclassification problems have been discovered. The two agencies have begun that information-sharing process. In addition, when the Misclassification Unit completes its unemployment insurance tax investigation and the investigation has passed the appeal process, a referral is made to the Division of Workers' Compensation to pursue enforcement as appropriate if employers have not already purchased the required workers' compensation insurance.

- A. Iowa Workforce Development Unemployment Insurance Tax Bureau: The field auditors in IWD's Unemployment Insurance Tax Bureau provide education and services to more than 72,000 employers who report wages quarterly and pay related unemployment insurance taxes. Auditors also work with new employers to ensure they get unemployment insurance accounts set up correctly when they start business and understand their quarterly reporting and unemployment insurance tax payment obligations. The correct classification of workers is discussed with employers when the new unemployment accounts are set up. Similarly, if an employer attempts to inactivate their unemployment account, field auditors ask the necessary questions to determine if the employer downsized their business or is attempting to classify everyone as an independent contractor. In addition, the auditors also assist contractors who are registering for a contractor registration certificate, taking the time during the application process to educate employers on the differences between an independent contractor and an employee.

The Unemployment Insurance Tax Bureau auditors also conduct two kinds of audits that may lead to discovery of misclassification – “random audits” and what are known as “missing wage investigations.” “Random audits” occur when a computer program randomly selects businesses for audit – business that are currently registered on the unemployment insurance tax system. “Missing wage” investigations occur when a worker files for unemployment benefits and it is discovered the worker's alleged employer did not report wages, and pay corresponding unemployment taxes, related to the worker, and other workers in the same classification, because he or she was an alleged “independent contractor.”

Of the audits and missing wage investigations completed by the Unemployment Insurance Tax Bureau field auditors from July 1, 2009 through December 30, 2010, auditors found 134 employers misclassifying 544 workers. These employers failed to report \$5,692,181 in employee wages to IWD for unemployment insurance tax purposes. The employers owe a total of \$130,511 for unpaid unemployment insurance tax, penalty and interest. In addition, Tax Bureau field auditors assisted contractor registration by securing 136 contractor registration applications, equaling \$6,800 in individual \$50 contractor registration fees.

- B. Iowa Workforce Development Division of Labor - Contractor Registration: Iowa law requires that a contractor seeking registration with the Iowa Division of Labor show

proof of workers' compensation insurance, if needed, and compliance with Iowa's unemployment tax law before a registration is issued. A \$50 fee must be submitted with the contractor registration application, unless the contractor meets fee exemption requirements.

The Misclassification Unit and IWD's tax bureau auditors play a critical role in processing the contractor registration applications by reviewing the submitted applications to determine if the contractor is obligated to report quarterly wages and pay unemployment taxes. The goal is to ensure that all contractors are aware of their obligations up front.

There are currently 18,939 active registered contractors and 635 contractors who have completed the contractor registration application, but whose information is being verified by unemployment tax auditors to ensure compliance with Iowa's unemployment tax law. Contractor registration staff are currently investigating 5,266 employers whose registrations have lapsed to ensure these contractors are following all applicable state laws.

In addition to investigating lapsed contractor registrations, the contractor registration staff also makes referrals of potential misclassification abuses to the Misclassification Unit for determination of unemployment insurance tax obligations. The contractor registration program made 10 referrals to the Misclassification unit over the 18-month period of July 1, 2009, through December 30, 2010, of potential misclassification abuses they found during their investigations.

- C. Iowa Workforce Development Workers' Compensation Division: The Workers' Compensation Division and the Misclassification Unit are working closely to ensure employers who are confirmed to have employees are providing workers' compensation coverage for their employees. The Workers' Compensation Division is provided with information about employers the Misclassification Unit has found to have engaged in misclassification. The Workers' Compensation Division reviews this information and takes appropriate steps to determine if the employer is providing workers' compensation coverage as required under Iowa law. The Workers' Compensation Division has forwarded 21 files to the Attorney General's Office for prosecution as a result of this process.
- D. Iowa Department of Revenue: The Iowa Department of Revenue (IDR) similarly engages in comprehensive outreach and education efforts. During 2010, the IDR Taxpayer Services area conducted 483 classes, contacted 1,329 businesses, and made 3,432 phone calls to discuss sales, use, and withholding tax issues. Employee misclassification is a topic that is covered during these contacts.

IDR has received 52 case referrals from Iowa Workforce Development's Misclassification Unit and is reviewing those audit leads to determine the next course of action. IDR has developed the audit program logic and process that will be used to track the revenue established and collected for all of the audits referred from IWD. IDR is also reviewing its completed audits to determine if any would be good referral candidates to IWD.

- E. Internal Revenue Service: The Iowa Workforce Development Misclassification Unit has met with Internal Revenue (IRS) staff twice in the last 18 months to compare and contrast their processes and rules that are applied to determine employer-employee relationships or independent contractor status. Some 200 attendees at these events were able to benefit from the joint presentations that focused on misclassification and other topics.

In addition to collaboration on outreach and educational events, the Iowa Misclassification Unit has a Questionable Employment Tax Practices (QETP) agreement in place with the IRS that allows for data-sharing of misclassification cases. The agreement allows IWD to receive copies of IRS audit findings of Iowa businesses that reflect potential misclassification of workers for state unemployment tax purposes. The entities also schedule two meetings a year to review the data-sharing allowed under the QETP agreement.

#### **IV. Federal/Intra-State Efforts**

Iowa's efforts to address misclassification are being recognized by the U. S. Department of Labor and officials in other states. Iowa has been invited to participate in the following:

**U.S. Department of Labor State Misclassification Forum**: Iowa was one of eight states in the country invited to participate in the U. S. Department of Labor's May 27, 2010 "State Forum on Misclassification." The eight states included: Connecticut, Iowa, Louisiana, Maryland, Massachusetts, New York, Ohio and Washington. This "working group" meeting involved presentations by officials in the eight selected states from federal wage and hour and OSHA officials. Iowa Workforce Development Director Elisabeth Buck participated on a panel with representatives from New York, Massachusetts, and Connecticut. The program sessions focused on: targeted enforcement, interagency collaboration, data sharing and analysis strategies, business and community involvement, joint training activities, and potential collaboration between federal and state agencies.

**White House Task Force on the Middle Class**: Iowa was similarly invited in the Spring of 2010 to participate in two teleconference calls organized by the White House Task Force on the Middle Class to discuss misclassification concerns, strategies and enforcement efforts. What Iowa learned is that states differ somewhat on the structure and approach of their misclassification efforts. For example, states with state prevailing or overtime laws may initiate misclassification efforts through their wage program. Other states initiate their enforcement approach through workers' compensation programs. Some, like Iowa, start their initial efforts through their unemployment division. All agreed that the misclassification problem is broader and deeper than officials realized, and touches many different laws necessitating information-sharing between various programs and agencies. State officials concur that outreach and education efforts are critical to getting the misclassification message out to affected workers and to law-abiding businesses that are placed at a competitive disadvantage by misclassifying businesses.

**United States Department of Labor:** The U.S Department of Labor held a national forum in Dallas, Texas, to bring states together to discuss the issue of worker misclassification. The State of Iowa was a featured presenter, along with representatives from New York, Utah, and Louisiana. Iowa's Misclassification Unit Manager Jason Tryon presented on how the Misclassification Unit was created, its successes, and the obstacles we are working to overcome. The forum was an excellent opportunity for states to network and share their successes, ideas and issues. It also provided the U.S. Department of Labor with the opportunity to update states on proposed legislation and potential funding for states that are actively engaged in preventing worker misclassification.

**National Association of Government Labor Officials:** Misclassification was among the topics discussed at the July annual meeting of the National Association of Government Labor Officials. Iowa Labor Commissioner Dave Neil was the current president presiding over the meeting.

**Intra-State Efforts:** Several northeastern states, including New York, Connecticut and Massachusetts organized a misclassification telephone conference call within the last two years to discuss misclassification concerns and strategies. In the Spring of 2010, that group was expanded to include several additional eastern states, and the State of Iowa. Topics vary from individual state reports to draft legislation. In addition to participate in these calls, Iowa has been contacted by officials in numerous states about how the Iowa Task Force and Misclassification Unit was created, the unit's structure and initial results.

## **V. CONCLUSION**

During the last 18 months, the Misclassification Unit, with the support and direction of the Misclassification Task Force, has aggressively sought to educate business and workers about the dangers of misclassification and taken appropriate enforcement action to protect Iowa's workers and law-abiding businesses. We have opened lines of communication between government agencies and helped create an environment of coordination and collaboration. The Misclassification Unit looks forward to continuing to work on this critical issue.