

# Review of Employee Misclassification in Virginia



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**Report No. 427**

This report is available on the JLARC website at

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# COMMONWEALTH of VIRGINIA

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July 12, 2012

The Honorable John M. O'Bannon III  
Chair  
Joint Legislative Audit and Review Commission  
General Assembly Building  
Richmond, Virginia 23219

Dear Delegate O'Bannon:

Senate Joint Resolution 345 of the 2011 Session directed the Joint Legislative Audit and Review Commission (JLARC) to study the misclassification of employees as independent contractors in Virginia. Specifically, staff were directed to review the status and consequences of employee misclassification in Virginia, and to estimate the amount of revenue potentially lost to the State and to local governments. Staff were also directed to recommend strategies for alleviating misclassification.

The final report was briefed to the Commission and authorized for printing on June 11, 2012. On behalf of the Commission staff, I would like to thank the staff at the Virginia Employment Commission, the Virginia Workers' Compensation Commission, the Department of Taxation, the Department of Labor and Industry, and the Bureau of Insurance, State Corporation Commission for their assistance during this review.

Sincerely,

A handwritten signature in black ink that reads "Glen S. Tittermary".

Glen S. Tittermary  
Director

GST/mle



# Table of Contents

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|                             |  |    |
|-----------------------------|--|----|
| <b>JLARC Report Summary</b> |  | i  |
| <b>1</b>                    | <b>Misclassification Has Adverse Effects on Businesses, Workers, and Government</b>  | 1  |
|                             | Worker Classification Affects Rights and Obligations of Employers and Workers  | 2  |
|                             | Multiple Tests May Determine Whether a Worker Is an Employee   | 3  |
|                             | Misclassification Can Occur Due to Confusion or an Intention to Avoid Costs  | 8  |
|                             | Other States Have Found Misclassification to Be Pervasive, Especially in Certain Industries  | 8  |
|                             | Four Virginia Agencies Are Involved With the Issue of Misclassification  | 10 |
| <b>2</b>                    | <b>Misclassification Creates Unfair Competitive Advantage and Adversely Impacts Workers</b>  | 13 |
|                             | Misclassification Creates Unfair Competitive Advantage   | 13 |
|                             | Misclassification Adversely Impacts Workers  | 18 |
| <b>3</b>                    | <b>Misclassification Occurs in Virginia, but Full Extent Is Unknown</b>  | 21 |
|                             | Extent of Misclassification Is Difficult to Quantify Because of Data Limitations   | 21 |
|                             | One Percent of Virginia Employers Were Audited, of Which a Quarter Misclassified Workers in 2010   | 22 |
|                             | Misclassification Rates From Other States Provide Rough Estimate of the Extent of Misclassification in Virginia                                    | 25 |
| <b>4</b>                    | <b>Misclassification Can Reduce State Revenues</b>   | 29 |
|                             | Fiscal Impact of Misclassification on State Stems From Foregone Income Taxes on Underreported Income   | 30 |
|                             | Unpaid Workers' Compensation Premiums and Unemployment Taxes Due to Misclassification Affect State-Administered Programs, but not the General Fund | 32 |
|                             | Misclassification Appears to Have Little Effect on Virginia Local Governments  | 34 |

|          |   |           |
|----------|---|-----------|
|          | Indirect Effects Could Be Sizeable but Are Difficult to Quantify                      | 34        |
| <b>5</b> | <b>Prevention, Detection, and Enforcement Strategies May Reduce Misclassification</b> | <b>37</b> |
|          | Prevention Strategies Attempt to Address the Root Causes of Misclassification         | 38        |
|          | Detection Strategies Attempt to Target Misclassifying Employers                       | 41        |
|          | Enforcement Strategies Promote Proper Classification                                  | 44        |
| <hr/>    |   |           |
|          | <b>JLARC Recommendations</b>  | <b>49</b> |
| <hr/>    |   |           |
|          | <b>Appendixes</b>   |           |
|          | A: Study Mandate  | 51        |
|          | B: Research Activities and Methods  | 53        |
|          | C: Responsibilities of Employers Toward Employees Versus Independent Contractors      | 61        |
|          | D: Industry Code (NAICS) Descriptions   | 63        |
|          | E: Examples of Misclassification Flyer and Complaint Form                             | 65        |
|          | F: Agency Responses   | 69        |
| <hr/>    |   |           |

# JLARC Report Summary:

## Review of Employee Misclassification in Virginia

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### Key Findings

- Employers who properly classify workers pay higher payroll costs and may be less competitive in their respective industries than employers who misclassify. Misclassified workers are often denied a variety of legal rights and benefits. (Chapter 2)
- A Virginia Employment Commission (VEC) audit of one percent of Virginia employers found 5,639 workers were misclassified in 2010. Based on findings in other states, Virginia could have on the order of 40,000 misclassifying employers and 214,000 misclassified workers. (Chapter 3)
- Worker misclassification lowers Virginia's income tax collections, leading to estimated foregone revenues on the order of \$1 million for workers identified during VEC audits and \$28 million based on other states' findings. VEC and the Virginia Workers' Compensation Commission may also forego revenue as a result of misclassification, but local government revenues are not affected. (Chapter 4)
- A comprehensive approach to the problem of worker misclassification would include strategies to prevent misclassification before it happens, find it when it occurs, and penalize employers who misclassify. (Chapter 5)

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Correct classification is important for employers, workers, and the State. Misclassification occurs when an employer improperly classifies a worker as an independent contractor instead of an employee. This can happen when the employer or worker does not understand the legal distinctions between employees and independent contractors, or when an employer wishes to avoid paying certain taxes and benefits on the worker's behalf. Employees have taxes withheld from their paychecks and have legal protections such as the minimum wage law, unemployment benefits, and workers' compensation insurance. Independent contractors are generally responsible for paying all of their own taxes and benefits, and are often not eligible for legal protections.

The General Assembly acknowledged these concerns by adopting Senate Joint Resolution 345 in 2011 (Appendix A). The study mandate directs the Joint Legislative Audit and Review Commission (JLARC) to review the status and consequences of employee misclassification in Virginia, estimate the amount of revenue po-

tentially lost to State and local governments, and recommend strategies for alleviating misclassification.

## **MULTIPLE TESTS MAY BE USED TO DETERMINE WHEN A WORKER IS AN EMPLOYEE**

Generally, a person who performs services for an employer is an employee if the employer can control both *what* will be done and *how* it will be done. The key factor is that the employer has the right to control the details of how the services are performed, even if the employee has substantial freedom of action.

By contrast, an independent contractor performs services required by an employer but is not subject to the employer's control with regard to how the services are performed. Independent contractors may have a written contract, but this is not a legal requirement in Virginia, and neither the presence nor absence of a contract is sufficient to prove the status of the worker. Instead, the nature of the relationship between the worker and employer determines the worker's proper classification.

Different tests to determine proper worker classification may be used to comply with the various laws involved with employment. The complexity of defining the employee-employer relationship is illustrated in Virginia's statutory definition of employment, which also provides numerous exclusions. Most truck owner-operators are statutorily defined as independent contractors, for example. Other statutes exclude a variety of other workers from the definition of employee, such as taxi drivers, certain fee- or commission-based sales personnel, and summer camp workers.

Four State agencies address aspects of worker misclassification although none of them focuses on the issue. The Virginia Employment Commission (VEC) audits a small percentage of employers for compliance as part of the State and federal unemployment insurance program. When misclassified workers are found, the employer is required to pay any previously unpaid taxes with interest, but no penalties are levied or imposed due to misclassification *per se*.

The Department of Labor and Industry (DOLI) receives some complaints about misclassification, which it investigates and attempts to resolve. Virginia Workers' Compensation Commission (VWC) staff may identify misclassification when resolving claims about workplace injuries. According to staff at the Virginia Department of Taxation (TAX), most income taxes are eventually collected from misclassified workers as long as employers file the required tax forms. Consequently, TAX does not focus specific efforts on preventing or detecting misclassification.



## **EMPLOYERS WHO MISCLASSIFY ENJOY UNFAIR COMPETITIVE ADVANTAGE AND INCREASE COSTS FOR EMPLOYERS WHO PROPERLY CLASSIFY**

Employers who misclassify can save significantly in payroll costs. Studies in other states reported that these savings can range from ten to 40 percent. As an example, a Virginia employer in the construction industry could save an estimated 26 percent of payroll costs by classifying an average-wage construction worker as an independent contractor instead of an employee. In industries where competitive bidding occurs, misclassifying employers may be able to underbid their competitors due to their lower payroll costs, leaving employers who properly classify unable to compete.

Employers who properly classify their workers may also face higher costs when unemployment tax and workers' compensation insurance rates are adjusted upwards to cover costs incurred by misclassified workers. Under certain circumstances, unemployed or injured workers who were misclassified and who should have been classified as employees can be eligible for benefits under these programs. When employers misclassify, they do not pay for these benefits for their workers. Therefore, workers' compensation insurance premiums and unemployment tax rates for employers who properly classify workers may subsequently be adjusted upwards to recover the costs. This further increases labor costs and places these employers at an even greater competitive disadvantage.

## **MISCLASSIFIED WORKERS MAY LACK ACCESS TO BASIC EMPLOYMENT PROTECTIONS AND BENEFITS**

Misclassifying workers as independent contractors denies these individuals certain mandatory benefits and protections, as well as benefits employers may voluntarily provide to employees. Many federal and State employment laws apply only to employees, not independent contractors. For example, independent contractors are not eligible for workers' compensation and unemployment benefits, which can be financially disastrous for a worker who is injured or laid off. Independent contractors are also not covered by laws related to minimum wage and overtime pay, family and medical leave, protection from discrimination in the workplace, and occupational safety and health. Independent contractors also generally do not receive employer-paid benefits such as health insurance or retirement, nor do their employers withhold taxes or make Social Security and Medicare tax payments on their behalf. As a result, their access to health care and adequate retirement savings may be compromised.

## **EXTENT OF MISCLASSIFICATION IS DIFFICULT TO QUANTIFY BECAUSE OF DATA LIMITATIONS**

As noted, VEC staff conduct audits of employers to ensure the proper payment of unemployment insurance taxes. These audits are the only data available on misclassifying employers and misclassified workers in Virginia.

The method used by VEC to select employers for audit does not allow for generalizations to be made about the entire employer population, however. For example, more than a third of the audits conducted in 2011 were of construction employers, because VEC staff believe misclassification is more common within this industry. Other employers were chosen for audit because of prior audit findings. This targeted auditing approach can be fruitful and enables VEC to efficiently utilize their resources, but it assumes that the incidence of misclassification among audited employers should be higher than among the general employer population. Thus, generalizing from these audits to Virginia's entire employer and worker population would not be methodologically sound.

To gauge the extent of misclassification, JLARC staff therefore used data from Virginia audits along with data from other states where audits were conducted using different methods that permit generalization.

## **ABOUT 580 VIRGINIA EMPLOYERS ARE KNOWN TO HAVE MISCLASSIFIED MORE THAN 5,600 WORKERS IN 2010**

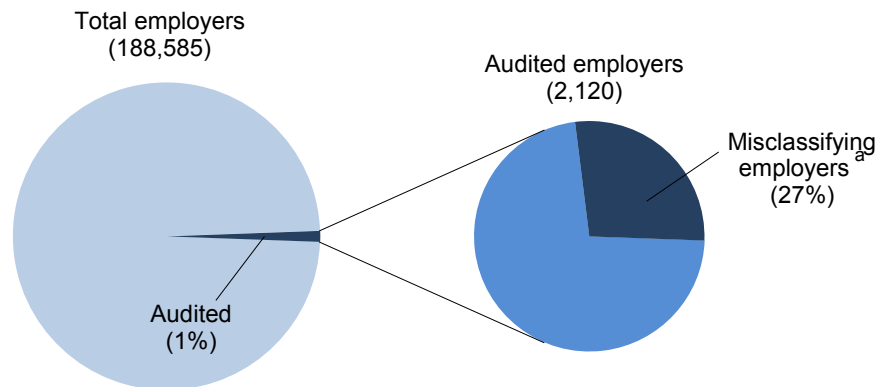
VEC audited 2010 data from one percent (2,120) of Virginia's 188,585 employers and found that 27 percent (584) misclassified at least one worker (see figure, next page). Of the employers known to misclassify, most (68 percent) misclassified fewer than six workers while 20 percent misclassified more than ten workers. The highest proportion of misclassifying employers was in the administration and support, waste management, and remediation services industry.

The audited employers had a total of 5,639 misclassified workers. The highest proportion of misclassified workers was in three industries: Real Estate and Rental and Leasing; Transportation and Warehousing; and Administrative and Support and Waste Management and Remediation Services.

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## Twenty-Seven Percent of Audited Employers Misclassified Workers in 2010, According to Virginia Employment Commission

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<sup>a</sup>At least one worker was misclassified by these employers.

Source: JLARC staff analysis of Virginia Employment Commission data.

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### **BASED ON OTHER STATES' ESTIMATES, VIRGINIA COULD HAVE ON THE ORDER OF 40,000 MISCLASSIFYING EMPLOYERS AND 214,000 MISCLASSIFIED WORKERS**

A statewide estimate of misclassification was developed by applying the average of misclassification rates estimated by selected other states to Virginia's total employer and employee population. Based on these estimates from other states, there could be on the order of 40,000 misclassifying employers and 214,000 misclassified workers in Virginia. The average rate at which employers misclassify was estimated to be 21 percent by states whose data could be generalized to all employers. These same states found that an average of six percent of workers were misclassified. While there are limitations with the other states' data, these rates were selected as proxies for Virginia statewide misclassification rates because results from random selection are more likely to be representative of a state's employer and employee population. Still, these estimates do not capture the precise extent of misclassification, which could be either higher or lower because of the numerous assumptions made by other states and JLARC staff.

### **MISCLASSIFICATION COULD HAVE COST STATE GENERAL FUND ON THE ORDER OF \$28 MILLION IN 2010**

Misclassification appears to negatively affect State general fund revenue primarily by lowering income tax revenue. Misclassification does not cause workers to underreport income or underpay taxes, but it can facilitate workers' tendency to do so because income taxes are not automatically withheld from their compensation and misclassifying employees are less likely to file the required tax documentation. Underreporting income and

underpaying taxes constitute tax evasion, which is a far broader issue than misclassification.

Using tax compliance findings from an Internal Revenue Service study, JLARC staff estimated that misclassified workers who underreport income may lower income tax collections and reduce Virginia's general fund on the order of \$1 million for those workers known to be misclassified and \$28 million for the estimated number of misclassified workers based on other states' data. These estimates are provided to illustrate the magnitude of additional income tax revenue the State could receive in future years if steps were taken to prevent or reduce misclassification.

### **OTHER STATES USE MULTIPLE STRATEGIES TO REDUCE MISCLASSIFICATION**

Other states use a variety of strategies to prevent and detect misclassification and enforce proper classification of workers. Prevention efforts have centered on bringing the issue of misclassification into focus, as well as clarifying definitions and educating workers and employers who may be misclassifying inadvertently.

Detection efforts used by other states have included agency coordination and data sharing, stepped-up audit efforts, and the use of formal complaint processes. Other states have also frequently implemented enforcement mechanisms such as levying civil and criminal penalties for misclassification, initiating stop work orders, and prohibiting future government contracts.

### **A COORDINATED APPROACH COULD REDUCE WORKER MISCLASSIFICATION IN VIRGINIA**

A coordinated approach could help prevent misclassification from occurring, and detect it more effectively when it does occur. Four State agencies administer laws and programs that are concerned with misclassification, and little information is currently shared among them. VEC's audit findings, for example, are not shared with TAX, although misclassified workers may owe Virginia state income taxes.

An interagency task force including representatives of the Secretary of Commerce and Trade, VEC, DOLI, VWC, and TAX could focus on employee misclassification and work to prevent it, as well as facilitate coordination among State agencies. The task force could recommend a clearer definition of "employee" and "independent contractor" for inclusion in the *Code of Virginia*, taking care to avoid de-conforming with key federal tax laws.

To strengthen enforcement, the General Assembly may wish to amend the *Code of Virginia* to make misclassification illegal and

specify civil financial penalties for employers found to misclassify workers. The General Assembly may also wish to authorize stop work orders on State contracts where the employer is found to misclassify. Such misclassifying employers could be barred from bidding on future State or local government work.



# Misclassification Has Adverse Effects on Businesses, Workers, and Government

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## In Summary

Misclassification occurs when an employer improperly classifies as an independent contractor a worker who meets the criteria for being an employee. Many basic employment rights as well as tax considerations hinge on proper classification of employees. Confusion over proper classification can result from the proliferation of statutory definitions and criteria for employee status, although employers can also intentionally misclassify workers to lower labor costs. Employers who improperly classify their workers can gain an unfair financial advantage over firms that correctly classify because they do not pay certain expenses such as unemployment taxes or the employer's share of Social Security. Employees who are misclassified as independent contractors lose the protection of key wage and safety laws and may forego unemployment and other benefits. Other states have found misclassification to be pervasive, especially in industries such as construction and landscaping. In Virginia, several agencies have varying roles regarding misclassification. The Virginia Employment Commission audits employer practices to ensure proper payment of unemployment taxes, and the Department of Labor and Industry investigates wage complaints that sometimes involve misclassification. The Virginia Workers' Compensation Commission may resolve disputes over employee misclassification, and the Department of Taxation collects underreported state income taxes, to the extent those can be identified.

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The U.S. Department of Labor estimated in 2005 that about seven percent of all employed individuals worked as independent contractors. 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 Virginia and nationally, there has been growing concern about the number of workers who are, in fact, employees but are being misclassified as independent contractors.

Such misclassification occurs when an employer improperly classifies a worker as an independent contractor instead of an employee. This can occur when the employer or worker does not understand the legal distinctions between employees and independent contractors, or when an employer wishes to cut labor costs by avoiding the payment of taxes and benefits on behalf of the worker. It can also happen if a worker agrees to work as an independent contractor to avoid wage garnishment or because he or she does not need employee benefits, among other reasons.

Employees have federal and State taxes withheld from their paychecks and are generally covered by legal protections such as the Fair Labor Standards Act, the unemployment insurance pro-

gram, and workers' compensation insurance. Independent contractors are usually responsible for paying all of their taxes and may not be eligible for legal protections.

The General Assembly adopted Senate Joint Resolution 345 in 2011 (Appendix A) directing the Joint Legislative Audit and Review Commission (JLARC) to

- review the status of employee misclassification in Virginia,
- review the consequences of misclassification on the workforce,
- estimate the amount of revenue potentially lost to State and local governments, and
- recommend strategies for alleviating misclassification of employees.

SJR 345 responds to two significant concerns. First, some employers in Virginia were concerned about the unfair competitive advantage gained by other employers who misclassify employees and incur lower costs. Second, several other states, the Internal Revenue Service (IRS), and the Government Accountability Office (GAO) have studied the issue of misclassification and found that it can impact employers, employees, and government revenues. A 2006 GAO report found that the federal government was deprived of \$2.72 billion in Social Security, unemployment taxes, and income taxes due to misclassification. This estimate was based on a 1984 IRS study of the fiscal impact of misclassification, which GAO adjusted to 2006 dollars.

In performing this study, JLARC staff conducted structured interviews with State agencies, key stakeholders, and other states. Additionally, JLARC staff analyzed employer and employee data from the Virginia Employment Commission (VEC) and reviewed relevant literature and documents. More information about the research methods used for this study can be found in Appendix B.

## **WORKER CLASSIFICATION AFFECTS RIGHTS AND OBLIGATIONS OF EMPLOYERS AND WORKERS**

Correct classification is important for employers, workers, and government because employee status entails very different obligations and rights than does independent contractor status. Although misclassification of workers is not itself a violation of federal or Virginia law, employers must classify workers as either employees or independent contractors to comply with tax law and other obligations. Workers may be reclassified over time if the nature of their relationship with the employer changes. Misclassifica-



**Misclassification occurs when an employer classifies as an independent contractor a worker who meets the criteria for being an employee.**

tion occurs when an employer classifies as an independent contractor a worker who meets the criteria for being an employee.

Certain federal laws designed to protect workers' rights only apply to employees, and not necessarily to independent contractors. These include the following laws:

- The Fair Labor Standards Act establishes minimum wage, overtime, and child labor standards.
- The Occupational Safety and Health Act requires employers to maintain a safe and healthy workplace for their employees and requires employers and employees to comply with all federal occupational health and safety standards.
- The Family and Medical Leave Act requires employers to allow employees to take up to 12 weeks of unpaid, job-protected leave for medical reasons related to a family member's or the employee's own health.
- The Americans with Disabilities Act prohibits workplace discrimination and requires employers to make reasonable accommodations for employees.

Similarly, State laws concerning occupational safety, health, and labor standards generally apply to employees, not independent contractors. Employee protections afforded by State programs such as unemployment insurance and workers' compensation are also not extended to independent contractors. Lastly, employers must pay federal employment taxes for Social Security and Medicare (FICA taxes) for employees, and withhold State and federal income taxes. Because independent contractors are considered self-employed, they are generally responsible for paying their own employment taxes and providing for their own health insurance and retirement.

## **MULTIPLE TESTS MAY DETERMINE WHETHER A WORKER IS AN EMPLOYEE**

Generally, a person who performs services for an employer is an employee if the employer can control both *what* will be done and *how* it will be done. The key factor is that the employer has the right to control the details of how the services are performed, even if the employee has substantial freedom of action. By contrast, an independent contractor performs services required by an employer but is not subject to the employer's control with regard to how the services are performed. This "common law" understanding derives from court decisions, not specific statutes that use more refined criteria to determine proper classification.

***While independent contractors may have written contracts acknowledging their classification, this is not a legal requirement in Virginia and does not prove the status of the worker.***

Different tests may be used by agencies and employers to determine proper worker classification to comply with various applicable laws. As noted by GAO, the factors used in these tests are “complex, subjective, and differ from law to law.” Neither an employer 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 and the nature of the relationship between worker and employer. While independent contractors may have written contracts acknowledging their classification, this is not a legal requirement in Virginia, and neither the presence nor absence of a contract is sufficient to prove the status of the worker.

### **Federal Laws Use Various Tests**

Various federal and State laws specify criteria or “tests” for determining when a worker is an employee, and these statutory requirements override the “common law” understanding mentioned above. These tests contain some overlapping criteria but also include unique factors. It can quickly become confusing to determine whether a particular worker is an employee or independent contractor when applying the different criteria.

The IRS, for example, sets out a 20-factor test for use in federal tax law, which is probably the most frequently cited set of criteria (Table 1). It is unclear under federal guidelines how many of these 20 items must be met in order to determine employee status. In fact, these factors are not necessarily complete; according to IRS guidelines,

In any employee [vs.] independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the party.

Different tests are used by other agencies in applying other laws. For example, the U.S. Department of Labor, in enforcing provisions of the federal Fair Labor Standards Act, and the Virginia Department of Labor and Industry (DOLI), in enforcing Virginia labor laws, rely on an “economic reality” test, as shown in Table 1. In addition to the economic reality test, staff from DOLI use a seven-factor test, developed by the Occupational Safety and Health Review Commission, when enforcing Virginia safety and health laws. Again, it is unclear whether all or a simple majority of these factors are required to determine a worker’s correct classification. DOLI staff also report that they often direct workers whose employment status is in question to obtain an official determination

**Table 1: Status of Worker as Employee May Be Determined by Different Tests for Different Purposes**

| Test  | Application   |
|---|---|
| <p><b>IRS 20-Factor Test</b><br/> <b>Worker is an employee if he/she...</b></p> <ul style="list-style-type: none"> <li>Complies with employer's instructions</li> <li>Requires training to do the work</li> <li>Has work integrated into employer's operations</li> <li>Is required to perform the services personally</li> <li>Has continuing relationship with employer</li> <li>Performs work within set hours</li> <li>Devotes most of time to work for employer</li> <li>Must perform services in order or sequence set by employer</li> <li>Must perform work on employer's premises</li> <li>Must submit reports</li> <li>May be discharged by employer</li> <li>Has the right to terminate the relationship</li> <li>Is paid by the hour, week, or month (rather than by job or commission)</li> <li>Has business or traveling expenses paid by employer</li> </ul> | <p><b>Worker is an independent contractor if he/she...</b></p> <ul style="list-style-type: none"> <li>Furnishes tools, materials, and equipment</li> <li>Has significant investment in facilities needed to do the work</li> <li>Can make a profit or suffer a loss as a result of performing the services</li> <li>Can work for more than one firm at a time</li> <li>Makes his/her services available to general public</li> <li>Hires, supervises, and pays assistants</li> </ul> <p>To establish conform-<br/>ance with federal tax law</p> |
| <p><b>Economic Reality Test</b><br/> <b>Worker is an employee depending on relationship to alleged employer as determined by ...</b></p> <ul style="list-style-type: none"> <li>Degree of control exercised by employer;</li> <li>Extent of relative investments of worker and employer;</li> <li>Degree to which employer determines worker's opportunity for profit and loss</li> <li>Skill and initiative required in performing the job</li> <li>Permanency of the relationship</li> </ul>  | <p>To enforce Fair Labor Standards Act by U.S. Department of Labor and Virginia labor laws by DOLI</p>  |
| <p><b>Seven-Factor Test</b><br/> <b>Worker is an employee depending on...</b></p> <ul style="list-style-type: none"> <li>Who the worker considers his/her employer</li> <li>Who pays worker's wages</li> <li>Who has responsibility to control the worker</li> <li>Who has power to control the worker</li> <li>Whether alleged employer has power to fire, hire, or modify worker's employment conditions</li> <li>Whether worker's ability to increase his/her income depends on efficiency rather than initiative, judgment, and foresight</li> <li>How worker's wages are established</li> </ul>  | <p>To enforce Virginia safety and health laws</p>   |

Note: DOLI, Virginia Department of Labor and Industry

Source: JLARC staff analysis of IRS, Employer's Supplemental Tax Guide, 2012; U.S. v Silk, 331 US 704 (1947); S&S Diving Company, 8 OSHC 2041 (1980), and DOLI staff.

about their status from the IRS, which can add up to six months to the process of wage payment.

### Exclusions in Virginia Law May Contribute to Confusion

The complexity of defining the employee-employer relationship for Virginia programs is illustrated by the multiple definitions of employee and employment, along with numerous exclusions, in Virginia law. The general rule stated in the *Code of Virginia* §§ 60.2-212 is that employment means the performance of any service by an individual for remuneration, unless the VEC determines otherwise. However, statutes also list numerous exceptions to the employment definition used for the Virginia Unemployment Compensation Act and the Virginia Minimum Wage Act (Table 2). The two laws also list differing exceptions, which may contribute to confusion about whether a particular worker is an employee for all legal purposes.

**Table 2: Laws Have Different Exceptions to Definition of "Employment" in Code of Virginia**

#### Virginia Unemployment Compensation Act Exceptions

|  |   |
|--|---|
| Truck owner-operators or lessees   | Domestic services in private homes or college fraternity/sorority houses <sup>a</sup> |
| Commission-based real estate and insurance sales                                 | Crew members on certain fishing vessels   |
| Ordained ministers and certain religious workers                                 | College students working for the school enrolled in or at an organized camp           |
| Elected officials  | Medical interns   |
| Most farm labor, except for certain crew arrangements                            | Commission-based petroleum wholesalers and court reporters                            |
| Fee-based licensed clinical social workers and certain other licensed counselors | Taxicab and limo drivers  |

#### Virginia Minimum Wage Act Exceptions

|   |   |
|---|---|
| Farm laborers <sup>b</sup>  | Newsboys, shoe-shine boys, caddies, babysitters, ushers, doormen, concession attendants, theater cashiers |
| Commission-based salesmen   | Taxi drivers  |
| Summer camp workers   | Anyone under 16, or if enrolled full-time in school or working for a parent, under 18                     |
| Anyone whose employer has less than four employees, not counting family members | Volunteers at nonprofit or charitable organizations   |

<sup>a</sup>Domestic service is exempt only if the employer does not pay \$1,000 or more in any quarter in a calendar year.

<sup>b</sup>Farm labor is exempt unless the employer has ten or more workers in 20 different weeks or a quarter of at least \$20,000 payroll in a calendar year.

Source: *Code of Virginia* §§ 60.2-212 et seq.; § 40.1-28.9.

The Virginia Workers' Compensation Commission (VWC) uses somewhat broader criteria when determining classification. According to VWC's *Employer Guide*,

Some important considerations in distinguishing between an employee and an independent contractor include (1) the right to hire, (2) the power to dismiss, (3) the obligation to pay wages, and most importantly, (4) the power to control the means and methods by which the work is done.

In the following workers' compensation case brought before the commission, the "right to control" was the primary factor in determining the status of the worker as an employee:

### ***Case Study***

*A laborer worked for an employer in the construction industry on and off for nine years. While working on a project, the laborer fell from the third floor onto concrete and sustained multiple injuries. The employer did not provide the laborer with workers' compensation insurance, as the employer claimed the worker had signed an independent contractor agreement, although the laborer disputed that claim. The worker had been paid an hourly wage and the employer maintained the right to hire and fire him. The employer determined the hours he worked and provided instruction for tasks and was often on the jobsite determining how work was performed. The employer also provided most of the tools needed for work.*

*VWC found that "an employer cannot escape liability under the [Workers' Compensation] Act by executing generic agreements that attempt to define the legal status of workers as independent contractors." VWC found that in this case the employer retained the "right to control" by providing the worker's equipment, transportation, instruction, and an hourly wage rather than payment for completing a job. The laborer was awarded disability and medical benefits. (Pugh v. Taylor Construction, 2002)*

Government agencies and the courts have emphasized that no single factor is paramount in every case, including whether there is a written agreement that a particular worker is serving as an independent contractor, and that the relationship between the worker and the employer is key to the determination of the worker's status. The importance of any one factor will vary depending on the facts of the case.

## **MISCLASSIFICATION CAN OCCUR DUE TO CONFUSION OR AN INTENTION TO AVOID COSTS**

Misclassification generally occurs for one of two reasons: confusion stemming from the multiple definitions and rules for determining when a worker is in fact an employee, or intentional misclassification by the employer to reduce costs.

Confusion can result from the multiple definitions of what constitutes an employee, which are complex, often situation-specific, and rely on the interpretation of multiple criteria, as discussed previously. As a result, employers may be confused about the proper classification of workers in certain cases. A study commissioned by the U.S. Department of Labor in 2000 found that there was

a perception among employers and workers, especially in the medium to high wage occupations, that the designation of employee or independent contractor status was an option to be agreed upon by both parties.

This is a misperception because employment status is a legal status determined by factors that go beyond the existence of an agreement or even a contract between employer and worker.

A second major reason for misclassification is the intentional action of an employer to cut labor costs by treating workers as independent contractors rather than as employees. With lower labor costs, an employer can gain a financial advantage over competitors.

*...by treating workers as independent contractors rather than as employees...an employer can gain a financial advantage over competitors.*

In an employer-employee relationship, employers pay half of Medicare and Social Security taxes, unemployment taxes, and provide workers' compensation insurance. Employers are typically required to pay minimum wage and overtime wages and may provide health insurance coverage, paid leave, and other benefits to employees. By contrast, employers are generally not obligated to make any of these payments to or on behalf of independent contractors. When unemployment is high, workers may be willing to accept misclassification as an independent contractor in exchange for a job. These issues are discussed more fully in Chapter 2.

## **OTHER STATES HAVE FOUND MISCLASSIFICATION TO BE PERVASIVE, ESPECIALLY IN CERTAIN INDUSTRIES**

There has been no prior review of worker misclassification in Virginia. The extent of misclassification has been examined by other states, the U.S. Department of Labor, and GAO. These sources used differing methods and data, but all found that misclassification occurred in a range of industries. According to GAO,

In 2007, states uncovered at least 150,000 workers who may not have received protections and benefits to which they were entitled because their employers misclassified them as independent contractors when they should have been classified as employees. These numbers likely undercount the overall number of misclassified employees, since states generally audit less than two percent of employers each year.

The same GAO report noted that a study commissioned by the U.S. Department of Labor in 2000 found that ten to 30 percent of employers audited in nine selected states had misclassified employees as independent contractors. Studies performed in other states found that six to 48 percent of audited firms had at least one misclassified worker. In most cases, however, the findings could not be generalized to the broader employer population because most states did not use a random selection strategy as the basis for their audits.

Studies in other states found that misclassification was more prevalent in certain industries. In particular, some states found higher levels of misclassification in the construction industry. In 2005, Maine, for example, began targeting construction firms for audits and subsequently reported that 45 percent of the audited firms misclassified at least some of their employees. An Indiana report noted that in 2008 it had conducted more audits of construction companies than any other sector, and that construction firms accounted for 27 percent of all misclassified workers in the state. Minnesota, however, noted in a 2007 study that “employers in the construction industry did not appear to misclassify more often than employers overall.”

Some states have adopted laws aimed at reducing misclassification, often targeting specific industries. The 2009 Maryland Workplace Fraud Act, for example, which applies only to the construction and landscaping industries, makes it a violation of law to fail to properly classify workers as employees and imposes penalties on those employers who knowingly misclassify their workers. The law also clarifies the definition of an independent contractor. Pennsylvania’s 2010 law also applies only to the construction industry. The law establishes a presumption that a worker is an employee, not an independent contractor, unless eight specific criteria are met, and assesses administrative fines up to \$2,500 per violation along with the prospect of a court-issued stop work order. Additional information about other states’ actions is discussed in Chapter 5.

## **FOUR VIRGINIA AGENCIES ARE INVOLVED WITH THE ISSUE OF MISCLASSIFICATION**

No single agency takes the lead on the issue of employee misclassification in Virginia, although four agencies administer laws and programs affected by misclassification. With the possible exception of VEC, these agencies do not have a particular focus on misclassification, but encounter the issue as part of their assigned responsibilities. Each agency manages its own complaint, audit, and filing process, with little coordination or information sharing between the agencies on the issue. Each agency devotes few resources to preventing, detecting, or penalizing misclassification.

### **Virginia Employment Commission Audits Employers to Ensure Proper Classification of Employees for Unemployment Taxes**

VEC is responsible for administering the unemployment insurance program set out in the *Code of Virginia* §§ 60.2-100 et seq. As a component of its tax compliance effort, VEC conducts annual site audits on a small percentage of employers to identify whether each employer paid the appropriate amount of unemployment taxes based on its payroll.

Because misclassification results in underreported wages, as part of their audits VEC staff seek to identify whether employers have misclassified workers. To identify misclassified workers and other underreported wages, VEC auditors review a variety of documents, such as federal tax documents, general ledgers, cash disbursements, check records, and vendor lists. These documents are then compared to employment and wage information previously reported to VEC by employers. If discrepancies are identified, auditors determine whether they are due to misclassification. When misclassified workers are identified, VEC informs the employer of additional taxes due, including interest.

### **Virginia Department of Labor and Industry May Identify Instances of Misclassification**

DOLI enforces State occupational safety laws. Employers have an obligation under these laws to ensure healthy and safe working conditions for their employees. Independent contractors are generally responsible for securing their own safety while working.

DOLI also administers and enforces laws governing the payment of wages and the minimum wage. Minimum wage protections pertain to only certain classes of employees and not to independent contractors. Workers misclassified as independent contractors may not receive wages to which they are entitled. These persons may file a wage complaint with DOLI.



DOLI staff indicate they received about 3,500 wage complaints in 2011, of which approximately 100 involved potential misclassification. Department staff interview the worker and employer and review any documentation in an effort to determine the worker's correct status. They also generally direct the worker to file with the IRS to obtain an official determination of his or her status (either an employer or employee can obtain a determination for income and employment tax purposes).

### **Virginia Workers' Compensation Commission May Resolve Disputes Involving Employee Classification**

The VWC is responsible for administering the Virginia Workers' Compensation Act (*Code of Virginia* §§ 65.2-100 et seq.). The act requires employers either to obtain workers' compensation insurance or to be self-insured.

When an employee is injured, the employer's insurance company and the employee usually settle on a compensation agreement, which can include payment for medical costs and wage replacement for time away from work. In these instances, VWC must approve the agreement and maintain a record. When a disagreement occurs, VWC resolves the dispute through mediation or a hearing. The judicial process begins if an employer denies liability for the employee's injury or illness, or if the parties cannot settle on the compensation to be awarded.

A small portion of cases brought before VWC may involve disagreement about the proper classification of a worker when the injury or illness was sustained. VWC investigates complaints about misclassification to ensure compliance with workers' compensation laws but does not focus solely on misclassification. Companies are required to certify to VWC that they have appropriate insurance coverage or are self-insured. Insurance carriers that provide workers' compensation coverage perform audits of employers and may identify misclassified workers. However, these findings are not generally communicated to VWC.

### **Virginia Department of Taxation Focuses on Underreporting of Income, Not Misclassification**

The Virginia Department of Taxation (TAX) administers and enforces Virginia's tax laws. TAX staff interviewed for this study acknowledged that misclassification can have an impact on income tax revenue, but also believe that most of the revenue lost when misclassified workers underreport their income is eventually identified and recouped. This occurs through the IRS programs in which informational returns (such as the Form 1099) filed by employers are matched to federal income tax returns filed by independent contractors and misclassified employees.

The IRS notifies workers when discrepancies are found between the amount employers report paying independent contractors (or in this case, misclassified workers) and the compensation amounts reported by the workers on their federal income tax returns. The IRS shares this information with TAX, which is then able to collect underreported Virginia income taxes. While this matching cannot occur if the employer never filed a Form 1099 on behalf of the misclassified workers (such as when a worker is paid in cash), TAX staff indicate that a significant effort would be required to find, investigate, and assess taxes against a large number of smaller taxpayers. TAX staff have several concerns about investing significant effort in such cases, including the relatively small revenue impact, difficulty in identifying the underreported income, and opportunity cost of not pursuing other, more productive revenue opportunities.

## Misclassification Creates Unfair Competitive Advantage and Adversely Impacts Workers

### In Summary

Both employers and workers are significantly affected by misclassification. Employers who properly classify their workers face higher labor costs and may also have to pay higher premiums and taxes to offset those unpaid by misclassifying employers. Employers who misclassify employees as independent contractors may save up to 40 percent in payroll costs and therefore enjoy a significant competitive advantage, especially if their products or services are price sensitive. To realize these savings, misclassifying employers do not withhold any taxes from workers' pay and deny the workers access to mandatory employee benefits and to the rights and protections afforded to employees. Specifically, misclassified workers often assume they are ineligible for unemployment benefits and workers' compensation coverage through their employer, are not protected by key wage and safety laws, and are usually not eligible for health insurance and other voluntary employer-provided benefits. This loss of benefits and protections can have significant effects on misclassified workers' health, safety, and financial stability.

Employers and workers alike are affected by misclassification. Misclassifying employers avoid paying both mandatory and voluntary payroll costs and consequently can undercut their competition. Employers who do not misclassify their workers face a potential loss of business and are forced to absorb the costs avoided by misclassifying employers in the form of higher premiums and taxes. Misclassified workers are expected to pay their Social Security and Medicare taxes in full, receive no retirement or health benefits, and are denied the right to certain labor protections afforded to employees. This lack of protection may put the worker's health, safety, and legal rights in jeopardy.

### **MISCLASSIFICATION CREATES UNFAIR COMPETITIVE ADVANTAGE**

Misclassification has a significant impact on employers—financially benefitting those who misclassify workers and penalizing those who do not. Employers who misclassify their workers as independent contractors can cut labor costs significantly because they are not required to pay taxes on behalf of independent contractors. This reduction in labor costs gives employers who misclassify an unfair competitive financial advantage over employers who do not misclassify. Studies in other states have found these savings can amount to as much as 40 percent of an employer's payroll. Additionally, employers are not required to provide certain le-

gal protections to independent contractors, nor are independent contractors eligible for health care or retirement benefits.

### Employers Can Reduce Payroll Costs by Misclassifying

Employers can avoid significant payroll costs by misclassifying workers because they are not required to pay mandatory taxes or insurance—such as federal and State unemployment taxes, half of both Social Security and Medicare taxes, and workers’ compensation insurance premiums—on behalf of independent contractors. Through 2010, employers matched an employee contribution of 7.65 percent in Social Security and Medicare taxes on earnings up to \$106,800 whereas independent contractors were responsible for paying the full amount of Social Security and Medicare taxes.

In addition, misclassifying employers generally do not offer employer-provided health insurance, retirement programs, life insurance, paid leave, or other benefits. While not all employers are required to offer access to such benefits, many employers do so voluntarily, as demonstrated in Table 3. (For more information regarding the differences in legal responsibilities of employers, workers classified as employees, and independent contractors, see Appendix C.)

**Table 3: Many Employers Voluntarily Offer Health, Retirement, and Leave Benefits**

| Type of Benefit <sup>a</sup>                         | Percentage of Private Employers Providing Benefit |
|--|---|
| Health Insurance                                     | 70%   |
| Retirement   | 64  |
| Holiday, Vacation, Sick, and Other Leave             |   |
| Paid Vacation  | 77  |
| Paid Sick Leave                                      | 63  |
| Paid Personal Leave                                  | 38  |
| Life, Short-Term, and Long-Term Disability Insurance | 58  |

<sup>a</sup> Benefits extended to private industry workers only. Excludes public industry workers.

Source: United States Bureau of Labor Statistics, *Employer Benefits Survey, 2011*.

**An employer can reduce payroll costs by an estimated 26 percent by classifying a construction worker ... as an independent contractor rather than an employee.**

Table 4 illustrates how an employer can reduce payroll costs by an estimated 26 percent by classifying a construction worker (who receives the 2010 average Virginia wage) as an independent contractor rather than an employee. This estimate is consistent with estimates developed in other states. A similar example developed in Minnesota also estimated 26 percent savings in payroll costs, while Connecticut cited an estimated 20 percent in savings.

**Table 4: Illustrative Employer Payroll Costs Per Hour for an Employee Versus an Independent Contractor in the Construction Industry**

|   | Payroll<br>Costs of an<br>Employee | Payroll<br>Costs of an<br>Independent<br>Contractor | Difference<br>Between<br>Independent<br>Contractor and<br>Employee |
|---|------------------------------------|---|--|
| <b>Hourly Base Rate<sup>a</sup></b>                     | <b>\$22.26</b>                     | <b>\$22.26</b>                                      | <b>\$0.00</b>  |
| <b>Mandatory Benefits Per Hour</b>                      |                                    |   |  |
| Virginia Unemployment Insurance Tax <sup>b</sup>        | 0.08                               | 0.00  | 0.08   |
| U.S. Unemployment Insurance Tax <sup>c</sup>            | 0.21                               | 0.00  | 0.21   |
| Social Security and Medicare Taxes <sup>d</sup>         | 1.70                               | 0.00  | 1.70   |
| Workers' Compensation Insurance <sup>e</sup>            | 1.06                               | 0.00  | 1.06   |
| Subtotal Mandatory Benefits Per Hour                    | 3.06                               | 0.00  | 3.06   |
| <b>Total Mandatory Costs</b>                            | <b>\$25.32</b>                     | <b>\$22.26</b>                                      | <b>\$3.06</b>  |
| <b>Voluntary Employer-Provided Benefits<sup>f</sup></b> | 4.67                               | \$0.00  | 4.67   |
| Subtotal All Benefits                                   | 7.73                               | 0.00  | 7.73   |
| <b>Total Payroll Costs With Benefits Per Hour</b>       | <b>\$29.99</b>                     | <b>\$22.26</b>                                      | <b>\$7.73</b>  |
| Percentage of Payroll Costs on Mandatory Benefits       | 10%                                | 0%  | (10%)  |
| Percentage of Payroll Costs on Voluntary Benefits       | 16%                                | 0%  | (16%)  |
| <b>Percentage of Payroll Costs on All Benefits</b>      | <b>26%</b>                         | <b>0%</b>   | <b>(26%)</b>   |

<sup>a</sup> Based on VEC wage data from 2010, the average annual wage for a construction worker in 2010 was \$46,295.

<sup>b</sup> Based on the rate for the construction industry (2.17 percent) in 2010 (includes 0.28 percent pool tax and 0.20 percent fund builder tax) on the first \$8,000 of wages paid.

<sup>c</sup> The federal unemployment tax rate for 2010 was 6.2 percent (with a federal credit of 5.4 percent for those employers who paid their state unemployment taxes on time) on the first \$7,000 of wages paid.

<sup>d</sup> Employers paid a combined tax rate of 7.65 percent for employees on annual wages up to \$106,800. Independent contractors are responsible for the entire tax amount, less certain work-related tax deductions.

<sup>e</sup> The rate for the construction industry was 4.78 percent on average for 2009.

<sup>f</sup> Employer-provided benefits equaled 21 percent of wages, on average, for private industries as of December 2010.

Source: JLARC staff analysis of data from various State and federal agencies; Minnesota Office of the Legislative Auditor, *Misclassification of Employees as Independent Contractors, 2007*.

Using data generated in the above example, an employer who misclassifies a construction worker as an independent contractor can save over \$16,000 annually. The reduction in payroll costs can be significant, especially if an employer misclassifies multiple workers. By misclassifying, employers gain a substantial unfair competitive advantage over employers who comply with tax and labor laws.

### **Employers Who Properly Classify Their Workers Face Loss of Business and Increased Costs When Other Employers Misclassify**

Employers who properly classify their workers pay higher payroll costs and thus may be less competitive in their respective industries than employers who misclassify. Employers who properly classify pay higher unemployment taxes and pay more for workers' compensation insurance to make up for revenue shortfalls caused by unpaid taxes and premiums by misclassifying employers.

***Misclassification Can Create an Unfair Competitive Advantage.*** Employers who misclassify gain a cost advantage over employers who properly classify. In industries where competitive bidding is common, such as construction, misclassifying employers can offer lower bids for projects because their labor costs are reduced. Employers who properly classify may be unable to compete.

JLARC staff interviewed several industry groups who expressed concern about this issue. A unionized electric company working in northern Virginia and Washington, D.C., reported that employee misclassification was the reason why some of its competitors could consistently underbid projects by as much as 30 percent. The company believes that one competitor in particular hires workers, pays them in cash, and does not consider them employees of the company, instead considering them to be self-employed. It is unclear whether the company pays taxes on behalf of these workers.

Other industry representatives also provided JLARC staff with statements from numerous workers claiming to be misclassified, and they shared similar concerns about remaining competitive. Additionally, staff at various State agencies, including DOLI and VWC, voiced concern about this problem on behalf of employers who classify correctly and often call to complain about underbidding by employers who misclassify workers.

**Unemployment Insurance Trust Fund**

Virginia's Unemployment Insurance Trust Fund pays unemployment benefits for unemployed workers. As of November 18, 2011, Virginia's trust fund balance was -\$212 million. This figure includes tax revenues and benefits paid out as of that date.

***Misclassification Can Increase Employers' Unemployment Taxes.*** In addition to having to pay the payroll costs associated with employees, employers who properly classify their workers must also pay unemployment tax rates which are higher because of misclassifying employers who do not pay unemployment taxes. Unemployment tax rates include an amount known as the "pool cost charge" which compensates for claims that cannot be assigned to an individual employer, including those for workers who are not covered. Unemployment tax rates also include a "fund building charge" when the trust fund does not maintain an adequate balance. This charge was assessed in both 2010 and 2011 to account for the fund's current insolvency. Both the pool cost charge and the fund building charge are included in the calculation of unemployment insurance tax rates for employers.

For example, an employer who started a business in 2011 would have been assigned a new employer base tax rate of 2.5 percent of employee wages. In addition, this new employer would pay a pool cost charge of 0.47 percent and a fund building charge of 0.2 percent. Thus, this employer would be paying an unemployment tax rate of 3.17 percent per covered employee.

The pool cost and fund building charges are affected by many factors other than misclassification, but because the pool cost charge

pays for non-covered workers, as more misclassified workers file for benefits, the pool cost charge may increase to cover the cost of these additional workers. Additionally, the current insolvency of the unemployment trust fund has triggered an increase in the fund building charge. It is not possible to tell the extent to which the rates have increased due to misclassification versus other factors such as the economic downturn.

#### **Statutory Employer Law**

Section 65.2-302 of the *Code of Virginia* establishes workers' compensation coverage requirements for contractors and businesses that hire subcontractors that perform the same trade, business or occupation, or fulfills a contract of the business and extends workers' compensation liability to the subcontractor's employees.

**Misclassification Affects Employers' Workers' Compensation Premiums.** Virginia employers with more than two employees are responsible for purchasing and maintaining workers' compensation insurance for their employees. In addition, contractors and businesses that hire subcontractors are required to provide coverage to their subcontractors under the Statutory Employer law. Employees who suffer on-the-job injuries or diseases may be eligible to receive workers' compensation benefits. Workers' compensation insurance can be acquired through a commercial insurance policy, a self-insurance program, or membership in a professional employer organization or group self-insurance association. Employers holding a commercial insurance policy pay premiums for each employee depending on the type of work being performed by the employee, the employer's claims history, safety records, and payrolls.

Premium costs vary depending on the rates assigned for each risk classification in an industry. For instance, industries with a high risk of injury such as coalmining, logging and tree removal, and roofing have higher insurance premium rates to cover the potential cost of employee injuries, which are more likely to occur than in certain other industries. The ratemaking process is dependent on the correct classification of risk with adequate rates to pay for any claims.

#### **Workers' Compensation Premiums**

Workers' compensation premiums are calculated by multiplying estimated payrolls by the rates for each industry classification on an insured employer's policy. This calculated premium may then be modified based on the employer's experience and other factors.

Employers may misclassify to avoid paying workers' compensation premiums, especially in high-risk industries. According to a California study, the high cost of premiums encourages more employers to misclassify, thus creating a cycle that drives up premium rates while encouraging more misclassification of high-risk workers. Employers that properly classify their workers may be motivated to misclassify in order to reduce their payroll costs and remain competitive in their respective industries.

Employers who classify properly must pay a higher premium rate to compensate for employers whose misclassified workers file claims but are not covered by workers' compensation insurance. A misclassifying employer may reclassify a worker as an employee when he or she is injured. The insurance carrier is required to pay such a claim if the worker is found to be an employee, even if no premiums had previously been paid on the worker. This claim would be included in the future ratemaking formula. Future pre-

miums for employers in this particular occupation may increase, as the insurance carrier must account for potential future claims based on the incidence of past claims. Moreover, if the premium for the injured worker goes uncollected, other employers in the same class code may end up indirectly subsidizing the claim.

In 2010, between \$3 million and \$50 million in workers' compensation premiums may have been unpaid by misclassifying employers, suggesting that employers who properly classify may have absorbed part or all of this amount by having paid higher workers' compensation premiums over time. Employers may also see an increase in their premium costs if there is an increase in the insurance premium tax. The insurance carrier is responsible for paying the insurance premium tax to VWC (as discussed in more detail in Chapter 3). This tax, which funds the administrative functions of VWC as well as the Uninsured Employer's Fund and the Second Injury Fund, fluctuates from year to year based on the previous year's expenditures. For example, when VWC has to pay out on an increased number of uninsured employer claims, the Uninsured Employer's Fund depletes more quickly, and the rate must be increased the following year to replenish the fund. VWC paid out significantly more in claims in 2011, so the premium tax increased in 2012. This increase is factored into the ratemaking calculation performed to determine employer premium rates. While employers are not responsible for paying the insurance premium tax outright, they may see an increase in their overall workers' compensation premium when the tax increases.

## **MISCLASSIFICATION ADVERSELY IMPACTS WORKERS**

Misclassification can affect workers' tax liabilities and responsibilities, access to a variety of benefits, and wage and workplace safety protections. Employees may also be entitled to certain employer-provided benefits that independent contractors are typically not afforded. When workers are wrongly classified as independent contractors, their short- and long-term financial stability, health, and legal protections may be compromised. Having to pay for their own Social Security, Medicare, retirement, and health insurance may be cost prohibitive for workers. Workers who forego paying for their own retirement and health insurance put the safety of their finances and overall health at risk.

### **Misclassification Affects Access to Workers' Compensation and Unemployment Benefits**

Misclassified workers may be eligible for both workers' compensation and unemployment benefits, although they seldom claim these benefits and face hurdles when they do try to claim them. According to VEC staff, workers are eligible to file for unemployment benefits if their earnings have been reported to VEC by the em-



employer or they have been found to be an employee following an audit. In the case of misclassified workers, wages are often not reported. This places the onus on workers to provide documentation of their pay because unemployment benefits are contingent upon the amount of wages reported. If wages are incorrect or unreported, benefits may be adversely affected. VEC staff stated that misclassified workers rarely apply for unemployment benefits because they are unaware they are eligible to do so.

***Misclassified workers rarely file to receive compensation for an injury on the job.***

VWC staff made similar comments regarding workers' compensation benefits, reporting that workers who are misclassified are often unaware of the existence of, or their eligibility to file for, workers' compensation benefits. Workers who believe they have been misclassified may request a hearing with VWC and their employer to determine proper classification. However, most misclassified workers reportedly do not realize they have this option. Thus, they rarely file to receive compensation for an injury on the job. Additionally, staff at VWC stated that they believe workers underreport injuries because they may be seen as less marketable if they have filed previous workers' compensation claims.

Misclassified workers who lack access to workers' compensation benefits can incur significant medical costs and loss of income should they be injured on the job. The benefits associated with workers' compensation include wage replacement, medical payments, permanent partial impairment and total disability payments, and death benefits as well as cost of living adjustments and vocational rehabilitation. If no benefit claim is filed, the worker will generally be responsible for paying all bills associated with the injury.

### **Misclassification Reduces Labor Law Protections**

Misclassified workers are not protected by the same labor laws as employees. Employers who misclassify deny their workers the rights and privileges afforded to employees, such as minimum wage, overtime, and in some states, the opportunity to unionize. As stated previously, misclassification itself is not a violation of any federal or Virginia labor law, but it can result in violations of these laws. For example, DOLI may encounter an instance of misclassification when investigating a wage claim. If there is a dispute over classification, DOLI will direct the employee to obtain a determination from the IRS, which may assess fines on the employer for unpaid federal taxes if the worker is found to be misclassified.

The Fair Labor Standards Act protects an employee's right to minimum wage and overtime. Under this law, many employees must be paid for any hours worked over 40 in a given week in the amount of one-and-a-half times their regular pay. Independent

contractors are not entitled to this protection and will most likely be paid an agreed-upon rate regardless of hours. Similarly, under Virginia State law, if independent contractors perform work without wages being paid or if they are paid less than minimum wage, they may not submit a wage claim to DOLI, as the Virginia Payment of Wage Law and the Virginia Minimum Wage Law only apply to employees. In the instance of a dispute over independent contractors' classification, they are directed to the IRS for determination.

While the Americans with Disabilities Act (ADA) and Age Discrimination in Employment Act cover employees, these laws do not apply to independent contractors. An employer is not required to accommodate an independent contractor who has a disability covered by the ADA, and can choose to not hire an independent contractor over the age of 40. An independent contractor is also not protected under the Family and Medical Leave Act, which means the employer is not required to provide for unpaid time off for medical reasons related to a family member's or the worker's own health.

The Occupational Safety and Health Act (OSHA) aims to prevent work-related injuries, illnesses, and deaths by issuing and enforcing standards for workplace safety and health. At both the State and federal level, OSHA regulations are only applicable within the employer-employee relationship, and do not cover independent contractors. According to DOLI staff, independent contractors are generally responsible for ensuring their own health and safety while on a job site. However, DOLI staff indicated that a multi-employer worksite requirement affords misclassified workers with some workplace health and safety protections. Under this requirement, if there are multiple independent contractors working at the same site, the general contractor has responsibility for the overall safety of the job site.

## Misclassification Occurs in Virginia, but Full Extent Is Unknown

### In Summary

Misclassification of workers occurs in Virginia, based on cases detected by the Virginia Employment Commission (VEC) during employer audits. VEC audited 2010 data from 2,120 Virginia employers (1.1 percent) and found that more than a quarter of them had misclassified workers. Among audited employers, 5,639 workers were found to be misclassified. Because VEC conducts targeted audits and does not use random sampling or other statistical methods, these findings cannot be generalized to the entire employer and employee population and the full extent of misclassification in Virginia cannot be estimated with precision. Based on an average misclassification rate estimated by other states that use an audit method that permits generalization, Virginia could have on the order of 40,000 misclassifying employers and 214,000 misclassified workers. These figures provide a rough estimate of the magnitude of the problem.

Understanding the extent of misclassification in the State is important to estimating its impact on employers, employees, and government revenues in Virginia. Understanding the impact of misclassification can help policymakers decide what, if anything, the State should do to address the issue. This chapter presents information on the instances of misclassification known to occur in Virginia, both in terms of the number of misclassifying employers and misclassified workers, and also provides a rough estimate of the extent of misclassification statewide.

### EXTENT OF MISCLASSIFICATION IS DIFFICULT TO QUANTIFY BECAUSE OF DATA LIMITATIONS

The Virginia Employment Commission (VEC) is the only entity that gathers data on the numbers of misclassifying employers and misclassified workers in Virginia. As discussed in Chapter 1, VEC auditors collect data during unemployment insurance audits of employers, a key purpose of which is to identify misclassified workers and recover unemployment taxes that were not paid on behalf of these workers. VEC staff currently audit approximately one percent of Virginia employers who pay unemployment insurance taxes each year. This data is the basis for JLARC staff's analysis of misclassification that is known to occur in Virginia. However, the method used to select audit targets does not allow for generalizations to be made about the entire employer population.

To maximize the efficiency of their audit efforts, VEC staff do not select employers to audit on a random basis, but rather target

#### Who Is Required to Pay Unemployment Insurance Taxes?

Most employers are required to pay unemployment taxes if (1) they have one or more employees who work for any portion of a day in 20 different weeks in a calendar year, or (2) their total gross payroll for any calendar quarter is \$1,500. (Domestic, non-profit, and agricultural employers have different requirements.)

### Random Sampling

A random sample is a subset of individuals (a sample) chosen from a larger population. Each individual is chosen by chance, such that each individual has the same probability of being chosen. This sample of individuals is considered to be representative of the entire population. In a non-random sample, certain types of individuals have a higher probability of being chosen and therefore cannot be considered representative of the entire population.

their audits toward businesses and industries suspected of misclassifying workers. VEC staff described these audits as “targeted random,” and noted that they have a list of eligible employers to be audited that they run about once a month to get current data. They look at the NAICS code, the size of the business, and any other parameters that would make the employer a good audit candidate.

In 2011, more than a third of VEC audits were conducted in the construction industry because VEC staff believe misclassification is more common among construction employers. Some employers were also selected because they had negative audit findings (including misclassified workers) in the past. As a result of this auditing method, the prevalence of misclassification among audited employers should be higher than among the general employer population and generalizing VEC’s audit findings to Virginia’s entire employer and employee population would not be methodologically valid.

Some other states conduct employer audits by using random sampling and other techniques, and have developed statewide estimates of the number of misclassifying employers and misclassified employees. In the absence of Virginia-specific data that can be generalized, a statewide estimate of the extent of misclassification was created by using the average result from these other states’ findings. Together, the estimates using both the VEC audit findings as a measure of known prevalence of misclassification and the other states’ average as a proxy for the full extent of misclassification in Virginia provide an “order of magnitude” estimate of misclassification in Virginia.

### **ONE PERCENT OF VIRGINIA EMPLOYERS WERE AUDITED, OF WHICH A QUARTER MISCLASSIFIED WORKERS IN 2010**

JLARC staff analyzed VEC’s data from audits conducted during calendar year 2011 to identify the number and proportion of employers known to misclassify and their characteristics. The same information was used to examine the extent to which workers were misclassified by these employers. (See Appendix B.) Data from prior-year audits was not available electronically; 2011 is the first year in which VEC compiled the misclassification data from its paper audit files into a single spreadsheet.

### **VEC Identified 584 Misclassifying Employers in 2010**

VEC audited 2010 data from 2,120 (1.1 percent) of Virginia’s 188,585 employers and found that 584 (27 percent) misclassified at least one worker (Figure 1). Of the misclassifying employers, most (68 percent) misclassified fewer than six workers, while 20 percent misclassified more than ten workers. The audited employer with

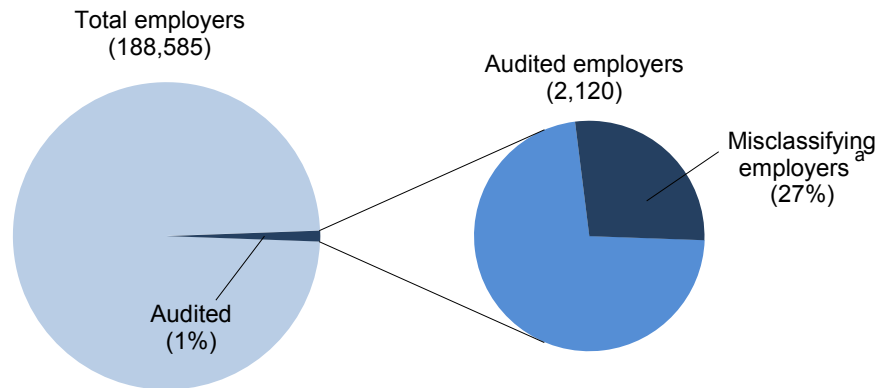
### VEC Conducted Audits in 2011 Based on 2010 Data

Although the VEC audits were conducted in calendar year 2011, the auditors examined 2010 data, and 2009 data in some cases. This report generally refers to the audit data as 2010 data.

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**Figure 1: Twenty-Seven Percent of Audited Employers Misclassified Workers in 2010 According to the Virginia Employment Commission**

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<sup>a</sup>At least one worker was misclassified by these employers.

Source: JLARC staff analysis of 2010 audit data from the Virginia Employment Commission.

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the highest number of misclassified workers had four employees and 205 misclassified workers, such that 98 percent of its workforce was misclassified.

Table 5 shows that the proportion of misclassifying employers is highest in the Administrative and Support and Waste Management and Remediation Services industry. (See Appendix D for more detailed descriptions of industry groups.) Of the audited employers in this industry, 40 percent (58 employers) misclassified. The majority (57 percent) of the audited employers in this industry were in the landscaping business, and 44 percent of these employers were found to have misclassified employees. It is important to note that, due to VEC's targeted auditing practices, it cannot be concluded from this data that these employers necessarily misclassify to a greater extent than other employers.

Table 5 shows that the Construction industry had the second highest proportion of misclassifying employers (33 percent of audited construction employers). Because VEC audited a disproportionate number of construction employers (more than one-third of audited employers were in the Construction industry), it cannot be concluded from this data alone that construction employers misclassify to a greater extent than other employers. Still, staff from VEC reported believing that misclassification is more prevalent in the Construction industry, as evidenced by the fact that they target that industry for audits. Staff at the Virginia Workers' Compensation Commission and Department of Labor and Industry also indicated that, in their opinion, misclassification is prevalent among

**Table 5: Administrative and Support and Waste Management and Remediation Services Industry Has Highest Proportion of Misclassifying Employers (2010)**

| <b>Industry<sup>a</sup></b>  | <b>% of Audited Employers Found to Be Misclassifying Within Industry</b> | <b>Number of Misclassifying Employers</b> |
|--|--|---|
| Administrative and Support and Waste Management and Remediation Services | 40%  | 58  |
| Construction   | 33   | 242                                       |
| Accommodation and Food Services  | 27   | 20  |
| Real Estate and Rental and Leasing                                       | 27   | 11  |
| Transportation and Warehousing   | 26   | 16  |
| "All Other" Industries <sup>b</sup>                                      | 24   | 51  |
| Health Care and Social Assistance  | 24   | 30  |
| Retail Trade   | 23   | 55  |
| Wholesale Trade  | 22   | 23  |
| Other Services (except Public Administration)                            | 19   | 42  |
| Professional, Scientific, and Technical Services                         | 19   | 31  |
| <b>Total</b>   | <b>27%</b>   | <b>579<sup>c</sup></b>                    |

<sup>a</sup>North American Industry Classification System (NAICS) code descriptions.

<sup>b</sup>Includes Educational Services; Public Administration; Manufacturing; Finance and Insurance; Information; Arts, Entertainment, and Recreation; Management of Companies and Enterprises; Utilities; Agriculture, Forestry, Fishing and Hunting; and Mining, Quarrying, and Oil and Gas Extraction.

<sup>c</sup>NAICS industry codes were missing for five misclassifying employers, so total is less than the total number of misclassifying employers (584).

Source: JLARC staff analysis of 2010 audit data from the Virginia Employment Commission.

construction employers. Some other states, such as Maryland and New Jersey, have adopted laws targeting misclassification in the construction and landscaping industries.

### **VEC Identified 5,639 Misclassified Employees in 2010**

VEC auditors found that collectively, audited employers had 5,639 misclassified workers, which represented one-fifth of all workers at audited employers. On average, misclassified workers comprised 52 percent of all workers at the misclassifying employers. The average number of misclassified workers per misclassifying employer was 9.7 and the median was three.

Although the Construction industry had the highest number of misclassified workers among audited employers (2,356 workers), three industries had a higher proportion of misclassified workers (Table 6). The Real Estate and Rental and Leasing industry had the highest rate of misclassification (37 percent), followed by Transportation and Warehousing (34 percent), and Administrative

**Table 6: Audited Employers in the Real Estate and Rental and Leasing Industry Misclassified at a Higher Rate Than Audited Employers in Other Industries (2010)**

| <b>Industry<sup>a</sup></b>  | <b>% of All Workers Who Were Misclassified Among Audited Employers Within Industry</b> | <b>Number of Misclassified Workers</b> |
|--|--|--|
| Real Estate and Rental and Leasing                                       | 37%  | 161                                    |
| Transportation and Warehousing   | 34   | 480                                    |
| Administrative and Support and Waste Management and Remediation Services | 32   | 580                                    |
| Construction   | 30   | 2,356                                  |
| Accommodation and Food Services  | 24   | 384                                    |
| Wholesale Trade  | 20   | 292                                    |
| Professional, Scientific, and Technical Services                         | 18   | 290                                    |
| Retail Trade   | 12   | 368                                    |
| Other Services (except Public Administration)                            | 12   | 196                                    |
| "All Other" Industries <sup>b</sup>                                      | 7  | 262                                    |
| Health Care and Social Assistance  | 7  | 150                                    |
| <b>Total</b>   | <b>20%</b>   | <b>5,519<sup>c</sup></b>               |

<sup>a</sup>North American Industry Classification System (NAICS) code descriptions.

<sup>b</sup>Includes Educational Services; Public Administration; Manufacturing; Finance and Insurance; Information; Arts, Entertainment, and Recreation; Management of Companies and Enterprises; Utilities; Agriculture, Forestry, Fishing and Hunting; and Mining, Quarrying, and Oil and Gas Extraction.

<sup>c</sup>NAICS industry codes were missing for five misclassifying employers, so total is less than the total number of misclassifying employers (584).

Source: JLARC staff analysis of 2010 audit data from the Virginia Employment Commission.

and Support and Waste Management and Remediation Services (32 percent). In the case of Real Estate and Rental and Leasing, most of the misclassified workers were found at a single audited employer.

### **MISCLASSIFICATION RATES FROM OTHER STATES PROVIDE ROUGH ESTIMATE OF EXTENT OF MISCLASSIFICATION IN VIRGINIA**

Because of the limitations discussed earlier, VEC's audit data cannot be used to estimate the extent of misclassification in Virginia. Therefore, a statewide estimate of misclassification was developed by applying the average of misclassification rates estimated by certain other states to Virginia's total employer and employee population. This estimate is provided to illustrate the potential magnitude of misclassification in the State using the best available information.

## Based on Other State Estimates, Virginia Could Have On the Order of 40,000 Misclassifying Employers and 214,000 Misclassified Workers

### Degree of Randomness

JLARC staff grouped the audits conducted in other states by the extent to which they selected employers for audit on a random basis. States in which 60 percent or more of the audited employers were selected randomly were categorized as having a high degree of random audits. In states with a low degree of random audits, less than 30 percent of audited employers were selected randomly. States with a moderate degree of random audits had between 30 and 60 percent of audited employers selected randomly.

Table 7 summarizes the misclassification rates found by studies in selected other states, grouped according to the degree of randomness of the states' audit methodologies. As shown in the table, estimates of misclassification in other states range from nine percent to 34 percent of employers and one to 20 percent of workers. The average employer misclassification rate (21 percent) estimated by states that conduct a high degree of random audits was selected as a proxy for a statewide misclassification rate because it may be the most precise, as the results of such audits should be more representative of states' employer and employee populations. The percentage of audited employers who misclassify in Virginia (27 percent) is higher than several other states and the other-state average. This is likely due, at least in part, to the targeted nature of VEC's audits.

**Table 7: Misclassification Rates Found by Studies in Other States Vary Widely**

| State (Years(s) of Data)                | % of Audited Employers That Misclassify Workers | % of Misclassified Workers Among Audited Employers |
|---|---|--|
| <b>High Degree of Random Audits</b>     |   |  |
| Colorado (2000)                         | 34%   | 9%   |
| Michigan (2003-2004)                    | 30  | 8  |
| Maryland (2000)                         | 20  | 6  |
| Illinois (2005)                         | 20  | 9  |
| Minnesota (2005)                        | 17  | 1  |
| Massachusetts (2001-2003)               | 13  | 5  |
| Maine (1999-2002)                       | 11  | N/A  |
| <i>Average</i>                          | <i>21%</i>                                      | <i>6%</i>  |
| <b>Moderate Degree of Random Audits</b> |   |  |
| Minnesota (2000)                        | 13%   | 2%   |
| Nebraska (2000)                         | 10  | 1  |
| Washington (2000)                       | 10  | 3  |
| New Jersey (2000)                       | 9   | 9  |
| <i>Average</i>                          | <i>11%</i>                                      | <i>4%</i>  |
| <b>Low Degree of Random Audits</b>      |   |  |
| Virginia (2010)                         | 27%   | 20%  |
| Wisconsin (2000)                        | 23  | 6  |
| New York (2002-2005)                    | 10  | 10   |
| <i>Average</i>                          | <i>20%</i>                                      | <i>12%</i>   |

Source: JLARC staff analysis of misclassification studies conducted in other states.

Based on the average employer misclassification rate (21 percent) estimated by states with a high degree of random audits and the size of Virginia's total employer population, there could be on the order of 40,000 misclassifying Virginia employers. Based on the



average employee misclassification rate (six percent) estimated by states with a high degree of random audits and the size of Virginia's total employee population, there could be on the order of 214,000 misclassified workers in Virginia.

### **Using Other States' Data to Develop a Virginia-Specific Estimate May Not Capture Extent of Misclassification in the State**

The Virginia estimates based on other states' data could either understate or overstate the extent of misclassification in Virginia. For example, there could be substantial variations in the types of industries represented by employers in other states, which could make their rates of misclassification different than Virginia's. In addition, using an average misclassification rate means that Virginia's rate could fall anywhere in the range of rates used to calculate the average. Virginia could be closer to the high end (34 percent) or the low end of the range (11 percent).

The other states' estimates may also be limited by the fact that all misclassified workers may not be counted because some workers are paid in cash, with no reporting to the Internal Revenue Service or state tax or unemployment agencies. VEC staff stated these types of workers are often not identified in audits because of the lack of documentation. Some employers may also not be subject to audits because they pay all of their workers in cash. For example, researchers from Maine stated,

Because this study relies exclusively on UC [Unemployment Compensation] tax audits to develop estimates of the dimensions and impacts of misclassification, it addresses primarily the forms of misclassification that can be documented. It cannot fully capture underground economy activities in construction and other sectors. Thus all estimates are, of necessity, low or conservative in nature.

Finally, many of the studies conducted by other states are several years old, and there is evidence that misclassification has been increasing. For example, Massachusetts researchers found a misclassification rate of eight percent in 1995-1997, which had grown to 13 percent by 2001-2003. Anecdotally, several agency staff interviewed for this study indicated that they believe misclassification is increasing and that the downturn in the economy over the last several years could be causing more employers to misclassify in order to lower costs. One employee group described misclassification as a vicious cycle. When more employers begin to misclassify to lower costs, other employers in the same line of business have an incentive to do the same so that they can remain competitive.



## Misclassification Can Reduce State Revenues

### In Summary

Worker misclassification appears to negatively affect State general funds primarily by lowering income tax revenue, but the precise extent of the impact in Virginia cannot be determined. According to the IRS, misclassified workers tend to underreport their income on tax returns, which results in foregone income tax revenue. JLARC staff estimates of this foregone revenue in 2010 are on the order of \$1 million from workers known to be misclassified and \$28 million based on average misclassification rates estimated by other states. No Virginia-specific data are available to develop a more precise statewide estimate. These foregone revenues are not easily recoverable by the State. Because misclassification allows employers to avoid paying unemployment taxes and workers' compensation premiums, the Virginia Employment Commission and Virginia Workers' Compensation Commission may also forego revenue. However, the State general fund is not affected by this foregone revenue because these agencies are funded with other revenue sources, including special taxes and fees. Ultimately, employers who properly classify workers pay for these programs' foregone revenue. The effects of misclassification on local government revenues appear to be very minimal. Possible indirect effects of worker misclassification, such as on social services and health care costs, are difficult to quantify.

JLARC staff calculated an order of magnitude for the amount of revenue potentially lost to the State and local governments from misclassification. Studies of misclassification in other states identified substantial lost state and local revenues from foregone income tax revenues, unpaid unemployment insurance taxes, and unpaid workers' compensation premiums. JLARC staff identified some potential lost State income tax revenue, but minimal impact from other unpaid taxes and insurance premiums, and no impact on local government revenues.

Misclassification does not cause non-compliance with tax laws, but misclassified workers and their employers have been shown to underreport and underpay certain State taxes. Misclassified workers tend to underreport their income and therefore underpay income taxes. Misclassifying employers do not pay taxes and insurance premiums on behalf of misclassified workers, primarily impacting the Virginia Employment Commission (VEC) and Virginia Workers' Compensation Commission (VWC), which are fully funded with non-general funds.

## FISCAL IMPACT OF MISCLASSIFICATION ON STATE STEMS FROM FOREGONE INCOME TAXES ON UNDERREPORTED INCOME

*Misclassification does not cause workers to underreport income or underpay taxes, but it can facilitate their tendency to do so.*

According to the IRS, misclassified workers tend to underreport their income on their tax returns, thereby underpaying income taxes. Misclassification does not cause workers to underreport income or underpay taxes, but it can facilitate their tendency to do so. Still, the issues behind underreporting and, in turn, tax evasion, are far broader than misclassification.

### Lack of Income Tax Withholding Makes it Easier for Misclassified Workers to Underpay Income Taxes

Independent contractors may find it more cumbersome to comply with income tax laws. Workers classified as employees have taxes withheld from their paychecks and remitted to the Virginia Department of Taxation (TAX) by their employers, which facilitates tax compliance. Conversely, workers who are classified as independent contractors do not have taxes withheld, but are themselves required to calculate and pay estimated income taxes on a quarterly basis in addition to filing an annual tax return.

Instead of receiving a Form W-2 from their employer documenting annual income and tax withholdings, independent contractors should receive a Form 1099-MISC showing their total annual compensation for income tax purposes. A copy of this form is provided to the individual, TAX, and the IRS.

Sometimes, however, employers do not provide misclassified workers with the required 1099-MISC. According to a 1984 IRS study frequently quoted in other state and federal misclassification studies, approximately 26 percent of workers who should have received 1099s did not receive them from their employers. These workers are still required to pay income taxes, but the lack of documentation from their employer means the workers must track their income for tax purposes. This lack of documentation also makes it easier for workers to avoid reporting all of their income and paying all of their taxes.

Classification as an independent contractor instead of as an employee has been shown to affect a worker's compliance with income tax laws. An analysis conducted by the IRS shows that tax compliance for employees whose income is subject to tax withholding is substantially higher than it is for workers (including independent contractors) whose income is not subject to withholding. Employees who are subject to withholding report 99 percent of their income on tax returns, based on this analysis. In contrast, misclassified independent contractors who receive 1099s report 77 percent

#### Forms W-2 and 1099-MISC

Form W-2 is issued by employers to workers who are classified as employees. The W-2 shows the employee's compensation for the year and how much was withheld by the employer in taxes on behalf of the employee. Form 1099-MISC is like a W-2 for independent contractors, but only shows the workers' compensation for the year. Employers are required to provide 1099s to independent contractors to whom they pay more than \$600 a year.

of their income on their tax returns, and those who do not receive 1099s report only 29 percent of their income.

**Estimate of Foregone Income Tax Revenues on the Order of \$28 Million in 2010**

Underreported income from misclassified workers may lower State income taxes and reduce the general fund on the order of \$1 million for workers known to be misclassified (5,639) and on the order of \$28 million for the estimated number of misclassified workers based on other states’ data (214,000).

As discussed in the previous section, whether workers receive a 1099 form appears to greatly affect how much of their income will be reported and taxes will be paid. As shown in Table 8, the estimated fiscal impact is highest from workers who do not receive 1099s because these workers, using results from the aforementioned IRS analysis, tend to underreport a larger percentage of their income. In addition, TAX staff say that the collection rate for workers who do not receive 1099s is low because TAX has no record of these workers’ compensation.

**Table 8: Estimates of Foregone Income Tax Revenue Vary Widely Based on Tax Documentation Received (2010; \$ in Millions)**

| Workers Received Documentation of Income (IRS Form 1099)? | Estimate Based on <u>Known</u> Number of Misclassified Workers (N=5,639) <sup>a</sup> | Estimate Based on <u>Estimated</u> Number of Misclassified Workers (N=214,200) <sup>b</sup> |
|---|---|---|
| Yes   | \$0.1   | \$2.8   |
| No  | \$0.7   | \$25.0  |
| <b>Total</b>  | <b>\$0.8</b>  | <b>\$27.8</b>   |

<sup>a</sup>Number of misclassified workers identified by the Virginia Employment Commission in 2010.  
<sup>b</sup>Number of misclassified workers in Virginia based on the average percentage of misclassified workers in other states.

Source: JLARC staff analysis of audit and employer data from the Virginia Employment Commission and the Virginia Tax Rate Schedule.

*These estimates are provided to illustrate the magnitude of additional income tax revenue that could be collected in future years if steps were taken to prevent or reduce misclassification.*

These estimates are provided to illustrate the magnitude of additional income tax revenue that could be collected in future years if steps were taken to prevent or reduce misclassification. The estimated revenues presented in Table 8, however, would not be easily recoverable. While the State could potentially recover a greater portion of the estimated taxes unpaid by workers known to be misclassified (\$0.8 million), doing so would require extensive time and effort on the part of VEC and TAX staff, as well as the communication of specific audit findings from VEC to TAX, which is not currently done. In addition, many people owe back income taxes, and misclassified workers represent just one category of all individuals

who owe back income taxes to the State. TAX devotes significant effort to this broader compliance problem. The statewide estimate of foregone income taxes from the number of workers who may be misclassified based on other states' misclassification rates (\$27.8 million) is not currently recoverable, as it is not based on specific individuals who could become subject to collection efforts.

### **UNPAID WORKERS' COMPENSATION PREMIUMS AND UNEMPLOYMENT TAXES DUE TO MISCLASSIFICATION AFFECT STATE-ADMINISTERED PROGRAMS, BUT NOT THE GENERAL FUND**

Employers who misclassify workers avoid paying both unemployment taxes and workers' compensation premiums covering these workers. While studies in other states have characterized these lost revenues as having a negative fiscal impact on states, they do not impact the State general fund. Instead, the foregone unemployment taxes and workers' compensation premiums impact the respective agencies (VEC and VWC), which are funded exclusively by federal funds and non-general funds derived from specific taxes and fees.

### **Unpaid Unemployment Taxes Impact the Unemployment Insurance Trust Fund**

Unemployment tax revenues are dedicated funding for the Virginia Unemployment Insurance Trust Fund and are used to pay unemployment benefits for unemployed workers. Misclassifying employers may have avoided paying between \$0.6 million and \$25.0 million in unemployment insurance taxes in 2010, depending on the number of misclassified workers used. Unpaid unemployment taxes represented between 0.13 percent to 4.8 percent of the total unemployment taxes collected in 2010 (\$524 million).

Misclassification could have a minor indirect effect on the general fund because of the General Assembly's decision to use general funds to pay interest on the federal loan for the unemployment insurance trust fund. Unpaid taxes could be a cause for the trust fund balance to be insufficient to cover benefit payments, as is the case currently. When the fund is insolvent, the State pays the benefits with funds borrowed from the federal government, but general fund revenues are not used. The cost of repaying borrowed federal funds is borne by employers, who are required to pay higher unemployment taxes. However, the State can opt to use general funds to pay the interest due on the federal loans. The 2011 Appropriation Act included \$8.9 million in general funds to pay such interest.

The extent to which misclassification affects the solvency of the trust fund is unclear. While misclassification is one reason the

fund's revenue stream may be reduced, the economic recession has likely had a more substantial impact on the fund because more individuals are unemployed and requesting unemployment benefits. VEC staff indicated it is not possible to determine what percentage of the fund's current insolvency is due to misclassification or to other reasons. It is not possible to say to what extent, if at all, reducing misclassification will improve the fund's solvency and reduce the amount of federal funds the State needs to borrow.

In fact, reducing the number of misclassified workers could result in increased claims for unemployment benefits, which would negatively impact the trust fund's balances. A study commissioned by the U.S. Department of Labor in 2000 concluded that if misclassified workers had been properly classified by the states under review, the respective states' unemployment insurance trust funds would have received more tax revenue, but also would have paid out benefits at a similar rate as for other properly classified employees.

### **Unpaid Workers' Compensation Insurance Premiums Impact the Workers' Compensation Commission**

#### **Workers' Compensation Insurance Premium Tax**

The State imposes a license tax on insurance companies that is based on a percentage of the direct gross premium income earned from the applicable insurance type and is imposed in lieu of the corporate income tax. The tax rate for workers' compensation premiums is set by VWC and is currently 2.60 percent: 2.25 percent for the administrative fund, 0.35 percent for the Uninsured Employer's Fund, and 0.0 percent for the Second Injury Fund.

Virginia requires that employers with three or more employees either self-insure or purchase workers' compensation liability insurance from an insurance company. In addition, contractors and businesses that hire subcontractors are required to provide coverage to their subcontractors under the Statutory Employer law. Misclassifying employers may have avoided paying between \$3 million and \$50 million in workers' compensation insurance premiums in 2010, based on estimates of the number of misclassified workers reported in Chapter 3. Because general funds are not used to pay workers' compensation claims for injured workers who are not covered by their employers' workers' compensation insurance, the non-payment of this insurance has no impact on the State's general fund.

Avoidance of workers' compensation insurance by employers can result in lost revenues for VWC and two funds the commission administers: the Uninsured Employer's Fund and the Second Injury Fund. These two funds and the administrative expenses of the commission are funded by the workers' compensation insurance premium tax (see sidebar), which is assessed on workers' compensation premiums paid by employers to insurance companies. When employers avoid purchasing workers' compensation from insurance companies, the base on which this premium tax is assessed is reduced, thereby reducing the revenues from the tax.

Based on the known and statewide estimated numbers of misclassified workers from Chapter 3, VWC could have lost an estimated

### **Uninsured Employer's Fund and Second Injury Fund**

The Uninsured Employer's Fund provides benefits to injured workers of employers who failed to secure adequate workers' compensation liability coverage. Each year, VWC processes approximately 300 claims of this type. The fund expended approximately \$3.3 million in 2010. The Second Injury Fund provides compensation for disability, medical treatment, and vocational rehabilitative services to employees who have suffered a previous loss from an industrial accident.

\$0.1 to \$1.3 million in premium tax revenues due to misclassifying employers' non-payment of workers' compensation in 2010. This loss of revenue could be offset, in part, by an increase in workers' compensation premiums for employers that pay workers' compensation for their employees. Again, these estimates are provided to illustrate the range of magnitude of additional premium tax revenues that could be collected if misclassification were reduced and employers paid workers' compensation premiums on behalf of their correctly classified employees.

VWC staff indicate that these potential lost revenues had little effect on the commission's operations or the financial status of the two funds. They stated, however, that if their operating revenues were substantially reduced due to misclassification, operations could be affected by a need to reduce administrative expenses.

### **MISCLASSIFICATION APPEARS TO HAVE LITTLE EFFECT ON VIRGINIA LOCAL GOVERNMENTS**

Some studies of misclassification conducted in other states have identified certain effects that misclassification can have on local government taxes. For example, Indiana identified \$60 million to \$100 million in lost local income taxes, and Ohio estimated \$36 million in lost income tax for six of its largest local governments.

The impact of misclassification on local governments in Virginia may be minimal because Virginia localities do not levy an income tax. Several local government finance officers were contacted for this study, and none could identify any local government impact from misclassification. In addition, TAX staff stated that they were not aware of any local taxes in Virginia that might be negatively affected by misclassification. To the extent that some misclassified independent contractors might pay local business taxes that they would not pay as employees (such as the Business, Professional and Occupational License Tax, which imposes a license fee on businesses' gross receipts), misclassification could in fact have a positive but likely minimal effect on local revenues.

### **INDIRECT EFFECTS COULD BE SIZEABLE BUT ARE DIFFICULT TO QUANTIFY**

The most direct impact of misclassification on State government revenues is from foregone income tax revenue. There may be indirect effects on State revenues from misclassification, particularly in the social services and health care areas, but these effects are difficult to quantify. For example, some studies in other states have found that when misclassified workers do not receive health insurance or workers' compensation through their employers, their health care costs could be passed to the state or taxpayers through public programs such as Medicaid. In addition, VEC staff stated



that non-custodial parents sometimes prefer to be misclassified as independent contractors to avoid wage garnishment for child support, which could in turn cause the child to require some form of public assistance. Misclassified workers who become unemployed also may not apply for unemployment benefits and therefore may purchase fewer goods, which could lower sales tax collections.

The administrative costs of State agencies could also be affected by misclassification. For example, when misclassified workers apply for unemployment benefits, VEC staff have to spend more time with them than they would with a correctly classified worker to investigate whether they were misclassified. VWC staff also indicated that they spend more time when dealing with misclassification issues.



## Prevention, Detection, and Enforcement Strategies May Reduce Misclassification

### In Summary

Other states use numerous strategies to reduce the extent of misclassification. These strategies vary in effectiveness, efficiency, and in resources required. Because employers may misclassify workers due to confusion over the correct definition of an employee, as well as to cut costs, a variety of strategies appear necessary. Efforts to prevent unintentional misclassification have focused on clarifying definitions and educating employers and workers about proper classification. More misclassifying employers could be detected by enhancing agency coordination and developing a complaint process accessible to the general public. Increasing the odds of being detected could also deter employers from misclassifying in the first place. Meaningful enforcement mechanisms such as instituting financial penalties and stop work orders on public contracts could increase the potential risks of misclassifying such that they outweigh potential benefits. Most states have combined several of these measures to develop comprehensive legislation to combat misclassification.

Misclassification of workers may result from confusion about proper classification or may be an intentional effort by employers to evade certain taxes and fees, as discussed in previous chapters. Although staff at Virginia agencies and industry representatives expressed a variety of opinions when asked whether confusion or financial motives are the primary cause of misclassification, a frequently expressed opinion was that employers misclassify primarily to cut their labor costs.

Proper classification of workers is necessary to ensure businesses comply with tax and labor laws, but as discussed in Chapter 1, the criteria used to determine whether a worker is an employee or an independent contractor are complex and numerous. The Virginia Employment Commission (VEC) and Virginia Workers' Compensation Commission (VWC) identify misclassification when investigating compliance with unemployment insurance and workers' compensation laws, respectively. Nevertheless, most misclassifying employers will remain undetected because there are no penalties for misclassification itself, and some employers will continue to misclassify even if identified.

A variety of strategies to alleviate or reduce the extent of misclassification were identified by JLARC staff through reviews of the literature and interviews with staff in other states. These strategies can be grouped into three categories: prevention, detection, and enforcement. Prevention strategies address the root causes of misclassification by aiming to reduce confusion, while detection

and enforcement strategies target and punish misclassifying employers. Addressing these three areas would create a comprehensive approach to the problem of misclassification by preventing misclassification before it happens, finding it when it occurs, and penalizing employers who misclassify.

## **PREVENTION STRATEGIES ATTEMPT TO ADDRESS THE ROOT CAUSES OF MISCLASSIFICATION**

### **Proposed Virginia Legislation**

The Worker Misclassification Act (SB 34) was introduced in 2010 but did not pass. The bill included a presumption of employee status unless (i) the individual has been and will continue to be free from direction and control of the employer, both under his contract of service and in fact, (ii) the service is outside the usual course of the business of the employer, and (iii) the individual is customarily engaged in an independently established trade, occupation, profession, or business, both under his contract of service and in fact. The bill also contained penalties for any form of retaliation, subjected violators to criminal and civil penalties, prohibited the violators from contracting with State or local governments, and authorized stop work orders in certain instances.

Preventing misclassification could save the State from costly measures to detect and enforce proper classification of employees. To the extent that misclassification results from employers' confusion about how to properly classify workers, misclassification could be prevented by providing employers and workers with clear guidance and information on worker classification.

Virginia does not currently have any specific misclassification prevention efforts in place, although certain State agencies attempt to educate employers and workers about proper classification. VWC includes information about employer-employee relationships, education, outreach, and other concerns and efforts in its Employer Guide, which states that under the Virginia Workers' Compensation Act, an employee is a person who is under written or implied contract of hire "except one whose employment is not in the usual course of the trade, business, occupation or profession of the employer." Additionally, employers and workers can contact commission staff with questions about proper classification, although this service may not be well publicized. Similarly, VEC staff offers guidance on proper classification when receiving calls from concerned employers and workers.

### **Clear and Consistent Definitions Could Help Prevent Misclassification**

A clear and consistent standard for what constitutes an employee under Virginia law would reduce potential confusion over the multiplicity of exemptions and exclusions currently available. In addition, it would give Virginia agencies a resource to which they can direct employers, and limit employers' ability to evade classification rules. This would likely decrease the number of future disputes over classification. (This discussion only relates to State efforts, as federal authority would be required to alter the classification tests used in the federal tax and labor laws discussed in Chapter 1.)

However, a clear and consistent standard can be difficult to develop. If the definition is too broad, it may allow employers to continue circumventing the rules. If it is too narrow, it may inhibit the legitimate use of independent contractors. It is important to note that clarifying definitions will not solve the problem of misclassifi-

cation, as employers who intentionally seek to evade the law will likely continue to do so.

To avoid confusion over which characteristics indicate independent contractor status, some states, including Maryland, New Hampshire, and Delaware, have enacted laws that presume employee status within certain industries.

- Maryland's Workplace Fraud Act assumes workers in the construction and landscaping industries are always employees and not independent contractors. Only if a worker meets a six-factor test can the worker be considered an independent contractor.
- New Hampshire has a similar law, which presumes employee status for all workers unless they meet 12 specific criteria that would qualify them as independent contractors.
- Massachusetts and some other states require independent contractors to sign formal agreements acknowledging their classification. According to the Massachusetts Attorney General, all employer-independent contractor relationships in that state should be established by a formal written agreement outlining each party's obligations and expectations.

### **Interagency Councils Encourage Information Sharing**

While the problem of misclassification is not new, the heightened awareness of the issue at the state and federal level is relatively recent. In an effort to learn more about the magnitude of misclassification and its effects, several states have created interagency councils. Some of these councils bring together the relevant state agencies to discuss the issue, while other councils are responsible for evaluating mechanisms to reduce misclassification and identifying potential barriers to these efforts.

An interagency council can be an effective way to enhance interagency collaboration, raise awareness about the issue of misclassification, and research the issue on a continuing basis. However, it may also lead to delays in needed reforms and be an additional administrative burden for its members.

Examples of other states' interagency councils include:

- New Hampshire's Executive Order 2010-3 requires the state's Department of Labor to establish cross-agency relationships, examine the extent of misclassification in the state, and maintain a public website outlining the most recent efforts by the state's Task Force for the Misclassification of New Hampshire Workers.

- Tennessee’s Employee Misclassification Advisory Task Force was created to make recommendations related to the issue of misclassification within the construction industry. It aims to bring together several related agencies to engage and protect the business community from misclassification. The task force intends to play a more active role in reducing misclassification by educating the workforce and enforcing compliance with tax and employment laws.
- New Jersey’s Construction Industry Independent Contractor Act created the Misclassification Task Force. This is an audit unit with investigators charged solely with enforcing the law prohibiting misclassification. Investigators conduct both targeted and random work site inspections with the primary goal of identifying misclassified workers. According to unit staff, most detection occurs through complaints by unions or individuals. New Jersey auditors are also required to conduct random inspections.

### **Other States Use Outreach to Educate Employers and Workers**

Outreach programs that educate employers and employees could allow the workforce to learn about proper classification in open meetings and through educational materials rather than in a possibly contentious audit setting. Educating the workforce would likely improve the understanding of the rules and regulations associated with worker classification. In turn, voluntary compliance with classification rules should increase.

- In an effort to educate the workforce, Iowa’s Misclassification Unit (within the state’s Workforce Development Department) holds events to raise awareness of workplace fraud that specifically address misclassification. The unit gives seminars and provides guidance on how to classify workers and how to adhere to federal and state employment laws. Organizations, interest groups, agencies, and the public are encouraged to call the misclassification unit to request information.
- Washington’s Department of Labor and Industry created a fraud prevention and compliance website detailing different types of workplace fraud involving employers and contractors. The department also maintains a fraud and prevention blog with up-to-date news concerning misclassification, as well as regular podcasts and articles from guest contributors.
- The Pennsylvania Construction Workplace Misclassification Act required a poster to be designed that would provide information about proper classification of workers, the penalties for misclassification, and the process for lodging a formal complaint. Investigators routinely provide employers with a

copy of the poster for their worksites. A copy of this poster can be found in Appendix E.

## **DETECTION STRATEGIES ATTEMPT TO TARGET MISCLASSIFYING EMPLOYERS**

*While some Virginia agencies encounter misclassification during audits or inspections, no single agency is tasked with specifically detecting misclassification.*

While some Virginia agencies encounter misclassification during audits or inspections, no single agency is tasked with specifically detecting misclassification. VEC identifies misclassified workers when they conduct employer audits, whose main purpose is to ensure unemployment insurance compliance. VEC audits only approximately one percent of the State's employers annually. The Department of Labor and Industry (DOLI) encounters misclassification as part of wage complaint cases which involve misclassified workers in about 35 percent of cases, according to DOLI staff. Finally, VWC may observe misclassification when a worker files a claim for compensation, although the extent to which this occurs is not tracked. Staff at each of these agencies said that they also receive tips, complaints, and suggestions related to misclassification from concerned citizens.

Without some likelihood of detection, the financial benefits of misclassification may continue to exceed the risk perceived by employers, and this issue will persist. Staff at Virginia agencies report that many employers are difficult to find because they operate on a cash-only basis. These employers reportedly believe that they are unlikely to be caught, and thus may intentionally misclassify their workers.

### **Agency Coordination and Information Sharing Raise Awareness of Misclassification**

Agency coordination and data sharing allows for active collaboration among State agencies while increasing their consistency, effectiveness, and efficiency in detecting misclassification. For example, VEC audit findings about misclassification could be shared routinely with the Virginia Department of Taxation (TAX), which could then examine misclassifying employers' tax histories and monitor future activity. Yet, such interagency coordination faces some implementation hurdles.

Some states have recognized the pervasiveness of misclassification and have attempted to create a cross-agency data sharing mechanism to address it.

- Utah adopted the Independent Contractor Database Act, which allows agencies to share information and included a process to compare data in order to identify and reduce incidents of misclassification and promote employer compliance with state and federal laws.

- Illinois' Employee Classification Act of 2008 requires the state's Department of Labor to notify other state agencies should a classification violation occur. The Department of Labor is expected to contact the Department of Employment Security, the Department of Revenue, the Office of the State Comptroller, and the Illinois Workers' Compensation Commission, each of which will assess the violator's compliance with relevant tax and employment laws.
- Washington's fraud prevention and compliance website allows state agency staff and the general public to verify certain information about an employer, such as the employer's workers' compensation insurance status, contractor registration, and any previous citations for wage complaints filed by an employee.

Virginia agencies do not often share information related to incidents of misclassification, regardless of the fact that misclassifying employers may be in violation of several laws relating to different State agencies. State agencies could initiate the provision of information about specific misclassified employees to other agencies whose employment or tax laws an employer may disregard. While this may happen occasionally across some agencies, there is no systematic or routine cross-agency collaboration regarding misclassification.

Sharing audit results may be hindered due to privacy issues related to employer and worker information, database incompatibilities between agencies, federal disclosure rules, and divergent rules concerning what constitutes an employee versus an independent contractor, as described in Chapter 1. Some of these concerns could be resolved through the interagency task force recommended later in this chapter.

### **Complaint Process Encourages Reports of Misclassification**

A single misclassification complaint form coordinated across the agencies would simplify the filing of complaints and could lead to quicker identification of misclassifying employers. A single form would also facilitate a streamlined complaint-handling process. Complaints would be investigated and may reveal instances of misclassification that may not otherwise have been detected. While some complaints may be invalid, the complainant's identifying information and details regarding the violation on the form may reduce false accusations.

Some states, including Colorado, Connecticut, Illinois, and Pennsylvania, have created a formal complaint process:



- In Colorado, any person may file a written complaint alleging misclassification by any employer. The complaint must include contact information and a description of the job duties performed by the worker being misclassified, and may be submitted via email or postal service. All complaints are reviewed and followed up with an investigation if necessary. Additionally, employers in Colorado may seek an advisory opinion on proper classification of workers by sending a formal request to the Colorado Department of Labor and Employment.
- Pennsylvania's Department of Labor and Industry has developed a Construction Workplace Misclassification Complaint Form which allows any person to lodge a complaint regarding an employer (see Appendix E). The comprehensive form requests the contact information for the person filing the complaint, which deters anonymous false complaints and allows the department to follow up with the individual lodging the complaint. It also requires business information regarding the employer against whom the complaint is lodged and employment information relating to the workers believed to be misclassified. Once this form is received, the complaint is investigated by the Bureau of Labor Law Compliance.

### **Virginia Interagency Task Force Could Provide Clarity and Education While Facilitating Cross-Agency Information Exchange**

As discussed earlier in this chapter, several other states have recognized that employee misclassification affects multiple agencies and have implemented an inter-agency council or task force. Creating such a group underscores the importance of the issue of worker misclassification and would alert misclassifying employers to the increased likelihood of being detected while assuring compliant employers that the issue is being addressed.

In Virginia, an interagency task force chaired by the Secretary of Commerce and Trade and including representatives of VEC, DOLI, VWC, and TAX could focus on and work to prevent employee misclassification. This task force could help develop a process for exchanging information, such as specific audit and investigatory findings between agencies, with the assistance of a variety of sources outside of State government, including employer groups and other interested parties. This task force should be established by Executive Order and chaired by the Secretary of Commerce and Trade or a designee, and could be phased out once its objectives are attained.

The establishment of a task force would acknowledge the importance to Virginia businesses of addressing employee misclassi-

fication in order to help them compete on a level playing field. The objectives of the task force could include

- developing and recommending to the General Assembly a clear definition of “employee” and “independent contractor,” taking care to avoid de-conforming with key federal tax laws,
- developing information sharing procedures so that audit and other findings about misclassified workers can be systematically shared with the other agencies, which would then investigate whether laws within their purview had been violated,
- developing and distributing materials designed to inform employers and workers about what distinguishes an employee from an independent contractor,
- publicizing existing ways for workers and employers to report suspected misclassification and to seek clarification of their own or others’ situations, and
- considering enforcement mechanisms, such as civil penalties or disbarment from bidding on future State or local contracts.

Participating agencies may require additional resources to support significant efforts to address misclassification.

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**Recommendation (1).** The Governor should establish an interagency task force on employee misclassification, to be chaired by the Secretary of Commerce and Trade or his designee. The task force should include representatives of the Virginia Employment Commission, Department of Labor and Industry, Workers’ Compensation Commission, and Department of Taxation. The task force should (1) develop and recommend legislation to provide a clear and consistent definition of “employee,” taking care to avoid de-conforming with key federal tax laws, (2) develop procedures for sharing information between agencies, (3) develop materials to educate workers and employers about the definition and the consequences of misclassification, (4) publicize ways for individuals to report suspected misclassification and seek clarification under the existing and any new definitions, (5) consider appropriate enforcement mechanisms, and (6) identify additional resources that may be required to prevent and detect employee misclassification.

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## **ENFORCEMENT STRATEGIES PROMOTE PROPER CLASSIFICATION**

The need for penalties or punitive measures depends in part on the extent to which employers are intentionally misclassifying workers. Enforcement strategies require a focused effort to diminish the incentive to misclassify. This can be achieved in various ways, including levying penalties, prohibiting further work, and allowing

for a private right of action. Although Virginia has penalties for failure to report income, withhold taxes, or comply with workers' compensation laws, there are currently no penalties for misclassification per se.

### **Criminal and Civil Penalties May Deter Misclassification**

Criminal and civil penalties are used by several other states to enforce proper classification. In some states, penalties are the cornerstone of misclassification legislation. Some state legislatures have passed or proposed laws relating to the recovery of civil penalties due to misclassification.

- Connecticut's Act Implementing the Recommendations of the Joint Enforcement Commission on Employee Misclassification increased the state's civil penalty from \$300 per violation to \$300 per day, per violation. According to the commission's report, as of 2010 the Connecticut Department of Labor had collected approximately \$90,000 in civil penalties. The increase in the penalty will significantly increase these revenues.
- In Illinois, any employer within the construction industry found in violation of the state's Employee Classification Act is subject to up to \$1,500 in civil penalties for the first offense and up to \$2,500 for each repeat offense found by the Department of Labor within a five-year period. Additionally, separate fines are incurred for each offense, each worker, and each day the offense continues.
- Florida's Administrative Code also contains a rule relating to misclassification whereby any employer who fails to secure workers' compensation for an independent contractor who should be classified as an employee is assessed a penalty. The penalty starts at \$2,500 per worker for each of the first two misclassified workers per site, and \$5,000 for any thereafter.
- In Maryland, according to the Workplace Fraud Act, employers who "knowingly" misclassify are subject to a civil penalty of up to \$5,000 per worker. Additional penalties may be imposed upon the employer if they do not produce requested records or written statements relevant to the classification of the worker in question within 15 days (\$500 per day) or do not come into compliance with laws pertaining to misclassification in a timely manner (\$1,000 per employee). The employer can also be responsible for paying administrative penalties to the state. Additionally, civil penalties can be assessed up to \$20,000 on anyone who "knowingly" advises an employer to misclassify.

***Substantial financial penalties can remove the incentive to misclassify.***

- In New Jersey, employers who misclassify in the construction industry may face both civil and criminal penalties. The misclassifying employer may be fined up to \$1,000 or imprisoned for up to 90 days. Each violation, which is issued for each worker and each day on which he or she worked, incurs an additional fine. If the misclassification is found to be “willful,” the maximum fine could reach \$150,000 and imprisonment could be up to ten years.

Substantial financial penalties can remove the incentive to misclassify. If the punishment for misclassification outweighs the payroll cost benefits, an employer may be deterred from misclassifying. Financial penalties also create additional revenue for the state, which can be used to fund enforcement efforts. Stiffer enforcement measures could also have the unintended effect of reducing the legitimate use of independent contractors by employers who fear misclassifying workers inadvertently. Consequently, the amount of the penalties should be carefully considered.

It is important to note that while many states have enacted these penalties, not all have enforced them. Staff in Maryland stated that they had not assessed any penalties since the law’s inception in 2009. Staff in New Jersey reported that they do not often assess penalties, and the ones they have assessed have been relatively low and rarely for first-time offenses. However, both states noted that simply having the penalties as a part of the law has helped deter misclassification.

### **Prohibition of Contracts and Stop Work Orders**

Another way to enforce proper classification of workers is by forbidding further work by an employer who has been found to misclassify. This can be achieved by a formal prohibition of contracts or a stop work order.

- In Vermont, an employer who is found in violation of the misclassification law (Act 142) may be subjected to a stop work order prohibiting the employer from contracting with the state or any of its subdivisions for up to three years.
- If an employer is found guilty of the Workplace Fraud Act in Delaware, he or she may face debarment from public contracts and other work. If the employer has a state contract, that state agency may withhold payment to cover back wages, benefits, taxes, or any other necessary remuneration for misclassified workers.
- Maine’s Workers’ Compensation Board has the power to issue a stop work order on an employer’s current business activity (such as work on a construction site) if the employer is

found guilty of misclassifying a worker as an independent contractor. According to the director of the board, hundreds of these orders have been issued to small businesses in the state.

- In New Jersey, the Commission of Workforce Development is authorized to issue stop work orders for an employer's second offense, halting the work at all sites in which misclassification is occurring or, in the case of a third offense, the cessation of work at all sites in which the employer is operating, whether or not misclassified workers are present at all sites.

Virginia's Procurement Manual contains language regarding the use of independent contractors but does not appear to contemplate specific actions being taken against employers that win State contracts and are found to misclassify workers. The manual cautions agencies and employers seeking to do business with the State when classifying their workers and advises them to request guidance from the IRS if they are confused about the guidelines:

*Contracting for the services of individuals as contractors should be treated the same as any other procurement transaction. Agencies contracting with individuals are cautioned that problems have arisen with the Federal Internal Revenue Service concerning withholding and Social Security taxes in situations where the individual contractor performs under the supervision and control of the agency. An employer-employee relationship has been determined to exist in such cases, thereby subjecting the Commonwealth to liability for such taxes plus those employment obligations established by State law or gubernatorial policy. When in doubt, consult your personnel officer and/or your Assistant Attorney General before entering into such a contract. For factors indicating whether an individual is an employee or an independent contractor see *Employer's Supplemental Tax Guide, Publication 15-A (January, 2002)*.*

### **Additional Enforcement Authority May Be Warranted**

It is likely that misclassification could be reduced if it were made illegal and there were significant financial consequences for employers who misclassify workers. Currently, there is no Virginia law against misclassification, and if a VEC audit finds that an employer has misclassified workers, the employer is required to remit any taxes that should have been paid, along with interest going back three years. The only penalty is interest on the back taxes, levied at a rate of 1.5 percent per month or 18 percent on an annual percentage rate basis.

In contrast, a civil penalty could be used to deter misclassification. Substantial civil penalties, possibly tied to the misclassifying employer's payroll, could provide such deterrence. The *Code of Virginia* already provides for significant financial penalties as a consequence of certain offenses. For example, *Code* §62.1-44.15 authorizes the State Water Control Board to issue civil penalties to water polluters of up to \$32,500 per violation and \$100,000 per occurrence, following several due process steps such as two written notices and a hearing.

The general procedure could be for State agency personnel who identify misclassification violations to issue a written notice to the misclassifying employer, initiating the process that could lead to a civil penalty levied by either the VEC or DOLI Commissioner. The exact procedure could be developed by the interagency task force. However, the financial penalties should be authorized and set by the General Assembly.

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**Recommendation (2).** The General Assembly may wish to amend the *Code of Virginia* to make misclassification of employees illegal, and to specify financial penalties for employers who misclassify workers.

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Virginia's Procurement Manual contains language regarding the use of independent contractors but does not identify actions to be taken against employers who misclassify workers and win a State or local contract. VEC auditors could target employers who win such contracts to ensure they are properly classifying their workers, with the prospect of a stop work order from the contracting State or local agency upon a finding that the employer is misclassifying workers. Penalties could also be applied, such as disbarment of the employer from bidding on any future State or local work for a set period of time.

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**Recommendation (3).** The General Assembly may wish to amend the *Code of Virginia* to authorize a stop work order to be issued to employers working on State contracts who are found to be misclassifying workers. Additional penalties could include disbarment of the employer from bidding on any future State or local contracts for a specified period of time.

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# JLARC Recommendations:

## Review of Employee Misclassification in Virginia

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1. The Governor should establish an interagency task force on employee misclassification, to be chaired by the Secretary of Commerce and Trade or his designee. The task force should include representatives of the Virginia Employment Commission, Department of Labor and Industry, Workers' Compensation Commission, and Department of Taxation. The task force should (1) develop and recommend legislation to provide a clear and consistent definition of "employee," taking care to avoid de-conforming with key federal tax laws, (2) develop procedures for sharing information between agencies, (3) develop materials to educate workers and employers about the definition and the consequences of misclassification, (4) publicize ways for individuals to report suspected misclassification and seek clarification under the existing and any new definitions, (5) consider appropriate enforcement mechanisms, and (6) identify additional resources that may be required to prevent and detect employee misclassification. (p. 44)
2. The General Assembly may wish to amend the *Code of Virginia* to make misclassification of employees illegal, and to specify financial penalties for employers who misclassify workers. (p. 48)
3. The General Assembly may wish to amend the *Code of Virginia* to authorize a stop work order to be issued to employers working on State contracts who are found to be misclassifying workers. Additional penalties could include disbarment of the employer from bidding on any future State or local contracts for a specified period of time. (p. 48)





## Study Mandate

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### SENATE JOINT RESOLUTION NO. 345

Agreed to by the Senate, February 23, 2011

Agreed to by the House of Delegates, February 22, 2011

*Directing the Joint Legislative Audit and Review Commission to study any misclassification of employees as independent contractors in Virginia. Report.*

WHEREAS, an employee is a person hired to provide services to an employer on a regular basis in exchange for compensation and who does not provide these services as part of an independent business; and

WHEREAS, an independent contractor is a person who performs services for another person under an express or implied agreement and who is not subject to expectations of a future commitment to plans or services; and

WHEREAS, defining who is an employee is complex and involves understanding several laws, rules, and court cases and the regulations of many state and federal agencies; and

WHEREAS, employers must withhold income, Social Security, and Medicare taxes from an employee's wages; and

WHEREAS, employers must also pay Social Security, Medicare, and unemployment taxes and comply with state and federal labor laws, including those related to minimum wage and overtime compensation rates; and

WHEREAS, a worker who is considered to be an independent contractor is responsible for paying his own income and self-employment taxes; and

WHEREAS, lawful independent contractor relationships are signified by a written contract and the opportunity for profit and loss by the contractor; and

WHEREAS, misclassification of workers may have serious consequences for state and federal governments by depriving them of revenue, including income, Social Security, Medicare, and unemployment taxes that support public services, such as unemployment benefits; and

WHEREAS, the United States Government Accountability Office estimated that in 2006 the federal government was deprived of approximately \$2.72 billion in Social Security, unemployment, and income taxes because of employee misclassification; and

WHEREAS, there is a need to determine the economic effect of any employee misclassification on the state and local governments in Virginia; now, therefore, be it

RESOLVED by the Senate, the House of Delegates concurring, That the Joint Legislative Audit and Review Commission be directed to study any misclassification of employees as independent contractors in Virginia.

In conducting its study, the Joint Legislative Audit and Review Commission shall (i) review the status of employee misclassification in the state, (ii) review the consequences of any misclassification to the workforce, (iii) estimate the amount of revenue potentially lost to the state and to local governments, and (iv) recommend strategies for alleviating any misclassification or improper classification of employees.

Technical assistance shall be provided to the Joint Legislative Audit and Review Commission by the Board for Contractors within the Department of Professional and Occupational Regulation. All agencies of the Commonwealth shall provide assistance to the Department for this study, upon request.

The Joint Legislative Audit and Review Commission shall complete its meetings for the first year by November 30, 2011, and for the second year by November 30, 2012, and the chairman shall submit to the Division of Legislative Automated Systems an executive summary and a report of its findings and recommendations no later than the first day of the next Regular Session of the General Assembly for each year. Each executive summary and report shall state whether the Joint Legislative Audit and Review Commission intends to submit to the General Assembly and the Governor a report of its findings and recommendations for publication as a House or Senate document. The executive summaries and reports shall be submitted as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents and shall be posted on the General Assembly's website.

# Research Activities and Methods

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Key research activities and methods for this study included

- structured interviews with State agency staff, key stakeholders, and other states;
- data analysis of employer and employee data from the Virginia Employment Commission; and
- document and literature reviews.

## **STRUCTURED INTERVIEWS**

During the review, JLARC staff conducted interviews with several State agencies and officials, industry groups, and staff in other states. These interviews provided background information on the status and extent of misclassification, whom it affects, strategies to reduce misclassification, and other issues relevant to the review.

### **Virginia State and Local Agencies and Officials**

JLARC staff conducted interviews with the following State agencies:

- Virginia Employment Commission (VEC),
- Workers' Compensation Commission (VWC),
- Department of Taxation (TAX),
- Department of Professional and Occupational Regulation (DPOR),
- Department of Labor and Industry (DOLI), and
- State Corporation Commission Bureau of Insurance (BOI).

JLARC staff also contacted local government finance officers to ask about potential effects of misclassification on local government. Finance officers in the cities of Roanoke and Chesapeake were contacted, as was a representative of the Commissioners of the Revenue.

In addition, JLARC staff interviewed several industry and employee groups to understand the impact of misclassification on employers and workers, including:

- Associated General Contractors of Virginia,
- Association for Construction Excellence,
- Virginia Trucking Association,
- Virginia AFL-CIO, and
- United Brotherhood of Carpenters and Joiners of America.

### **Other States**

To better understand how other states are addressing the issue of misclassification, the study team interviewed staff in both Maryland and New Jersey. These states were selected due to their similarity in population to Virginia, their efforts to alleviate misclassification, and the length of time these efforts have been in place. Both interviews included individuals involved with their state's workplace fraud and misclassification units. Personnel in additional states were also contacted to better understand specific laws and information.

### **DATA ANALYSIS**

JLARC staff conducted two main data analyses. First, audit and employer data from VEC were used to calculate the known and estimated number of misclassifying employers and misclassified workers in the State. Second, the misclassification estimates and other data were used to calculate the estimated fiscal impact of misclassification on the State.

#### **Analysis of VEC Employment Data**

To determine the extent of misclassification in Virginia, JLARC staff created a database that combined two datasets from VEC. The first dataset contained misclassification data for all audits conducted during calendar year 2011, which were based on 2010 data. This dataset included the VEC account number, number of misclassified workers identified during the audit, and type of audit (regular or large). The second dataset included additional data for all employers who pay unemployment insurance in the State:

- VEC account number
- employer name
- employer location (FIPS)
- employer address
- employer ownership type code (i.e., federal government, state government, local government, or private ownership)

- private industry organization type code (i.e., corporation, individual proprietorship, other organization type, or partnership)
- North American Industry Classification System (NAICS) code
- number of employees, by quarter
- total wages paid, by quarter
- multiple establishment employer indicator (MEEI) for the quarter

These two datasets were combined to create a comprehensive employer-level database for all Virginia employers that pay unemployment insurance on behalf of their employees.

***Analysis of Misclassifying Employers and Misclassified Workers Identified During VEC Audits.*** The employer-level database was used to calculate the number of misclassifying employers and misclassified workers identified during the VEC audits. In addition, other basic statistics were calculated, including the proportion of each employer's workforce that was misclassified, number and proportion of misclassifying employers and misclassified workers by industry, and number and proportion of misclassifying employers and misclassified workers by employer size.

When calculating these statistics, the following assumptions were made:

- Employees and misclassified workers in the VEC datasets represented one full-time equivalent employee or worker.
- All employers correctly reported their data to VEC. Based on discussions with VEC staff, JLARC staff assumed employers only reported employees who were covered by unemployment insurance to VEC (misclassified workers and legitimate independent contractors were not included). In addition, JLARC staff assumed employers reported their employment data correctly. For example, if zero employees were reported by an employer for a particular month, JLARC staff assumed that this was correct.

***Calculation of Statewide Estimate of Misclassifying Employers and Misclassified Workers.*** In addition to identifying the known number of misclassifying employers and misclassified workers identified during VEC audits, JLARC staff calculated estimates of misclassifying employers and misclassified workers statewide. As discussed in Chapter 3, JLARC staff decided against using the VEC audit data as the basis for the statewide estimates because the audited employers were not selected on a statistically random

basis, and could therefore not be generalized to the statewide employer and employee populations (i.e., JLARC staff could not assume that non-audited businesses misclassified at the same rate as audited businesses within each industry).

Instead, JLARC staff developed a statewide estimate using the misclassification rates from other states' studies of misclassification. Staff selected misclassification rates for states that conduct highly random unemployment audits because these were assumed to be more representative of the statewide populations. JLARC staff calculated the average of the other states' rates of employer and worker misclassification, and applied the rates to the total number of employers and employees in the VEC database.

### Calculation of Fiscal Impacts on State Revenues

The known and estimated number of misclassified workers was the basis of the estimated fiscal impacts of misclassification on State revenues. In addition, both fiscal impacts used an average annual per-worker compensation that was calculated using 1099 data provided by TAX.

#### Average Compensation per Misclassified Worker

TAX staff provided JLARC staff with data on the total compensation reported on 1099s for non-employee compensation in FY 2009. This was divided by the number of individuals receiving 1099s (for non-employee compensation) to calculate the average compensation per worker receiving a 1099.

**Impact of Misclassification on State Income Taxes.** As discussed in Chapter 4, misclassified workers tend to underreport their income, and workers who do not receive 1099s tend to report even less of their income than workers who receive 1099s. Because of the reporting differences for these two groups of misclassified workers (those who receive 1099s and those who do not), JLARC staff calculated the estimated fiscal impact of foregone taxes separately for the two groups using several estimates and assumptions.

One range of estimates is based on the known number of misclassified workers identified in 2010 through VEC audits (5,639 workers) and uses the IRS assumption that 29 percent of these workers did not receive 1099s and the remaining 71 percent did receive them. A second estimate was developed based on the estimated number of misclassified workers derived from other states' rates of misclassification (approximately 214,200 workers), and also assumes that 71 percent of the workers received 1099s and 29 percent did not. For both estimates, JLARC staff assumed that the workers who received 1099s reported 77 percent of their income, and workers who did not receive 1099s reported 29 percent of their income.

Assuming average annual compensation of \$21,081 per worker, JLARC staff calculated the difference between the amount of income tax due on the full compensation (less standard deductions and exemptions) and the amount due on the underreported amounts to estimate the tax revenue foregone per misclassified

worker. The per-worker estimates were then multiplied by the estimated number of misclassified workers to calculate the total income tax revenue that is estimated to be foregone.

Table B.1 provides an example of how JLARC staff calculated the impact of foregone income tax revenues due to misclassification. The example is for workers who receive 1099s and uses the estimate of misclassified workers based on other states' misclassification rates.

**Table B.1: Calculation of Income Tax Impact for Misclassified Workers Who Receive 1099s (Using the Estimate of Misclassified Workers Based on Other States' Data)**

|           |   |                      |
|-----------|---|----------------------|
| A         | Estimated percentage of workers who receive 1099s <sup>a</sup>  | 74%                  |
| B         | Estimated number of misclassified workers in Virginia (based on other states' estimate)   | 214,203              |
| C = (A*B) | Estimated number of misclassified workers in Virginia who receive 1099s   | <b>158,510</b>       |
| D         | Average compensation (gross) per worker   | \$21,081             |
| E         | Virginia state personal exemption (\$930) and single standard deduction (\$3,000) for tax year 2010 <sup>b</sup>                      | (\$3,930)            |
| F = (D-E) | Average <u>taxable</u> compensation per worker (less deductions and exemptions)   | <b>\$17,151</b>      |
| G         | Estimated percentage of income reported by misclassified workers who receive 1099s  | 77%                  |
| H = (D*G) | Estimated income reported by misclassified worker (who receives 1099) on tax return   | <b>\$16,232</b>      |
| I         | Tax owed on actual compensation (row F) (i.e., tax that should have been paid on fully reported income, less deductions) <sup>c</sup> | \$729                |
| J         | Tax owed on underreported compensation (row H) (i.e., tax that was paid on income that was actually reported) <sup>c</sup>            | \$681                |
| K = (J-I) | Difference in tax owed on actual compensation and reported compensation (amount "foregone" by State per worker)                       | <b>(\$48)</b>        |
| L = (C*K) | Estimated amount of State income taxes foregone   | (\$7,608,480)        |
| M         | Estimated percentage of this income tax <u>not</u> collected by TAX   | 37%                  |
| N = (L*M) | Total estimated State income tax foregone   | <b>(\$2,815,138)</b> |

<sup>a</sup> *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, Coopers & Lybrand, June 1994.

<sup>b</sup> From State Form 760 (2010 and 2011 tax returns).

<sup>c</sup> From Virginia Tax Rate Schedule.

Source: JLARC staff analysis of data from the Virginia Employment Commission and the Department of Taxation.

**Impact of Misclassification on the Workers' Compensation Premium Tax.** Table B.2 illustrates how JLARC staff calculated the impact of misclassification on revenues from the workers' compensation insurance premium tax. The example is for the known number of misclassified workers identified by VEC staff. Because workers' compensation rates are higher for employers in the construction industry, the fiscal impact for misclassified construction workers was calculated separately. For the estimated number of misclassified workers based on the other states' misclassification estimates, the average workers' compensation rate of 1.11 percent (which is

for all industries, including construction) was applied because JLARC staff were unable to break out the number of misclassified construction workers.

**Table B.2: Calculation of Fiscal Impact From Employers' Avoidance of Workers' Compensation Insurance**

|          |  | Construction Industry | All Other Industries | Total for All Industries |
|----------|--|-----------------------|----------------------|--------------------------|
| A        | Known number of misclassified workers identified by VEC  | 2,356                 | 3,283                | 5,639                    |
| B        | Average wage per worker  | \$21,081              | \$21,081             |                          |
| C= (A*B) | Total wages for known number of misclassified workers in Virginia  | \$49,666,836          | \$69,208,923         | \$118,875,759            |
| D        | Average workers' compensation premium rate paid by employers for workers' compensation insurance                                   | 4.78%                 | 0.87%                |                          |
| E= (C*D) | Total workers' compensation premiums that should have been paid by employers on behalf of misclassified workers                    | \$2,374,075           | \$602,118            | \$2,976,192              |
| F        | Workers' compensation premium tax rate (paid by insurance companies to the State on premiums they receive)                         | 2.60%                 | 2.60%                | 2.60%                    |
| G= (F*E) | Workers' compensation insurance premium tax revenue foregone from avoided workers' compensation on behalf of misclassified workers | \$61,726              | \$15,655             | <b>\$77,381</b>          |

Source: JLARC staff analysis of audit data from the Virginia Employment Commission and other data provided by the Bureau of Insurance and Workers' Compensation Commission.

## DOCUMENT AND LITERATURE REVIEWS

As part of the research for this study, JLARC staff conducted a review of misclassification documents and literature focusing on the extent of misclassification in other states and nationwide as well as proposed and attempted methods to alleviate the issue. In addition, much information was obtained from the websites of organizations specializing in misclassification and related issues, such as the U.S. Government Accountability Office, Internal Revenue Service, U.S. Department of Labor, and the Bureau of Labor Statistics. The team also reviewed numerous documents and information developed by other states as part of the review of misclassification in other states. Important reviews of misclassification are listed in the bibliography.



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Appendix **C**

# Responsibilities of Employers Towards Employees Versus Independent Contractors

| Responsibility                     | Workers Classified as Employees                              |  | Workers Classified as Independent Contractors               |  |
|------------------------------------|--|--|---|--|
|                                    | Employers  | Workers  | Employers   | Workers  |
| Income tax                         | Withhold tax from employees' pay                             | Pay full amounts owed through withholding        | Provide workers and IRS with tax form 1099 to report income | Pay full amounts owed through estimated tax payments |
| Social Security and Medicare taxes | Withhold one half of taxes from employees and pay other half | Pay half of total tax amount through withholding | None  | Pay full amounts owed through estimated tax payments |
| Unemployment tax                   | Pay full amount on reported payroll                          | None   | None  | None   |
| Workers' compensation premiums     | Pay full amount on reported payroll                          | None   | May have to pay for statutory employees                     | Can cover self under policy for employees            |
| Minimum wage and overtime          | Pay to eligible employees                                    | None   | None  | None   |
| Safe and healthy workplace         | Provide safe and healthy workplace & comply with standards   | Comply with standards                            | General contractors may provide at shared work site         | Ensure own health and safety                         |
| Employer-provided benefits         | May offer retirement, health, and other benefit plans        | None   | None  | Can pay for own benefits                             |

Source: GAO reports, literature review, and interviews with Virginia State agency staff.



## D

# Industry Code (NAICS) Descriptions

The North American Industry Classification System (NAICS) is used by the federal government to classify businesses for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy. This appendix provides more detailed industry information on the audited employers for the five industries in which VEC found the most misclassification during its 2010 audits. A complete list of the NAICS codes and descriptions can be found at <http://www.census.gov/eos/www/naics/>.

## Accommodation and Food Services

|                          |   |
|--------------------------|---|
| Bed-and-Breakfast Inns   | Hotels (except Casino Hotels) and Motels        |
| Caterers                 | Limited-Service Restaurants                     |
| Food Service Contractors | RV (Recreational Vehicle) Parks and Campgrounds |
| Full-Service Restaurants | Snack and Nonalcoholic Beverage Bars            |

## Administrative and Support and Waste Management and Remediation Services

|   |   |
|---|---|
| All Other Support Services                            | Packaging and Labeling Services               |
| Carpet and Upholstery Cleaning Services               | Private Mail Centers                          |
| Employment Placement Agencies                         | Professional Employer Organizations           |
| Exterminating and Pest Control Services               | Remediation Services                          |
| Facilities Support Services                           | Repossession Services                         |
| Hazardous Waste Collection                            | Security Guards and Patrol Services           |
| Janitorial Services                                   | Security Systems Services (except Locksmiths) |
| Landscaping Services                                  | Septic Tank and Related Services              |
| Locksmiths  | Solid Waste Collection                        |
| Office Administrative Services                        | Telephone Answering Services                  |
| Other Business Service Centers (including Copy Shops) | Temporary Help Services                       |
| Other Services to Buildings and Dwellings             | Travel Agencies                               |

## Construction

|   |   |
|---|---|
| Commercial and Institutional Building Construction                | Other Nonresidential Building Finishing Contractors                           |
| Highway, Street, and Bridge Construction                          | Other Nonresidential Foundation, Structure, and Building Exterior Contractors |
| Industrial Building Construction                                  | Other Residential Building Finishing Contractors                              |
| New Housing For-Sale Builders                                     | Other Residential Foundation, Structure, and Building Exterior Contractors    |
| New Multifamily Housing Construction (except For-Sale Builders)   | Power and Communication Line and Related Structures Construction              |
| New Single-Family Housing Construction (except For-Sale Builders) | Residential Drywall and Insulation Contractors                                |
| Nonresidential Drywall and Insulation Contractors                 | Residential Electrical Contractors  |
| Nonresidential Electrical Contractors                             | Residential Finish Carpentry Contractors                                      |

Nonresidential Finish Carpentry Contractors  
 Nonresidential Flooring Contractors  
 Nonresidential Glass and Glazing Contractors  
 Nonresidential Masonry Contractors  
 Nonresidential Painting and Wall Covering Contractors  
 Nonresidential Plumbing, Heating, and Air-Conditioning Contractors  
 Nonresidential Poured Concrete Foundation and Structure Contractors  
 Nonresidential Roofing Contractors  
 Nonresidential Siding Contractors  
 Nonresidential Site Preparation Contractors  
 Nonresidential Structural Steel and Precast Concrete Contractors  
 Oil and Gas Pipeline and Related Structures Construction  
 Other Heavy and Civil Engineering Construction  
 Other Nonresidential Building Equipment Contractors

Residential Flooring Contractors  
 Residential Framing Contractors  
 Residential Glass and Glazing Contractor  
 Residential Masonry Contractors  
 Residential Painting and Wall Covering Contractors  
 Residential Plumbing, Heating, and Air-Conditioning Contractors  
 Residential Poured Concrete Foundation and Structure Contractors  
 Residential Remodelers  
 Residential Roofing Contractors  
 Residential Siding Contractors  
 Residential Site Preparation Contractors  
 Residential Tile and Terrazzo Contractors  
 Water and Sewer Line and Related Structures Construction  
 All Other Nonresidential Specialty Trade Contractors  
 All Other Residential Specialty Trade Contractors

### **Real Estate and Rental and Leasing**

Construction, Mining, and Forestry Machinery and Equipment Rental and Leasing  
 Formal Wear and Costume Rental  
 General Rental Centers  
 Home Health Equipment Rental  
 Lessors of Miniwarehouses and Self-Storage Units  
 Lessors of Nonresidential Buildings (except Miniwarehouses)  
 Lessors of Residential Buildings and Dwellings  
 Nonresidential Property Managers

Office Machinery and Equipment Rental and Leasing  
 Offices of Real Estate Agents and Brokers  
 Offices of Real Estate Appraisers  
 Other Activities Related to Real Estate  
 Other Commercial and Industrial Machinery and Equipment Rental and Leasing  
 Residential Property Managers  
 Truck, Utility Trailer, and RV (Recreational Vehicle) Rental and Leasing

### **Transportation and Warehousing**

Charter Bus Industry  
 Deep Sea Freight Transportation  
 Farm Product Warehousing and Storage  
 Freight Transportation Arrangement  
 General Freight Trucking, Local  
 General Freight Trucking, Long-Distance, Less Than Truckload  
 General Freight Trucking, Long-Distance, Truckload  
 Local Messengers and Local Delivery  
 Mixed Mode Transit Systems  
 Motor Vehicle Towing

Nonscheduled Chartered Passenger Air Transportation  
 Other Warehousing and Storage  
 Refrigerated Warehousing and Storage  
 Special Needs Transportation  
 Specialized Freight (except Used Goods) Trucking, Local  
 Specialized Freight (except Used Goods) Trucking, Long-Distance  
 Taxi Service  
 Used Household and Office Goods Moving

## E

# Examples of Misclassification Flyer and Complaint Form



## CONSTRUCTION WORKPLACE MISCLASSIFICATION ACT ACT NO. 72

**FACT:** If you work in construction, you may not be classified as an independent contractor unless:

1. You have a written contract with the business or person you work for.
2. You control and direct your own work.
3. You possess the tools that are needed to perform your work.
4. Your arrangement with the business you work for allows you to earn a profit or suffer a loss from your work.
5. You are an owner or partner in your own business.
6. Your business location is separate from the location of the business or person which hired you to perform the construction.
7. You previously worked as an independent contractor, or you hold yourself out to the public as available and able to work as an independent contractor.
8. You had liability insurance of at least \$50,000.

**FACT:** Any person who misclassifies an employee as an independent contractor could face criminal prosecution, administrative fines up to \$2,500 per violation and a court-issued stop work order.

*It is also unlawful for a person:*

- \*To contract with an employer knowing that the employer intends to misclassify workers.
- \*To retaliate against workers who exercise their rights under this law, including the right to file a complaint.

**FACT:** You can contact the Bureau of Labor Law Compliance with questions or to report an employer may be violating the law.



Department of Labor & Industry | Bureau of Labor Law Compliance  
651 Boas Street, Room 1301 | Harrisburg, PA 17121  
(800) 932-0665 | Fax: (717) 787-0517 | E-mail: ra-li-slmr-lic@state.pa.us | www.dli.state.pa.us

*Auxiliary aids and services are available upon request to individuals with disabilities.  
Equal Opportunity Employer/Program*

LLC-71 02-11



## CONSTRUCTION WORKPLACE MISCLASSIFICATION COMPLAINT FORM

**Instructions:** Please review and complete all pages of this form. Sign and date the bottom of the complaint, and mail the completed form to:

**Bureau of Labor Law Compliance  
651 Boas Street, Room 1301  
Harrisburg, PA 17121  
Telephone: (800) 932-0665 Fax: (717) 787-0517**

Please print:

---

### YOUR INFORMATION

Name of person filing complaint: \_\_\_\_\_

Address: \_\_\_\_\_  
Street (apt #) City State Zip

Telephone number: (\_\_\_\_) \_\_\_\_\_ - \_\_\_\_\_ Fax: (\_\_\_\_) \_\_\_\_\_ - \_\_\_\_\_  
(Include area code) (Include area code)

E-mail address: \_\_\_\_\_

Occupation and job title: \_\_\_\_\_

---

### BUSINESS INFORMATION

Name of business you are complaining about: \_\_\_\_\_  
(A business includes a corporation, partnership, sole proprietorship or person)

Address: \_\_\_\_\_  
Street (apt #) City State Zip

Telephone number: (\_\_\_\_) \_\_\_\_\_ - \_\_\_\_\_ Fax: (\_\_\_\_) \_\_\_\_\_ - \_\_\_\_\_  
(Include area code) (Include area code)

What type of construction services does the business perform? \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Owner of the business: \_\_\_\_\_



## EMPLOYMENT INFORMATION

**For any of the questions below, you may add additional information on separate pages and include any documents that you feel are helpful.**

Provide the following information about each worker that you believe the business misclassified, including yourself if applicable:

|       | Name | Type of work performed | Worksite name and location |
|-------|------|------------------------|----------------------------|
| You   |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |
| Other |      |                        |                            |

Provide the following information about each worksite where you believe the business misclassified workers:

| Worksite name and location | Project | Dates when work performed | Worksite supervisor | Name of general contractor |
|----------------------------|---------|---------------------------|---------------------|----------------------------|
|                            |         |                           |                     |                            |
|                            |         |                           |                     |                            |
|                            |         |                           |                     |                            |
|                            |         |                           |                     |                            |
|                            |         |                           |                     |                            |
|                            |         |                           |                     |                            |

What led you to believe that this business misclassified employees as independent contractors? \_\_\_\_\_

\_\_\_\_\_

Did the business have any other person who provided the workers directions or orders besides the workplace supervisor(s)? If so, please identify the(se) person(s) and the worksite(s). \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Did the business supply the workers with tools, equipment and other supplies to do their work? If yes, what tools, equipment and supplies were provided by the business? \_\_\_\_\_

What tools, if any, did the worker(s) supply? \_\_\_\_\_

Did any of the workers have their own business? If yes, please explain and provide the business location. \_\_\_\_\_

Did any of the workers have their own liability insurance? If yes, when was it in effect? (Please provide a copy of the declarations page, if available.) \_\_\_\_\_

How were the workers paid? (Please check all that apply and explain in detail.)

- Per job \_\_\_\_\_
- Per hour \_\_\_\_\_
- Per day \_\_\_\_\_
- Piece work \_\_\_\_\_
- Other \_\_\_\_\_

Who paid the workers? \_\_\_\_\_

Do you have wage records (such as paystubs, W-2 or 1099 forms ) relating to any of the workers? \_\_\_\_\_

Did any of the workers have a written agreement to perform work at any of the worksites? (Please attach, if available.) \_\_\_\_\_

***I verify that facts set forth in this complaint are true and correct to the best of my knowledge, information and belief. I sign this complaint subject to 18 Pa.C.S. § 4904 (relating to unsworn falsifications to authorities).***

**Signature \_\_\_\_\_ Date \_\_\_\_\_**

*Auxiliary aids and services are available upon request to individuals with disabilities.  
Equal Opportunity Employer/Program*

Note: Flyer and form created by the Pennsylvania Department of Labor and Industry in response to the Construction Workplace Modification Act.

Source: Pennsylvania Department of Labor and Industry website at <http://www.dli.state.pas.us>.

## Agency Responses

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As part of an extensive validation process, State agencies and other entities involved in a JLARC assessment are given the opportunity to comment on an exposure draft of the report. JLARC staff provided an exposure draft of this report to the Secretary of Commerce and Trade, the Virginia Employment Commission, the Virginia Workers' Compensation Commission, the Department of Taxation, the Department of Labor and Industry, and the Bureau of Insurance, State Corporation Commission. Appropriate technical corrections resulting from their comments have been made in this version of the report. This appendix includes the written response letters that were received.





# COMMONWEALTH of VIRGINIA

Office of the Governor

James S. Cheng  
Secretary of Commerce and Trade

June 1, 2012

Mr. Glen S. Tittermary  
Director  
Joint Legislative Audit and Review Commission  
General Assembly Building, Suite 1100  
Capitol Square  
Richmond, Virginia 23219

Dear Mr. Tittermary:

I have received the draft JLARC Report on the "Review of Employee Misclassification in Virginia" sent to my office on May 24, 2012. I appreciate your sending and will review with the impacted agencies within my purview.

Sincerely,

A handwritten signature in black ink, appearing to read "James S. Cheng", written in a cursive style.

James S. Cheng





JUN - 1 2012

# COMMONWEALTH of VIRGINIA

## Virginia Employment Commission

John R. Broadway  
Commissioner

703 East Main Street

Post Office Box 1358  
Richmond, Virginia 23218-1358

May 30, 2012

Mr. Glen S. Tittermary, Director  
Joint Legislative Audit and Review Commission  
201 North Ninth Street  
General Assembly Building, Suite 1100  
Richmond, Virginia 23219

Dear Mr. Tittermary:

In accordance with your letter of May 24, I am writing to acknowledge that I have received and reviewed the draft of a report entitled *Review of Employee Misclassification in Virginia*.

Sincerely,

A handwritten signature in blue ink that reads "John R. Broadway".

John R. Broadway  
Commissioner





JUN - 4 2012



COMMONWEALTH of VIRGINIA

WILLIAM L. DUDLEY, JR.  
Chairman

ROGER L. WILLIAMS  
Commissioner

VIRGINIA WORKERS' COMPENSATION  
COMMISSION

1000 DMV Drive  
Richmond, Virginia 23220  
[www.workcomp.virginia.gov](http://www.workcomp.virginia.gov)  
(877) 664-2566  
(804) 367-6124 (Fax)

JAMES J. SZABLEWICZ  
Chief Deputy Commissioner

VIVIAN R. GUIDT  
Interim Executive Director

MARJORIE P. PLATT  
Clerk

June 4, 2012

Glen S. Tittermary, Director  
Joint Legislative Audit & Review Commission  
General Assembly Building, Suite 1100  
Richmond, VA 23219

Re: *Review of Employee Misclassification in Virginia*

Dear Director Tittermary:

Thank you for the opportunity to review the exposure draft of the section of the report *Review of Employee Misclassification in Virginia* that is relevant to the Virginia Workers' Compensation Commission. My staff and I respect the complexity of employee misclassification and applaud the considerable time and research devoted to preparing this ambitious report for members of the General Assembly. It is a comprehensive report and provides a thoughtful suggestion in recommending an Interagency Task Force.

The report indicates, "Virginia employers with more than two employees are responsible for purchasing and maintaining workers' compensation insurance for their employees." The statement is accurate to a point, but only captures a portion of Virginia's workers' compensation insurance coverage requirements. This law is not well understood. The Statutory Employer law, § 65.2-302 establishes coverage requirements for contractors or businesses that hire subcontractors that perform the same trade, business or occupation, or fulfill a contract of the business. This law broadens the definition of "employer" under Virginia workers' compensation.

For purposes of this report, by failing to consider the Statutory Employer law, which broadens the definition of employer under workers' compensation, it appears that the impact of misclassification in workers' compensation has been underestimated, if not significantly underestimated. This one segment of the employer community is unique to workers' compensation. Consider for example, a contractor with no direct employees is probably not considered an employer under other agency laws. Under workers' compensation, however, a contractor with no employees that hires a subcontractor with employees to perform the same trade or business is a (statutory) employer.

Since the statutory employer law applies primarily to contractors, a segment of the employer community that studies show tend to engage in employee misclassification at higher rates than the employer community at large, overlooking this law which details coverage requirements for contractors is a material oversight. Thirdly, because the formula for pricing workers compensation premium is primarily based upon three elements: 1) payroll; 2) classification code (industry); and 3) experience (loss history), it is well established that based upon the classification codes for contractors that the premium paid by contractors is higher, if not significantly higher than the employer community at large. This is because the assigned risk rates for each Virginia’s 640 different classification codes are based upon industry hazard. Construction work is more hazardous than is, for example, working as an office worker. So the basic manual premium for a construction contractor will total more than that of a worker in a less hazardous industry, given the exact same payroll and experience or loss history. An example is provided.

| <b>Classification Code</b> | <b>Occupation</b> | <b>Payroll</b> | <b>Rate</b> | <b>Experience Modification</b> | <b>Basic Manual Premium</b> |
|----------------------------|-------------------|----------------|-------------|--------------------------------|-----------------------------|
| 8810                       | Clerical          | \$100,000      | 0.17        | 1.0                            | \$1,700.00                  |
| 5551                       | Roofing           | \$100,000      | 21.77       | 1.0                            | \$21,770.00                 |

Consideration should be given to the Statutory Employer law when considering the number of employers that are misclassified under workers compensation law. Unpaid workers’ compensation insurance fines upward the estimate of unpaid workers’ compensation premium to accurately reflect workers’ compensation coverage requirements.

It is mentioned in the report that workers who are not covered by an employer’s workers’ compensation policy have the option to purchase a policy for self-coverage. An employer that is not required by law to buy and maintain a workers’ compensation insurance policy can obtain insurance voluntarily. However, in the event an employer does not have coverage, an employee cannot voluntarily obtain coverage for himself or herself.

JLARC staff inquired of VWC staff if the Commission performs misclassification investigations. The Insurance Department of VWC receives phone call and web inquiries on the topic of employee misclassification with some frequency, daily if not more. These inquiries are responded to by phone and e-mail. VWC also receives some reports of misclassification. VWC investigates the employer to ensure that it has current, valid Virginia workers’ compensation coverage, however, outside of a claim VWC generally has insufficient facts to determine if a worker is misclassified. If the employer is insured the insurance carrier has a right to audit the employer and routinely does perform premium audit. If the employer is uninsured, VWC pursues compliance action.

Page Three

*Review of Employee Misclassification in Virginia*

Over recent years VWC has attempted to identify ways to provide education and information to the business and insurance community, particularly on the issues of independent contractors vs. employees and on the statutory employer law. While your report references VWC's Employer Guide in your Prevention Strategies section, it mentions only information about the employer-employee relationship. The Employer Guide contains a section tailored for Contractors and Subcontractors and provides particular guidance on Employee vs. Independent Contractor, listing the four factors that generally distinguish the two. Additionally, VWC has provided education and outreach that has included:

- Partnering with the Contractors Institute to update the Contractor's Basic Manual (workers' compensation insurance section) which includes a section on Independent Contractors vs. Employees. All contractors in Virginia have to obtain education and licensing. Updated the manual in layman's terms for contractors.
- Partnered with the Independent Insurance Agents of Virginia to provide insurance agent training, included independent contractor vs. employee and misclassification
- Provide employer training at VOSH annual conference, VEC employer conferences and Rotary that all include training on independent contractor vs. employee

The economy continues to struggle and as the General Assembly ponders this report and the strategies to alleviate misclassification that have been recommended, it is important to emphasize the point made in the report that honest employers are currently paying more than their fair share. Strategies to combat misclassification will help the honest business community.

Sincerely,



Vivian R. Guidt  
Interim Executive Director  
Virginia Workers' Compensation Commission  
1000 DMV Drive  
Richmond, VA 23220  
(804) 205-3603



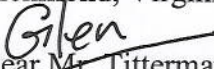


# COMMONWEALTH of VIRGINIA

## Department of Taxation

June 4, 2012

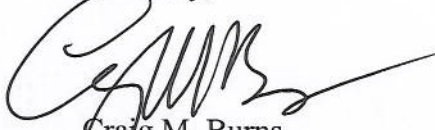
Mr. Glen S. Tittermary, Director  
Joint Legislative Audit and Review Commission  
Suite 1100, General Assembly Building  
Richmond, Virginia 23219

  
Dear Mr. Tittermary:

Thank you for the opportunity to review and comment on portions of the exposure draft report: *Review of Employee Misclassification in Virginia*, dated May 24, 2012. The staff at the Department of Taxation believes the report section we reviewed is very well done and will be quite useful to the members of the General Assembly in understanding the issues associated with employee reporting requirements and misclassification. We also appreciate you incorporating our comments of May 31, 2012, particularly those related to the revenue impact and the definition of wages, into the final report draft.

Thank you again for the opportunity to comment on relevant sections of the exposure draft. Please note that our technical comments are limited to the portions of the report that we were provided to review. Should you have any further inquires, please feel free to contact my office.

Sincerely,

  
Craig M. Burns  
Tax Commissioner

c: The Honorable Richard D. Brown, Secretary of Finance





# COMMONWEALTH of VIRGINIA

## DEPARTMENT OF LABOR AND INDUSTRY

Courtney M. Malveaux  
COMMISSIONER

Main Street Centre  
600 East Main Street, Suite 207  
Richmond, VA 23219  
PHONE (804) 371-2327  
FAX (804) 371-6524  
TDD 711

June 5, 2012

Glen S. Tittermary, Director  
Joint Legislative Audit and  
Review Commission  
General Assembly Building  
201 North 9th Street, Suite 1100  
Richmond, Virginia 23219

Dear Director Tittermary:

Thank you for the opportunity to comment on the Exposure Draft of the Review of Employee Misclassification in Virginia. My staff and I have reviewed the Draft and provided several technical comments and corrections to your staff by e-mail. We plan to monitor the results of this study as it proceeds to the Governor and General Assembly.

If there is anything I or my staff can do to be of assistance as the Study is completed, please let me know. Thank you again for this opportunity.

Sincerely,

A handwritten signature in cursive script that reads "Courtney M. Malveaux".

Courtney M. Malveaux  
Commissioner





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