

## **A Survey of Federal and State Actions to Counter Misclassification Fraud**

Presented to:

Washington Joint Legislative Taskforce on  
the Underground Economy in the Construction Industry

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by:

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The failure of construction industry employers to properly classify workers as employees is a priority concern of the United Brotherhood of Carpenters. I am therefore pleased to present this paper on the issue to the Joint Legislative Taskforce on the Underground Economy in the Construction Industry. My comments will focus on how we see the practice being carried out and to survey the solutions sought by federal and state authorities. I will not take much space describing the degree and effects of fraud, because that road has already been well traveled by the Taskforce.

### **Fraud in the construction industry**

The misclassification fraud we see in the construction industry comes in two forms. First, there are the employers who intentionally misclassify employees as independent contractors and report their payments to the Internal Revenue Service and the workers with 1099 misc. forms. Second are the employers who pay their workers by check or cash and do not report their payments as the law requires to insurers, state and federal authorities. This latter method can be the response to increased enforcement of 1099 misclassification or other labor, tax and immigration laws. It is also the method that is the most challenging to law enforcement because transactions are hidden.

Typically on the state level we see enforcement come from audits by unemployment tax and workers compensation compliance investigators of employers that pay into the system. That becomes complicated when employers chose not to participate at all, employee contact information is not kept, purported construction companies use fake addresses and primary contractors use subcontractor agreements to shield themselves from liability. When this occurs, the effect can be devastating. Take, for instance, the following information from Florida. Note that Florida has very strong state law on workers-compensation premium fraud, racketeering and money laundering.

In three years one billion dollars of cash was funneled by just ten construction companies through check cashing businesses into the Florida construction industry.<sup>1</sup> The largest loss was workers compensation premiums-about \$200 million.<sup>2</sup> That is according to a 2007 presentation by the Florida Department of Financial Services Division of Insurance Fraud and the Eighteenth Statewide Grand Jury report on money laundering by check cashers released in March of 2008.<sup>3</sup> The net result was a loss of \$409 million in workers compensation premiums and state and federal employment taxes.<sup>4</sup>

The Eighteen Statewide Grand Jury and reports by the Division of Insurance Fraud describe a sophisticated workers compensation premium fraud scheme.<sup>5</sup> We have taken those descriptions as well as those of recent prosecutions and indictments by the US Attorney's Office in South Florida along with press reports and information from our interviews of carpenters and contractors to construct the attached chart and the following summary:<sup>6</sup>

A primary interior systems contractor supplements its workforce with a labor subcontractor. The labor subcontractor provides labor only, and may be an individual with a crew of workers. (Typically, these subcontractors are not licensed employment leasing services.) To protect itself from liability, the primary contractor needs a corporate identity and a workers compensation policy for the labor subcontractor.

A person we will call a "facilitator" provides a shell company identity and an insurance policy. The shell company exists in the records of the secretary of state, but the address for the company may be bogus or the purported officers have no involvement in the daily activities of running a construction business. The facilitator "rents" the construction company to the labor subcontractor. (The shell company may be used by many subcontractors who do not know one another on different projects in the state.)

Workers compensation premiums are based upon the amount of payroll, the type of work performed and the claims experience of the employer. The facilitator secures the workers

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<sup>1</sup> *Eighteenth Statewide Grand Jury, Second Interim Report of the Statewide Grand Jury, Check Cashers: A Call for Enforcement*, Case No. SC 07-1128, p. 13 (West Palm Beach, FL, March 2008)(hereinafter Grand Jury Report).

<sup>2</sup> Presentation by the Florida Department of Financial Services Division of Insurance Fraud to the Florida Workers' Compensation Fraud Task Force, slides 31 and 32 (January 10, 2007). The presentation can be found at <http://www.fldfs.com/fraud/presentations/WorkersCompTaskForce.htm> (hereinafter Taskforce Presentation).

<sup>3</sup> Grand Jury Report, p. 13 and Taskforce Presentation, slides 31 and 32.

<sup>4</sup> Taskforce Presentation, slides 31 and 32.

<sup>5</sup> Grand Jury Report, pp. 10-14 and *Joint Report to the President of the Florida Senate and the Speaker of the Florida House of Representatives*, The Florida Department of Financial Services (January 1, 2007 and January 1, 2008), p. 1.

<sup>6</sup> See, *Construction Company Owner Sentenced to 10 years for Payroll Tax Evasion*, Press Release, US Attorney's Office, Southern District of Florida (February 25, 2008), *Broward County Tax Preparer Sentenced for Tax Fraud Related to Workers' Compensation Insurance Scheme*, Press Release, US Attorney's Office, Southern District of Florida (February 7, 2008), *Florida Framing Contractors Sentenced to Probation in Scheme to Avoid Payroll Tax*, Bureau of National Affairs, Construction Labor Report, vol 53, no. 2640, p. 1003 (October 3, 2007), *Undocumented Workers Paying Tab for S. Florida Fraud*, WorkCompCentral (September 29, 2006).

compensation policy from an insurance agent that only covers a fraction of the true payroll. The larger, true, payroll is not revealed to the insurance carrier. The labor subcontractor gets an insurance certificate. Insurance certificates for workers compensation do not reveal work classification codes, nor do they reveal payroll information. (Those are on the information page of the insurance policy which is not required to be disclosed to the primary contractor.)

The labor subcontractor can now provide the primary contractor with an insurance certificate showing workers compensation coverage and a corporate identity. The labor subcontractor receives checks in the name of the shell company. The checks are brought to a designated check cashing store. (Transactions over \$10,000 are required to be described in currency transaction reports (CTRs) to the US Treasury Department. They are shared with state authorities.) The CTRs are not filed or they are falsified by the check cashing business. A percentage of the check, larger than what the law provides, is shared by the check cashing store and the facilitator. The labor subcontractor is given cash and the cash is given to the workforce. (Sometimes, the labor subcontractor deducts from the pay to the workers a portion of the percentage taken by the facilitator and check cashing store.)

The Internal Revenue Service does not know how much money was given by the primary contractor to the labor subcontractor. Nothing in federal law requires reporting to the IRS by a corporation of the amount of money paid to another corporation.<sup>7</sup> The amount paid to the subcontractor is lumped into the primary contractor's business deductions. That leaves the facilitator's accountant free to underreport on the quarterly employment-tax reports and yearly returns for the shell company. In our example, let's say, in the course of a year the primary contractor pays the labor subcontractor \$1 million. The accountant only reports \$150,000 paid for the services performed by three employees. The rest, \$850,000, is left to be paid in unreported cash.

That is how, in a large construction market like Florida's, just ten contractors can generate \$1 billion dollars of unreported cash in a short amount of time. There are variations to the scheme with various degrees of culpability. The facilitator may be the primary contractor or the check cashing store. The labor subcontractor may operate under a "real" corporate identity, but use shell companies to pay its foremen's crews. Certainly, though, these transactions don't arise from legitimate entrepreneurship or confusion over the requirements of the law. This is organized crime.

And it happens on all types of construction projects-single-family residential, hospitals, schools, and \$100 million condominium towers. The Eighteenth Statewide grand jury concluded its description of workers' compensation premium fraud with the following:

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<sup>7</sup> See, *General Explanations of the Administration's Fiscal Year 2009 Revenue Proposals*, Department of the Treasury (February 2008), p, 63, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals*, Department of the Treasury (February 2007), p. 63.

“In the short term, it may be prudent for the legislature to inquire of the [construction] industry, when considering this Grand Jury’s recommendations, why they have apparently decided over the last few years to move increasingly to an all cash payroll.<sup>8</sup>”

Florida isn’t the only state where this is happening. We have seen variations of the fraud scheme in Nevada, Massachusetts, Connecticut, New York, Louisiana, Georgia, Virginia, Maryland, Idaho, Washington and in other states. The violations of the law we see not only include employment and tax law, they also include money laundering, racketeering, grand theft, mail fraud, wire fraud and insurance fraud.

Attached are summaries of state, federal, university and other studies of misclassification fraud. Given the methodology of the studies and the anecdotal information we see in states like Florida, the estimates of the size and cost of the fraud in most of the studies are conservative. Taken together, what the studies do say is that fraud is a serious problem in the construction industry, it reduces government revenue, shifts tax and workers-compensation insurance costs to law-abiding employers,<sup>9</sup> lowers working conditions and steals jobs from legitimate employers and their employees.

### **What needs to be done**

We are seeing unscrupulous employers supersede legislatures by using market-place competition to unilaterally repeal over a hundred years of labor and employment tax laws in order to gain an economic advantage. To accomplish that, they rely on weaknesses in the law and a patch-work quilt of law enforcement. Here are items that we believe can reverse the trend.

\*Increase the capabilities of law enforcement agencies through better funding, sharing of information and enforcement taskforces-including more cooperation with federal authorities and other states where appropriate. (In just four months the New York misclassification taskforce found \$19.4 million in unreported wages, 2,078 misclassified workers, and assessed \$1.4 million in unemployment taxes, penalties and interest.<sup>10</sup> If possible, it gets more shocking. They found 646 employees owed \$3 million in wages.<sup>11</sup> )

\*Strengthen laws by creating more enforcement tools, like stop work orders and private causes of action. The failure to properly classify an individual as an employee is not in and of itself a violation-the failure to report wages, for instance, is the violation. Make the failure to properly classify an individual as an employee unlawful.

\*If definitions of “employment” are changed, create uniform definitions with presumptions of employee status. Any new definition should not weaken “employment.”

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<sup>8</sup> Grand Jury Report, p. 14.

<sup>9</sup>For a good discussion on cost shifting due to workers compensation premium fraud read: *Fraud in Workers’ Compensation Payroll Reporting: How Much Employer Fraud Exists and How are Honest Employers Impacted*: Report for the Commission on Health and Safety and Workers’ Compensation, by Frank Neuhauser and Colleen Donovan, University of California, Berkeley (August 2007), pp. 1-3 and 7.

<sup>10</sup> *Report of the Joint Enforcement Task Force on Employee Misclassification to Eliot Spitzer, Governor State of New York* (February 1, 2008), pp. 3-4, and 11-13.

<sup>11</sup> *Ibid.*, pp. 4 and 12-13.

Also, some states have taken steps to reduce the incentive to misclassify by treating employees and independent contractors similarly.

\*More concern needs to be shown for employers who play by the rules. Reward them by adopting policies that will discourage irresponsible contractors from bidding public work.

\*Encourage better self policing by the industry through enforcement actions using joint employment, conspiracy and racketeering charges. Thorough investigations need to be done on potential impact cases that will punish all of the actors involved, from the labor broker to the accountant and primary contractors-if that is where the evidence leads. Also, require disclosure on workers compensation certificates of classification codes and the wages premiums are based upon. Workers compensation certificates should be required with applications for building permits. In addition, employers need to keep records that describe their use of independent contractors.

\*Track cases where misclassification fraud is found to determine the effectiveness of statutes and enforcement strategies.

### **Federal response**

Misclassification fraud has caught the attention of the federal government. The IRS has initiated an information sharing and joint unemployment tax auditing program with a majority of states, including Washington, following recognition that misclassification is part of the \$345 billion federal tax gap.<sup>12</sup> In addition, misclassification in the construction industry has been identified as a 2008 enforcement priority by the US Department of Labor.<sup>13</sup>

There are three pieces of pending federal legislation:

S. 2044 Independent Contractor Proper Classification Act of 2007: This bill was introduced by Senator Obama (Ill.) in September 2007. The legislation amends the revenue code's safe harbor provisions which allow misclassification in certain instances. The bill reduces the number of safe harbors and further limits their application. It allows the IRS to issue regulations on employment status. A process for determining employment status is created that protects workers from retaliation. Treasury and Labor are required to share information and issue annual reports on their law enforcement work related to misclassification. Labor has to focus on industries where the practice is prevalent.

HR 5804 Taxpayer Responsibility, Accountability and Consistency Act: This bill was introduced in April of 2008 by Rep. McDermott (WA), Rep. Tierney (MA) and Representative Neal (MA). Reporting of corporate to corporate transactions to the IRS is

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<sup>12</sup> This is the Questionable Employment Tax Practices program. See information at: <http://www.irs.gov/newsroom/article/0,,id=175457,00.html> and *IRS Entering Accords with States to Target Worker Misclassification for Examinations*, Bureau of National Affairs, *Daily Labor Report*, No. 94, p. A-4, Wednesday, May 16, 2007.

<sup>13</sup> *Wage and Hour Collects a Record \$220 Million in Back Wages for Over 341,000 Employees in Fiscal Year 2007*, US Department of Labor, p. 5, available at: <http://www.carpenters.org/misclassification/ALL%20DOCUMENTS/DOL%20WHD%202007%20Statistics%20Fact%20Sheet-misclassification%20as%20IC%20a%202008%20focus.pdf>.

required. (This is also an administration proposal.)<sup>14</sup> The bill reduces the number of safe harbors and further limits their application. It allows the IRS to issue regulations on employment status. A process for determining employment status is created that protects workers from retaliation. Treasury is required to issue annual reports on their law enforcement work related to misclassification and to inform Labor about discoveries of misclassification.

HR 6111 Protecting Workers from Misclassification Act: Rep. Andrews (NJ) and Rep. Woolsey (CA) introduced this legislation in May 2008. The bill makes it a violation to fail to properly classify an individual as an employee. Employers of independent contractors would have to keep records of their use and notify them of their status. Labor is required to keep a web site that summarizes employee rights under federal law. State labor departments are required to establish auditing and investigative plans to identify employers that misclassify employees or pay unreported compensation. Reports from the states on their plans and enforcement efforts are to be made to Labor. Information on violators may be shared by Labor with IRS if appropriate. Labor's wage and hour division has to target audits in non-compliant industries.

### **State Response**

State legislators and executives have been taking action. Attached is a compilation of state initiatives including laws and executive orders in 2007 and 2008 that impact enforcement of state wage and employment tax laws.<sup>15</sup> Not included are pre-2007 laws, but they are cited below. What I've done here is index the laws by subject matter. The index isn't exhaustive, but it hits the high points. Refer to the attached list if you want to see them indexed by state.

#### Certification required to be an independent contractor

Minnesota Chapt.135 § 15 (2007), Montana for workers compensation §39-71-419.

#### Conspirators, other than direct employer, specifically punished:

Florida §440.105

A flaw of the Illinois bill is that it specifically says that contractors will not be liable for the actions of their subcontractors. PA95-0026 §10(f) (Ill. 2007) It may only mean that there isn't strict liability, so existing conspiracy laws will apply. It will take a judge to figure that one out.

#### Databases to be used to identify violators

All of the taskforces are studying or requiring information sharing by agencies. Some, though, get technical and specifically require use or creation of databases. See Utah SB 189 (2008). Also, see California SB 869 (2007) which requires comparing companies registered with unemployment tax to those with workers' compensation coverage.

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<sup>14</sup> See fn. 7.

<sup>15</sup> Prevailing rate laws, though, are not included. They have not been included, because they have been the subject of legislation for many years, so they are numerous. The point of this research is to track efforts affecting the more basic laws effected by misclassification fraud. Those actions have been in an upswing.

### Failure to classify as an employee punished

Illinois PA95-0026 (2007), Massachusetts GL 149-§148(b), New Jersey A4009 (2007).

### Misclassification as an independent contractor punished

Connecticut PA 7-89 (2007), Florida §440.107(7)(f) , Kansas §44-766 (2006), Missouri HB1549T (2008), New Mexico SB657 (2005).

### Penalty revenue to enforcement

Again, there are many states that allow for penalty money to fund enforcement. This is a list of newer actions: Colorado HB 1366 (2007), Connecticut §31-69a (1994), Florida HB 561 §10 (2006), Illinois PA95-0026 (2007), New Hampshire SB 92 (2007), New Jersey A4009 (2007).

### Penalties, in general

There are a variety of penalties, including criminal, civil, administrative, debarment and stop work orders. See the specific law you are interested in on the attached CD or the attached index by state.

### Presumptions of employment

Many states have presumptions of employment, especially in their unemployment codes, like Louisiana, Tennessee and others. This is a list were the presumptions were either established or re-affirmed: Illinois PA95-0026 (2007), Minnesota Chapt. 135 § 15 (2007), Montana for workers compensation if no independent contractor certification §39-71-419 (2005), New Jersey A4009 (2007), Massachusetts §149-148(b).

### Private cause of action allowed for effects of misclassification or non-reporting

There are many states that, for instance, allow employees to bring private suits to collect unpaid wages. Below are statutes that apply more directly to the effects of misclassification fraud. Here are samples of laws that allow employers to bring suit for unfair competition: Connecticut §52-570e (1990), Florida §440-140 (1993). Here are statutes that allow employees to bring suit: Illinois PA95-0026 (2007), Minnesota §181.722 (2005), New Jersey A4009 (2007).

### Responsible bidder/contractor laws for permitting/registration and public construction

There are numerous state and local laws with criteria for bidders on public work. What is less common are laws that address the contractor's labor and employment tax law performance. In New England states there are numerous local ordinances that do that and, especially in Ohio, require registration and compliance with workers compensation and local income tax laws.<sup>16</sup> There have been some arguments that state laws do not allow municipalities or other public entities to take those items into consideration for bidders on public contracts. Here are two examples of state actions that could enable consideration of labor and employment tax issues for bidders: Ohio Res. 07-98 School Facilities Commission (2007) and Washington HB 2010 (2007).

### Stop work orders

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<sup>16</sup> See examples in the attached CD.

Connecticut PA 7-89 (2007), Florida §440-107, Massachusetts GL 152§25C, New Jersey A4009 (2007), New York A 6163 (2007).

### Taskforces

California Unemp Ins Code §329 (1995), Connecticut PA 8-156 (2008), Iowa (study only) EO 8 (2008), New Hampshire (study only) SB 500 (2008), New Jersey EO 96 (2008), New York EO 17 (2007), Massachusetts EO 499 (2008), Michigan EO 2008-1 (2008), Utah SB 189 (2008) , Vermont S 345 (2008), West Virginia (by internal collaboration) and Washington SB 5926 (2007)(study only).

### Tax withholding from independent contractors in the construction industry

Minnesota Chapt. 154 HF 3201 (2008), New Jersey S 468 (2006).

### “Universal”<sup>17</sup> definitions of employment

New Hampshire SB 92 (2007), New Jersey A4009 (2007), Minnesota Chapt.135 § 15 (2007), Washington HB 3122 (2008).

### Workers compensation coverage required, with some exceptions, for independent contractors

There are numerous states that require employers to have workers compensation insurance for independent contractors/sole proprietors, but then apply exemptions. Listed here are more recent created laws: Colorado HB 1366 (2007), Delaware SS1 (2007), Florida §440-02(15)(c)(3), Montana (if not a certified independent contractor) §39-71-419, New Hampshire (on public construction work) HB 471 (2007), Tennessee HB 1645 (2008).

### Workers’ compensation premium fraud

Again, many states punish workers-compensation premium fraud specifically or as an insurance fraud. These are newer state laws addressing the problem: New Hampshire SB 500 (2008), South Carolina SB 332 (2007), Vermont S 345 (2008).

All of the material cited here is in the attached CD.

### **Enforcement actions**

We have not seen an abundance of enforcement activity coming from these laws and initiatives, because they are new. There has been some, for instance, in Connecticut,<sup>18</sup> Massachusetts<sup>19</sup> and New York<sup>20</sup> with positive outcomes. In general, we are seeing

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<sup>17</sup> To fit into this category, the law had to apply to more than one code-workers compensation and unemployment, for instance.

<sup>18</sup> “*Stop Work*” *Legislation Puts Brakes on Employers Trying to Avoid State Laws*, Connecticut Department of Labor News Release (August 13, 2008).

<sup>19</sup> *Construction Company Pleads Guilty to Premium Evasion, Payroll Fraud*, WorkCompCentral (March 24, 2008) and [Massachusetts]AG Issues Advisory to State Employers on *Complying with Worker Classification*, Bureau of National Affairs Construction Labor Report, vol. 54, no. 2670, p. 1988 (May 7, 2008).

<sup>20</sup> See fn 10 and *Workers’ Comp Board Issues 1,000<sup>th</sup> Stop Work Order: Businesses That Refuse to Carry Comp Face Closure*, Workers Comp. Board Press Release (NY September 2, 2008).



increased interest and the number of enforcement actions growing under new and existing law, including private actions in, for example, California and Washington.<sup>21</sup> Much of the Florida law on workers compensation premium fraud and stop work orders has been in existence for many years and there are many well documented cases.<sup>22</sup> Despite the enormous magnitude of the problem there, increased enforcement has contributed to lowering of workers' compensation costs in the construction industry.<sup>23</sup> In the attached CD are sample reports on enforcement actions brought under these new laws and initiatives as well as under long-term existing law.

## **Conclusion**

As you can see, there has been growing activity over the past few years on the federal and state levels. While new legislation is welcome for strengthening laws and creating more enforcement tools, that legislation and existing laws are of no use without adequate funding for the enforcement personnel needed to get the job done. Given the harm misclassification fraud has done to the construction industry, the lost revenues and associated criminal activity, the issue is important enough for legislators, enforcement agencies, state attorney generals and local prosecutors to make it a priority.

It is important to note that the efforts to bring order to the construction industry are not only welcomed by employee organizations, they are also supported by employers.<sup>24</sup> We are not seeking new employment benefits-only better enforcement of what the law already requires, fair competition and more vigilance by the construction industry.

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<sup>21</sup> See, e.g., the examples on the United Brotherhood of Carpenters Misclassification Fraud web site at [www.carpenters.org/misclassification](http://www.carpenters.org/misclassification) and *King County Court Approves Settlement of \$635,000 in Drywallers' Class Action*, Bureau of National Affairs Construction Labor Report, vol. 53, no. 2637, p. 910 (September 12, 2007), *Construction Brothers Guilty of Tax Evasion*, Newsday, by Robert e. Kessler (April 12, 2008) and *[California] State Court Orders Drywall Contractor to Pay \$1.3 million in Fines, Restitution for Failures*, Bureau of National Affairs Construction Labor Report, vol. 54, no. 2675, (June 11, 2008).

<sup>22</sup> See, e.g., *Florida Busts 25 Job Sites in Panhandle*, WorkCompCentral (August 8, 2007) and *Joint Report to the President of the Florida Senate and the Speaker of the Florida House of Representatives*, The Florida Department of Financial Services (January 1, 2007 and January 1, 2008).

<sup>23</sup> *2007 Workers' Compensation Annual Report*, Florida Office of Insurance Regulation , p. 25 (January 1, 2008).

<sup>24</sup> See, e.g., *Testimony of Scott Morrissey, Owner Red Line Wall Systems, Inc., Commercial Drywall and Metal Stud Installation Company* before the US Senate Committee on Small Business & Entrepreneurship (August 28, 2008) (on attached CD) and *Contractors Speak Up on Workers Comp.*, Nashua Telegraph, by Ashley Smith (August 19, 2008).