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## Misclassification of Workers Payroll Fraud

### **Quality Construction Alliance Position:**

*Congress should reform or repeal Section 530 of the 1978 Revenue Act, which is overly permissive in providing a safe harbor for misclassification of workers as independent contractors instead of employees and supports legislation which would provide DOL more tools to address misclassification. The QCA also supports S. 770 which would expand the Fair Labor Standards Act to cover misclassification and would impose a notice requirement at the time a non-employee begins providing services as an independent contractor. Congress should also enact a 1099 reporting requirement for services performed by corporations, as it already does for services provided for individuals. Payroll fraud goes undetected because subcontractors paying workers "off the books" can easily underreport employment tax reports.*

### **Issue:**

**Section 530** was enacted in 1978 in response to complaints that the IRS was being overly aggressive in taking action against business principals using "independent contractors" as employees, by retroactively subjecting them to federal employment taxes, penalties and interest for misclassification violations. The 530 safe harbor was intended to be temporary. The safe harbor allows a business to treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee. Section 530 illogically includes "common industry practice" as a reasonable basis for protection.

Misclassification is a well-documented and growing practice in the construction industry and is blatantly used as a cost-cutting tool to the detriment of workers and competing contractors. An employer-employee relationship generally exists when the person for whom the services being provided has direction and control over the person performing the work. IRS has specific carve-out rules and exceptions for real estate agents and direct sellers and special treatment for engineers, computer programmers and systems analysts.

- Employers pay fifty percent of an employee's Social Security and Medicare taxes and those who misclassify their workers reap substantial savings and gain unfair competitive marketplace advantages by avoiding those taxes. They also avoid federal and state unemployment insurance taxes, payment of workers' compensation premiums, and even overtime pay.
- The construction market is skewed in favor of law-breakers against law-abiding employers. It is not a union versus nonunion issue. The practice is rapidly spreading to other industries. An illegal workforce makes it easier for employers to exploit the current system.
- Reform will not kill entrepreneurship. Successful business owners across the country every day compete while paying all the appropriate taxes for their employees. It does not make sense that some can't start a business if they have to follow the law.
- Given the magnitude of underreporting to the IRS, increasing taxpayer compliance would generate substantial revenue to the federal government to reduce the tap gap. The federal government loses Social Security and Medicare taxes, income taxes and unemployment insurance.



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- Misclassification costs local government and communities in taxes and unemployment insurance. Independent contractors and workers paid off the books are not covered by workers' compensation. Less revenue means less money that is available for vital federal, state and local services and programs. According to GAO, **if only 1% of employees were misclassified nationally, the loss in overall employment insurance would be nearly \$200 million annually.** It is already more than 1% and growing.
- QCA employers maintain a system of apprenticeship training, health and welfare, pension benefits, and career advancement training that ensures an adequate supply of highly-skilled trade persons who are compensated and classified correctly as employees; allowing the misclassification of workers threatens to degrade the quality of high workforce standards in a vitally important industry – and one that maintains high wage and benefit standards.
- Workers who should be classified as employees also lose out on the protections and benefits of employment status, including public law benefits and employer-provided fringe benefits as well.

**The 1099 reporting requirement for services** that was enacted in the 2010 health care reform legislation was recently repealed along with the repeal of the 1099 reporting on goods. Maintaining the 1099 reporting on services would have closed the loophole being exploited to hide off the books payments to employees.

- The IRS is currently conducting a new study, auditing 6,000 businesses, the first IRS study since 1984.
- The Inspector General of Treasury estimates that misclassification and off the book payments contribute to the \$54 billion employment tax gap.

### Status of Misclassification/Payroll Fraud Legislation

#### S. 770

The Payroll Fraud and Prevention Act

Sponsor: Senator Sherrod Brown (D-CO)  
Co-Sponsors: Senator Harkin (D-IA), and Senator Blumenthal (D-CT).  
Last Major Action: Referred to Senate Committee  
Status: Read twice on April 8, 2011 and referred to the Committee on Health, Education, Labor, and Pensions.

The act would amend FLSA to make misclassification a violation of law.

Awaiting introduction: A bill to amend Section 530 of the IRS Code to ensure employers have a genuinely reasonable basis for treating an individual as an independent contractor.

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