World Review of Business Research
Vol. 7. No. 1. March 2017 Issue. Pp. 20 – 31

Employee or Independent Contractor? Closing the Billion Dollar Tax Revenue Gap Created by the Financial Services Industry

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The distinction between independent contractors and employees misclassified as independent contractors in the financial services industry is a complicated and critical tax issue. Misclassification is often the result of tax-savings measures instituted by financial services firms. Consequently, the federal, state and local governments lose billions of dollars in revenue due to misclassification as financial services firms circumvent their tax obligations. This article highlights an array of issues surrounding the misclassification of employees as independent contractors in the financial services industry to include: the legal definition of an independent contractor, the tax reasons why a financial services firm would misclassify an employee as an independent contractor, the tax revenue gap created by employee misclassification, an overview of the financial services industry, and the application of the substance over form tax doctrine as an alternate approach to close the billion dollar tax revenue gap created by employee misclassification.

JEL Codes: K34, K22, and K31

1. Introduction

The distinction between independent contractors and employees misclassified as independent contractors in the financial services industry is a complicated and critical tax issue. Misclassification is often the result of tax-savings measures instituted by financial services firms. Consequently, the federal, state, and local governments suffer revenue losses due to misclassification as financial services firms circumvent their tax obligations.

Financial services firms have traditionally defeated an attack on their independent contractor model by (1) carefully crafting an agreement that memorializes the contractual relationship and concedes control over the manner and means of performance to the contractor and (2) utilizing the securities laws' control requirement of firms over their registered representatives as a

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justification for exercising the extent of their control. In the end, it is the actual business practice of the firm rather than the written agreement itself that should be the determining factor in classifying the relationship.

Internal Revenue Service (IRS) sanctions should not be imposed on the financial services industry as a whole. Within the industry, there are firms that comply with the statutory requirements that enable their registered representatives to be properly classified as independent contractors. The IRS should penalize only the firms that breach the independent contractor threshold and treat the registered representatives as employees. To distinguish the firms that comply from the firms that do not, the substance over form tax doctrine should be used to analyze the substance of the actual activities of the registered representative controlled by the firm as opposed to the form of the independent contractor agreement signed between the two parties.

Goodof & Christenson (2015) discussed in detail the costs and benefits of use of independent contractors rather than employees. Carre and Wilson (2004) summarized the extent and cost of misclassification in the construction industry in Massachusetts. McGee, Goodof, Bandyopadhyay, and Christensen (2016) offers a progress report on misgivings of misclassification with an emphasis on loss of tax revenues. Buscaglia (2009) and Moran (2010) have researched the various state legislations across the United States and found many variations within each in the context of statutes and definitions of independent contractors.

Several government studies document the extent to which misclassification drains federal revenues. A 2009 report by the Government Accountability Office (GAO) estimated independent contractor misclassification cost federal revenues $2.72 billion in 2006. The GAO’s estimate was derived from data reported by the IRS in 1984, finding that 15% of employers misclassified 3.4 million workers at a cost of $1.6 billion (in 1984 dollars). From 2000 to 2007, the number of misclassified workers identified by state audits increased from approximately 106,000 workers to over 150,000 workers. These counts likely undercount the overall number of misclassified employees because states generally audit less than 2% of employers each year. A 2010 study by the Congressional Research Service estimated that a proposed modification to the IRS’s “Safe harbor” rules, which currently allow employers significant leeway to treat workers as independent contractors for employment tax purposes, would yield $8.71 billion for fiscal years 2012 - 2021. The proposal would permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law.

This article covers a range of issues surrounding the misclassification of employees as independent contractors in the financial services industry. It is organized as follows: Section 2 is an overview of the financial services industry; Section 3 defines an independent contractor and discusses the tax misclassification impact; and Section 4 discusses the billion dollar tax revenue gap created by employee misclassification and how the application of the substance over form tax doctrine is an alternate approach to minimize the tax revenue losses resulting from employee misclassification.

2. Overview of the Financial Services Industry

The financial services industry is structured under the independent broker-dealer business model. The business model is comprised of broker-dealers and associated registered representatives. A “broker” is any person who buys and sells securities, or effects transactions in securities, for the account of others. The term “dealer” generally refers to a person who buys or sells securities for his or her own account as part of a regular business. The majority of securities firms act as both a broker and a dealer, thus the common usage of the term “broker-dealer” to describe them. The term “registered representative” generally refers to a person who sells securities associated with a broker-dealer. Registered representatives are associated persons of a broker-dealer because they are a part of the broker-dealer's workforce.

2.1 How Broker-Dealers Control Registered Representatives Through Securities Laws

Broker-dealers and their registered representatives are heavily regulated by the Securities and Exchange Commission (SEC) to protect consumers. The Securities Exchange Act of 1934 mandates that anyone who effectuates securities transactions register with the SEC or associate with a corporation that is registered with the SEC. There is a corresponding SEC requirement that a registered broker-dealer become a member of a self-regulatory organization (SRO), such as the Financial Industry Regulatory Authority (FINRA). Under FINRA requirements, broker-dealers are responsible for overseeing the securities operations of their associated registered representatives. A broker-dealer is liable for any violations of federal securities law by an associated registered representative.

FINRA’s Conduct Rules state that a broker-dealer is responsible for supervising the securities operations of its registered representatives. Broker-dealers are required to have written procedures that are reasonably designed to achieve compliance by their registered representatives. These written procedures must be crafted to ensure supervision of the types of businesses in which the broker-dealer engages in that relate to the activities of its registered representatives. A broker-dealer must review its operations, at least annually, to ensure compliance with federal securities laws and FINRA Conduct Rules.

Accordingly, a broker-dealer must establish procedures for the review of all outgoing written and electronic correspondence of its registered representatives with the public relating to the broker-dealer’s securities business. The rules require broker-dealers to designate a registered principal with authority to carry out the supervisory responsibilities of the broker-dealer. The principal is charged with reviewing and approving the registered representative’s correspondence and insuring the suitability of his or her trading activity. Any public displays of a registered representative’s name and business functions must state his or her association with the applicable broker-dealer. A principal must also implement and enforce a system of supervisory control policies to ensure that registered representatives are complying with securities laws.

2.2 The Argument for Misclassification in the Financial Services Industry

The financial services industry is vulnerable to the misclassification challenge. Firms in the financial services industry are targets because of the regulatory responsibilities that require control of registered representatives. The Ninth Circuit noted this distinction in Hollinger v. Titan Capital Corp. by stating that "Congress adopted § 20(a) [of the Securities and Exchange Act of 1934] in an attempt to protect the investing public from representatives who were inadequately supervised or controlled." The *Hollinger* court agreed with the Securities and Exchange Commission (SEC) that § 15 of the 1934 Act requires that "the representative - broker-dealer relationship is necessarily one of controlled and controlling person because the broker-dealer is required to supervise its representatives. On this basis of control, the *Hollinger* court held that "[a] broker-dealer has control and subsequent vicarious liability under the Securities Act with respect to its registered representatives, even when the representatives are independent contractors." As a result, a tension exists between the regulations in the 1934 Act (in its associated duties to supervise and control independent representatives) and the criteria on which courts rely when analyzing whether an independent contractor or employment relationship exists. As the argument goes, the 1934 Act regulations require financial services companies to exert control over the day-to-day manner and means of the performance of their brokers or registered representatives notwithstanding their classification as independent contractors. As the Ninth Circuit and SEC reasoned in *Hollinger*: "Because a sales representative must be associated with a registered broker-dealer in order to have legal access to the trading markets, the broker-dealer always has the power to impose conditions upon that association, or to terminate it. The broker-dealer's ability to deny the representative access to the markets gives the broker-dealer effective control over the representative at the most basic level . . . [including] ongoing control over the types of transactions made by the representative and her ways of handling clients' accounts."

Accordingly, the agencies and individuals attacking the independent contractor model utilized in the financial services industry have identified the broker-dealer and registered representative relationship as one steeped in employee misclassification. The plaintiff often has unsuccessfully concluded that since the broker-dealer-registered representative relationship requires control an employment relationship exists. Courts have ruled that this is not the case. The presence of control in some limited fashion over independent representatives does not operate to create an employer-employee relationship. While control is a very important element, is not the sole determinant of an employer-employee relationship. In order to determine whether a worker is an employee or an independent contractor, courts rely on other indicia of independence, such as skill, corporate form, number of clientele, self-sufficiency, and the opportunity to increase profits or incur a loss. The substance over form tax doctrine creates an alternative approach for courts to consider in analyzing employee misclassification cases.

3. Defining an Independent Contractor & the Tax Misclassification Impact

An independent contractor provides a good or service under the terms of a contract to another individual or business. The independent contractor is not subject to the employer's control or guidance except as designated in a mutually binding agreement. The general rule is that an

individual is an independent contractor if the employer has the right to control only the result of the work and not what will be done and how it will be done.

The business model of most trades and professions draws a clear line to distinguish employees from independent contractors. In the financial services industry, however, the line is often blurred, and registered representatives are typically classified as independent contractors. There are several different statutory tests used to determine if an individual is an employee or an independent contractor. The IRS offers guidelines to establish who is and who is not an independent contractor.

3.1 Lack of Uniformity in Employee Classification Tests

There is no uniform test under state law that determines whether a worker is properly classified as an employee or an independent contractor. Employee classification challenges under federal statutes, such as the National Labor Relations Act, the Civil Rights Act, the Fair Labor Standards Act, the Employee Retirement Income Security Act, and the Internal Revenue Code, rely on varying application of the common law test of employment. Even when the facts of the case are identical, the availability of an assortment of tests utilized to distinguish between employees and independent contractors results in different entities classifying workers differently. Therefore, how a worker is classified depends strongly on who is making the determination. The lack of uniformity within the law results in a wavering application of the test and can leave a firm with uncertainty as to the outcome or steps to take to bring its independent contractor business model in line with the law.

Nevertheless, courts analyzing whether an independent contractor or employment relationship exists under a statute or at common law rely on the primary element of control. Attacks on the independent contractor business model focus on the indicia of control over the manner and means of an independent contractor’s performance of his or her services. Issues arise when the line distinguishing control over desired results, which is generally acceptable in an independent contractual relationship, and control over the manner and means of performance, which is generally not permitted in an independent contractor arrangement, become obscure.

When firms obscure the lines of control, their independent contractor relationships are susceptible to judicial scrutiny. The independent contractor business model has been attacked by the National Labor Relations Board, state agencies that administer workers compensation or unemployment compensation, the IRS, independent contractors, and labor unions. These agencies, groups, and individuals are attacking the independent contractor business model and seeking reclassification of independent contractors as employees based on allegations that companies are exerting control over contractors’ time and schedule, the person(s) or client(s) with whom contractors will be working or are allowed to use to assist the contractors in the completion of their work, and contractor’s methods for performing their work.

3.2 Internal Revenue Service Test

For federal tax purposes, common law principles apply to the factual question of whether an

individual is an employee or an independent contractor. Under the common law, an employer-employee relationship exists when the principal has the right to control and direct the service provider, not only as to the result to be accomplished but also as to the details and means by which that result is accomplished. Based on this general rule, the facts that provide evidence of the degree of control and independence fall into three categories: behavioral, financial, and type of relationship.

In 1987, the IRS issued Rev. Rul. 87-41, which provides guidance concerning the factors that are used to determine whether an employment relationship exists between the Individual and the Firm for federal employment tax purposes and applies those factors to the given factual situations to determine whether the Individual is an employee of the Firm for such purposes. The ruling does not reach any conclusions concerning whether an employment relationship for federal employment tax purposes exists between the Individual and the Client in any of the factual situations.

As an aid to determining whether an individual is an employee under the common law rules, the IRS identified twenty factors which indicate whether sufficient control is present to establish an employer-employee relationship. The twenty factors were developed based on an examination of cases and rulings regarding employment status. The IRS particularly notes that the twenty factors are designed only as guides for determining whether an individual is an employee because “special scrutiny is required in applying the twenty factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee).”

The 20-factors include the following:

1) *Instructions*. A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions.

2) *Training*. Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.

3) *Integration*. Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.

4) *Services Rendered Personally*. If the services must be rendered personally, presumably the

person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.

5) *Hiring, Supervising, and Paying Assistants*. If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.

6) *Continuing Relationship*. A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.

7) *Set Hours of Work*. The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.

8) *Full Time Required*. If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor on the other hand, is free to work when and for whom he or she chooses.

9) *Doing Work on Employer's Premises*. If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.

10) *Order or Sequences Set*. If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so.

11) *Oral or Written Reports*. A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.

12) *Payment by Hour, Week, Month*. Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on s straight commission generally indicates that the worker is an independent contractor.

13) *Payment of Business and/or Traveling Expenses*. If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.

14) *Furnishing of Tools and Materials*. The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.

15) *Significant Investment*. If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship.

16) *Realization of Profit or Loss*. A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee.

17) *Working for More Than One Firm at a Time*. If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor.

18) *Making Service Available to General Public*. The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

19) *Right to Discharge*. The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.

20) *Right to Terminate*. If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

The IRS uses no single factor to establish an employee or independent contractor status.

Rather, the IRS looks at several factors that help it determine whether or not an employer has the right to control the details of how services are performed.

3.3 Tax Reasons for Misclassifying an Employee as an Independent Contractor

Firms misclassify workers for two primary incentives: (1) to avoid paying social security taxes and (2) to avoid paying unemployment taxes. In addition to social security and Medicare taxes, these tax savings result in firms saving 20 to 40 percent in business expenses. If the worker is considered an independent contractor, the hiring firm has none of these obligations, but must file an information return with the IRS reporting payments to the independent contractor if those payments equal or exceed a specific dollar amount. The independent contractor is responsible for paying income and other applicable taxes. In addition, the independent contractor must pay self-employment taxes.

4. The Billion Dollar Tax Revenue Gap Created by Employee Misclassification

The most recent IRS estimate of the tax gap is approximately $345 billion. The employment tax portion of this figure due to underreporting is estimated to be about $54 billion. An estimated $1.6 billion is attributable to worker misclassification. The $1.6 billion estimate is based on Tax Year 1984 data. The IRS's preliminary analysis of operational and program data for 2006 found that underreporting attributable to misclassified workers is likely to be markedly higher than $1.6 billion. The lost tax revenue due to employee misclassification adversely impacts the effective administration of many federal and state programs.

The U.S. Government Accountability Office estimates that employer misclassification costs the federal government $2.72 billion in 2006. Approximately 60 percent of the lost revenue is attributable to unpaid income taxes and the remaining losses stem from unpaid social security, Medicare, and federal unemployment taxes. States also suffer tax revenue losses. The State of Virginia estimated that in 2010 there were roughly 40,000 employers misclassifying their employees. These misclassifications potentially cost the state $28 million in general fund revenue.

A Department of Labor study in 2000 revealed nearly $200 million in lost unemployment insurance tax revenue per year through the 1990s due to misclassification. Carrying this number forward to 2005, estimated unemployment insurance losses would be $343 million per year. States also suffer unemployment insurance tax revenue losses. In New York, estimated losses to the state unemployment insurance fund total $175.6 million annually. Illinois and Massachusetts estimate annual unemployment insurance revenue losses to be $53.7 million and $35 million.

Additionally, a federal tax loophole exists, known as the Safe Harbor Provision (Section 530 of the Revenue Act of 1978). Section 530 precludes the IRS from collecting income taxes from employers who reasonably misclassify their workers as independent contractors. The loophole was intended to be temporary until more workable rules were created. However, in 1982 the

provision was extended. As a result, any employer with a reasonable explanation is relieved from paying back taxes and the IRS cannot correct the misclassification in future tax years. Nearly 40 percent of unpaid taxes and penalties cannot be assessed by the IRS due to the restrictions of Section 530. The U.S. Treasury estimated that a modification to Section 530 would yield $8.71 billion in tax revenues from 2012 to 2021.

4.1 The Substance Over Form Resolution

A fundamental principle of income tax law is that taxation should be based upon the substance of a transaction, not the form. The substance over form doctrine runs, in one respect or another, throughout the tax law. The earliest application of the substance over form doctrine traces back 89 years ago to the Supreme Court's holding in Weiss v. Stearn in which the Court stated: “Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants.... [W]hen applying.., income tax laws...we must regard matters of substance and not mere form.”

The Supreme Court relies upon the settled principle that “courts will not permit themselves to be blinded or deceived by mere forms of law” and that “[t]he rule just stated is of peculiar importance in tax cases; for, unless the courts are very careful to regard substance and not form in matters of taxation, there is grave danger on the one hand that the provisions of the tax laws will be evaded through technicalities and on the other that they will work unreasonable and unnecessary hardship on the taxpayer.”

The IRS has the right to disregard the form adopted by the taxpayer and look instead to the actual substance of a transaction. As explained in Comm’r v. Court Holding Co., such a right on the part of the IRS is necessary, since “[t]o permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.”

The tax laws enacted by Congress operate conceptually at the substantive level of transactions. Such laws impose taxes based on the essential nature of a transaction, not on its constructed label. Thus, to mandate that a consideration of a transaction be based on its form rather than its substance, subjects the vast majority of tax laws to a circumstance for which they were not enacted and may well be contrary to their congressional intent. Laws passed with the congressional intent that they operate in a substantive sphere have both unfair and unforeseen consequences when they are not implemented in this manner. This is the current dysfunction in how the tax law is being applied in certain employee classification cases involving financial services firms.

A classic case articulating the application of substance over form to a taxpayer’s employee classification challenge is Bartels v. Birmingham. In *Bartels*, the taxpayers, dancehall operators, entered into contracts with various band-leaders. The contracts provided that the taxpayers were the employers of the band-leaders and their musicians. At trial, the taxpayers argued, in direct contravention of the contracts, that the band-leaders were themselves independent contractors and were the employers of their own musicians. The Court

disregarded the IRS's attempt to hold the taxpayers to the legal form they had adopted and instead allowed the dancehall operators to argue, and ultimately to establish, that in substance the band-leaders were independent contractors. The Court concluded, "the contractual language did not authorize the Service to collect taxes from one not covered by the taxing statute." The approach taken by the court to apply the substance over form doctrine to a taxpayer's employee classification challenge should be implemented in similar cases involving financial services firms.

5. Conclusion

The determination of a registered representative's status as an independent contractor should be based on the hiring firm's actual business practices, not just the control designated by the requirements of securities laws or the independent contractor agreement entered into with the broker-dealer. Firms in the financial services industry have abused IRS guidelines for many years in classifying their captive registered representatives as independent contractors but exerting control, outside of the SEC and FINRA control requirements, that is indicative of an employer-employee relationship. This manner of control clearly nullifies the independent part of the relationship that the tax law requires. So long as the tax rules appear to favor all registered representatives as independent contractors, financial services firms will continue to dodge their tax liabilities. Utilizing the substance over form tax doctrine permits a more appropriate analysis to reduce the billion dollar tax revenue losses suffered by federal and state governments due to employee misclassification.

This study may aid lawmakers as they consider the issues of worker misclassification and the tax gap. Future researchers can build upon this study by proposing additional guidelines to classify workers properly. By understanding the dilemma and impact of worker misclassification on the tax gap, lawmakers can develop regulations to curb the abuse of employers incorrectly classifying employees as independent contractors. This will aid in closing the billion dollar tax gap created by this issue.

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