



SMALL BUSINESS
LEGISLATIVE
COUNCIL

Statement of John Satagaj
President and General Council
of the Small Business Legislative Council

Before the House Committee on Ways and Means

On

The Classification of Individuals as Independent Contractors or Employees

May 8, 2007

Chairmen McDermott and Neal, Ranking Members English and Weller and members of the Committee, my name is John Satagaj and I serve as President and General Counsel for the Small Business Legislative Council (SBLC). SBLC is a permanent, independent coalition of nearly 60 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views. I wish to thank the Committee for the invitation to testify on the issue of the classification of individuals as independent contractors or employees.

Small Business Philosophy

SBLC was founded in 1977. We have been involved in the debate on this topic since 1977. We can make one observation with certainty. Our economy is far more complex and diverse and the challenge of having any third party, including the federal government, determine the classification of individuals as an independent contractor or an employee, is many times more difficult today than when SBLC entered this debate in 1977. Over that 30-year span we have tried many times to provide clarity and assist small business in classification certainty. What small business owners will tell you about any government regulation is that they appreciate certainty. However, at the same time the rules need to be sufficiently flexible to deal with the diverse nature of our economy.

The delegates to the 1980 White House Conference on Small Business agreed there was a need to articulate a small business "bill of rights." Their recommendation, while not expressly addressing the independent contractor issue, established a framework for why encouraging independent contractors to pursue the American Dream is essential to our economy and society. They said:

"The American Dream is to be an owner of one's own business. Almost everyone has had the dream, and millions of Americans have lived it. The American Dream is the cornerstone of our 200-year-old American Heritage and also is the reason for our

country's position as the most economically powerful nation in the world today. Could we have achieved this status as a nation if we had not been presented with opportunity unencumbered by government regulation? Could we have achieved this nation's status if entrepreneurs had not had the fortitude and shown the initiative to take advantage of opportunity when it presented itself? America was founded on the principle of each individual's fundamental rights, i.e., Freedom of Speech, Freedom of Religion, Freedom of the Press, Freedom of Assembly, Freedom to Bear Arms, etc., fundamentally, the Right to 'Life, Liberty, and the Pursuit of Happiness.' The Pursuit of Happiness can and does take the form of one going into business for oneself, the fulfillment of the American Dream.

"Now, therefore, in consideration of the foregoing and; whereas the Small Business Community is represented by some 14 million small and independent businesses, and; whereas these 14 million businesses represent 100 million people and 58 percent of all private sector jobs in America and; whereas 97 percent of all newly-created jobs in the past seven years have been created among these 14 million small and independent businesses representing 48 percent of America's gross business product and; whereas 50 percent of all new inventions, innovations, and patents are developed in the small and independent sector of American business...

"Therefore, be it resolved that said 14 million small and independent businesses have fundamental, inalienable, and constitutional rights:

The right to start, own, and manage a business without government interference.

The right to compete fairly for capital with the assurance that capital will be available for private use.

The right to reward for the risk, effort, and genius necessary to make an independent business work.

The right to determine price just as the buyer has the right to buy or not at that price.

The right to be governed by reasonable and understandable laws set forth by elected representatives, not by bureaucratic dictate.

The right to be innocent until proven guilty by a jury of our peers; not by administrative edict.

The right to equal representation with Big Business, Big labor, and Government on matters relating to America's economic policies." [emphasis added]

"The right to start, own, and manage one's own business"—the American Dream. It seems like a principle we all automatically assume is as much a part of our nation's heritage as the Constitution and the Bill of Rights. After all, Thomas Jefferson's independent yeoman farmers were the forbearers of our entrepreneurial sector. Our nation is built upon a foundation of individual opportunity.

Back in the 1970s, Milton D. Stewart, the first chief Counsel for Advocacy for Small Business, articulated the need for an economic bill of rights. In addition to the right to start, own, and manage one's own business, Stewart also asserted that the economic bill of rights should include the right to live in an economically-diverse society and that all citizens have an equal entrepreneurial right to participate in our free enterprise system, regardless of such factors as race, creed, or sex. He once observed:

“As Jefferson realized at the nation's birth, economic independence is the only guaranty of political liberty. This country's 14 million small businesses provide 14 million sources, not only for economic opportunity, but also for that liberty. Every one of this nation's business owners can say anything he or she pleases. No one can fire these people or take their jobs away. If you spread the wealth and power in society, you inevitably spread freedom. The larger the small business sector, the more equality of opportunity we have for individuals and the safer our freedom of expression is from abuse. Small business fosters creativity and innovation. It is the bulwark against concentration and the remorseless abuses of power to which that leads.”

While our society seems to accept the belief that there is a right to start, own, and manage one's own business, there has never been a formal game plan to ensure that right is encouraged, promoted, and exercised.

Independent Contractors as Entrepreneurs

Independent contracting is both the embodiment of the American Dream and the means by which it becomes an achievable dream. The essence of the American spirit is individual opportunity. For most “would be” entrepreneurs, the only asset they can bring to their new business is their own skills. Few small businesses start out with the venture capital, informal or formal, to open their business on day one, complete with employees, assets, suppliers, and customers. Independent contractor status is, in fact, the first step on the small business ladder. The risk of becoming an independent contractor is a very limited but direct risk. *If I fail, I do not eat. I do not have the comfort of punching a time clock and knowing the check will be there on payday. But if I am a success, I do not carry the burden of that time clock on my back.*

It seems clear why individuals would seek to become entrepreneurial, independent contractors. The choice is theirs to make and the risks and rewards theirs to evaluate. Likewise, it is equally clear to us why the nation benefits. Not only does entrepreneurial activity reflect our heritage of individual opportunity, but it also brings with it innovation, creativity, productivity, and economic growth.

Therefore, Congress should recognize that encouraging independent contractors is consistent with our nation's economic heritage and social philosophy. Public policy should be built around the presumption that Americans should be encouraged to start, own, and manage a business, not the presumption they are “misclassifications.”

Although it is clear to us why independent contractors seek the status and why the nation benefits, we are not convinced it is well understood in public policy circles exactly why the availability of independent contractors is critical to the survival of other small businesses. To explain why they are a critical cog in a functioning small business economy, we must lapse briefly into public-policy speak. A service provider is an independent contractor. The service

recipient is the business that utilizes them. It might be more accurate to refer to the service recipient as a service expediter, for frequently the general public or other customers are the beneficiaries of the service, not the so-called service recipient.

Nevertheless, the service recipient does benefit from the independent contractor relationship. As remains too often the case, sinister motives are attributed to the business that utilizes an independent contractor. Many of these motives relate to tax liability. The truth is, behind most decisions to use independent contractors you can find the word *flexibility*—the hallmark of a successful small business.

In the dynamic tension between big and small business, the tradeoff is between economies of scale and flexibility. In a big business, enough work may be found to employ one individual with a particular skill or asset. If the market or technology changes, many big businesses find themselves caught with resources that are no longer productive or efficient.

On the other hand, if the work is not there for the skill or asset which the individual can provide, the small business owner is either going to tap an independent contractor or not provide the service. Too often, big businesses must try to force the market to adjust to them. In the small business sector, the business adjusts to the market. If a market or demand changes, the small business is able to adapt to it. If new skills and new technologies are needed, the small business can re-tool itself for those changes. Responding sooner, faster, better, and more efficiently is what allows small businesses to survive, compete, and prosper. Utilizing independent contractors is part of that success story. Mandating that the individual be reclassified as an employee solves nothing because inefficiency and excess capacity is a quick route to bankruptcy.

At the same time, an independent contractor can maintain a standard of living and a way of life, and keep skills and assets in the marketplace available to a number of industry participants. Utilizing an independent contractor facilitates the sale of the service recipients' goods or service. Because the services or assets of the service provider and service recipient are mutually interdependent, they do not, and should not, lead to the conclusion that the relationship should be that of employer-employee.

As I said, we have participated in efforts in the past to provide standards. We have been involved in several legislative projects, the most recent in the 107th Congress. Each effort encountered the same extraordinary challenges of providing a set of standards than can be applied reasonably and fairly. I can tell you that, if anything, the challenges of developing a set of standards today are far more difficult than ever, given the changes in our economy just since the 107th Congress.

Tax Gap Implications of Independent Contractor or Employee Classification

We are all well aware that overshadowing this discussion is the broader debate on the nature of the tax gap and how it can be closed. With my colleagues at the United States Chamber of Commerce and the National Federation of Independent Businesses, we have established Coalition for Fairness in Tax Compliance (CFTC). While it is the position of the CFTC that every individual and business should pay in a timely manner their fair share of taxes, and those taxpayers that do not fulfill this obligation place compliant taxpayers at a disadvantage; regulatory and legislative strategies to collect outstanding obligations can place excessive and obtrusive burdens on the backs of honest taxpayers.

Honest small business taxpayers are especially at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture the few "bad actors" that do not fulfill their tax obligations. Small businesses already bear a disproportionate share of the cost of regulation.

The CFTC is a coalition of small business organizations that will fight for the rights of these honest small business taxpayers as the executive and legislative branches develop strategies to address the "Tax Gap." It is the mission of the Coalition for Fairness in Tax Compliance to fight for the rights of tax compliant small business owners by:

- Supporting the accurate use and collection of information on the source, size, and scope of the problem of tax non-compliance that forms the foundation for policy decisions.
- Supporting targeted, sensible regulatory and legislative measures that will reduce tax non-compliance without generating undue burdens on the small business community.
- Encouraging tax compliance by developing tax simplification proposals for sections of the tax code that are confusing and complicated.
- Opposing regulatory and legislative strategies proposed by lawmakers in an attempt to increase tax compliance that impose excessive and obtrusive burdens on honest small business owners.

The CFTC is eager to facilitate a dialogue. To that end, we have established a website www.taxcompliancefairness.org, which we invite people to utilize.

We have invested an enormous amount of time in trying to find the best way to address the parts of the tax gap that might be closed. For last two years, we have held many meetings with the IRS and others to explore ways we can address this issue in a fair and reasonable way.

When you look at the information available, two observations immediately jump out. The aggregate "Tax Gap" is simply a collection of dozens of tax-compliance functions, business activities, and taxpayer profiles which have little or nothing in common. Solutions must be up to the task of yielding tax revenues without placing a disproportionate burden on the affected taxpayers. Second, the data and research necessary to make informed decisions does not appear to exist. There are so many questions in need of answers before policymakers can begin to craft solutions that will be effective and not burdensome.

The tax gap report suggests that sole proprietors, taxpayers reporting business income on a Schedule C, underreport their income. The group we are discussing today is a subset of that Schedule C universe. While the Department of Labor has published some estimates of contingent workers, a subset of which are characterized as "independent contractors," we do not have high degree of confidence in how much we collectively understand about Schedule C filers, based on our experience with IRS data on sole proprietors. Are there other characteristics that distinguish this subset or subsets of the subset that might be relevant to this discussion? From experience, I can say, one size does not fit all.

I know there is some discussion of what the states are doing to address the classification issue. First, this historically has been an issue in which the states have been eager to preserve their own systems for classification. Past efforts to establish a uniform system have not worked. Second,

to the extent some states have developed new initiatives, I would think we need to wait to see how those initiatives ultimately take shape. Our experience is that there is often a pendulum effect, as businesses, employers, employees, and the state governments discover the unanticipated ramifications of employment classification policy changes.

This leads me to one other point about revenue collection, benefits, and particularly the unemployment compensation system. We would ask whether there has been sufficient study of the impact on states of the reclassification of independent contractors as employees not only in terms of an increase in unemployment insurance tax paid by employers into the system but whether there are concurrent increases in the amount of benefits paid out thus offsetting the revenue projections. Indeed, we have some similar concerns about some elements of the tax gap data, that is, whether the data accounts for some offsetting effects.

Conclusion

Our nation has made an investment in entrepreneurial activity, and we do not want to damp that spirit unnecessarily. The majority of small businesses are compliant taxpayers. For a variety of reasons, not the least of which is for competitive purposes, they want other business taxpayers to be compliant. We have working hard to find proposals that would facilitate compliance without placing greater burdens on the compliant small business taxpayers.

Thank you for the opportunity to testify on behalf of SBLC.