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# THE MISCLASSIFICATION OF EMPLOYEES AS INDEPENDENT CONTRACTORS

Employer misclassification of their employees as independent contractors is a widespread phenomenon in the United States. The Internal Revenue Service (IRS) estimates that employers have misclassified millions of workers nationally as independent contractors.<sup>1</sup> While some employers misclassify their workers as independent contractors in error, often employers misclassify their employees intentionally in order to reduce labor costs and avoid paying state and federal taxes.

The distinction between genuine independent contractors and employees misclassified as independent contractors, while complicated, is a crucial matter. While the definition of misclassification is a function of a complex set of statutes and policies set forth by federal and state agencies, the effect on employees is straightforward. Misclassified employees lose workplace protections, including the right to join a union; face an increased tax burden; receive no overtime pay; and are often ineligible for unemployment insurance and disability compensation. Misclassification also causes federal, state, and local governments to suffer revenue losses as employers circumvent their tax obligations.

This fact sheet will cover a range of issues surrounding the misclassification of employees as independent contractors, including legal definitions of independent contractors; the reasons why an employer would misclassify an employee as an independent contractor; the extent of misclassification; the costs and consequences of employee misclassification; and what states and the federal government are doing to combat misclassification.

## **Defining Independent Contractor**

An independent contractor provides a good or service to another individual or business, often under the terms of a contract that dictates the work outcome, but the contractor retains control over how they provide the good or service.<sup>2</sup> The independent contractor is not subject to the employer's control or guidance except as designated in a mutually binding agreement. The contract for a specific job usually describes its expected outcome.<sup>3</sup> Essentially, independent contractors treat their employers more like customers or clients, often have multiple clients, and are self-employed.

For some professionals, the line between employee and self-employed independent contractor is often blurred, and employers can classify workers as either. There are several different standards used to determine if an individual is legally an independent contractor. While

the intricacies of contracting are too numerous for a comprehensive treatment and the applicability of the test depends on the specific workplace situation, generally, the independent contractor tests employed by the IRS and the Department of Labor (DOL) offer useful guidelines as to who is and who is not an independent contractor.

### ***Internal Revenue Service Test:***

The IRS has a stake in identifying the misclassification of employees because it typically results in lost tax revenue. However, the IRS does not have one set of qualifications that it uses to determine the status of “employee” or “independent contractor.” Instead, the IRS looks at a number of factors that help it determine whether an employer has the right to control the details of how the worker(s) performs the services. Generally, if the employer controls the services the worker performs, then the worker is an employee, not an independent contractor.<sup>4</sup>

According to the IRS, the facts that provide evidence of the degree of control and independence fall into three categories:

1. Behavioral: Does the company control or have the right to control the worker as well as how the worker does his or her job? For example, if a company provides training for the worker, this signals an expectation to follow company guidelines and therefore indicates that the worker is likely an employee.
2. Financial: Are the business aspects of the worker’s job controlled by the payer? (These include things like how a worker is paid, whether expenses are reimbursed, who provides tools, supplies, etc.). Only an independent contractor can realize a profit or incur a financial loss from his or her work.
3. Type of Relationship: Are there written contracts or employee-type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue, and is the work a key aspect of the business? <sup>5</sup>

The issue of who has the right to control is often not clear-cut and the tax code does not define “employee.” Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor.<sup>6</sup>

### ***The DOL Economic Reality Test:***

The DOL has an interest in ensuring accurate classification because only employees receive Fair Labor Standards Act (FLSA) benefits (Federal minimum wage, overtime pay, etc.). The DOL uses an “economic reality test” to determine who is an employee and, thus, eligible for FLSA benefits, by trying to establish *whether the worker is economically dependent on the supposed employer*. According to the DOL, “an employee, as distinguished from a person who is engaged in a business of his or her own, is one who, as a matter of economic reality, follows the usual path of an employee and is dependent on the business which he or she serves.”<sup>7</sup>

The DOL derives its position from judicial precedent. As the U.S. Supreme Court has not established a single rule or test for determining whether an individual is an independent contractor or an employee, the DOL stresses seven factors the Court has considered significant:

1. The extent to which the services rendered are an integral part of the principal's business.
2. The permanency of the relationship.
3. The amount of the alleged contractor's investment in facilities and equipment.
4. The nature and degree of control by the principal.
5. The alleged contractor's opportunities for profit and loss.
6. The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor.
7. The degree of independent business organization and operation.<sup>8</sup>

These seven factors of the economic reality test aim to assist employers in determining employee or independent contractor status, but in most cases, common sense judgments are sufficient. An employee who only invests time in one enterprise and who sells his or her services to only one "customer," the employer, is economically dependent upon that work. An independent contractor is in business for him or herself, invests in his or her own equipment and supplies, and has a broad customer base.<sup>9</sup>

### **Reasons for Misclassifying an Employee as an Independent Contractor**

The largest incentive for misclassifying workers is that employers are not required to pay Social Security and unemployment insurance (UI) taxes for independent contractors. These tax savings, as well as savings from income and Medicare taxes results in employers saving between 20 to 40 percent on labor costs.<sup>10</sup> A 2013 report from the Treasury Inspector General for Tax Administration concluded that employers can save an approximate average of \$3,710 per employee earning an annual income of \$43,007 when they misclassify the employee as an independent contractor.<sup>11</sup> There are a number of other advantages, beyond savings on state and federal tax costs, an employer may derive from misclassifying an employee, including:

- Misclassifying employees as independent contractors can free employers from their legal responsibilities to their workers, such as providing a minimum wage, and abiding by hour laws, because employment and labor laws are based on traditional employee-employer relationships.<sup>12</sup>
- Employers may misclassify workers as a way to circumvent laws enforced by the Equal Employment Opportunity Commission (EEOC). The EEOC protects the workplace civil rights of employees, including prohibitions of employment discrimination based on factors such as age, race, gender, or disability.<sup>13</sup>
- Employers can thwart union organizing or dilute bargaining units by misclassifying workers. Independent contractors are not covered by the National Labor Relations Act.
- Independent contractors are usually not permitted to enroll in employer-based health and pension plans, allowing employers to save money on company provided benefits.<sup>14</sup>

- Employers may misclassify their employees to avoid having to verify that workers are U.S. citizens or covered by a work visa. By doing so, employers can ignore labor laws with impunity and exploit low-wage immigrant workers with few legal repercussions.

**Misclassification in the FedEx Business Model—a Case Study:** Estimates suggest that FedEx cuts its labor costs by as much as 40 percent by misclassifying drivers as independent contractors. Although drivers have little control over the way in which they perform their job or run their routes, FedEx has long denied that FedEx Ground and FedEx Home drivers are employees entitled to benefits and the right to unionize. By classifying drivers as independent contractors, FedEx can transfer operation costs onto its drivers, avoid paying UI and Social Security taxes for the workers, and exclude drivers from FedEx’s health and pension plans.<sup>15</sup> FedEx drivers have pursued legal redress in a number of states, including class action lawsuits.<sup>16</sup> In August 2014, the Ninth Circuit Court of Appeals ruled that FedEx misclassified 2,300 workers in California and Oregon as independent contractors.<sup>17</sup> In October 2014, the Kansas Supreme Court, ruling that FedEx drivers are company employees, not independent contractors.<sup>18</sup> FedEx decided to settle the California lawsuit in June, 2015 for \$228 million.<sup>19</sup> Other litigation is still pending.

### **The Extent of Misclassification**

Accurate data on the extent of employer misclassification is unavailable because employers do not voluntarily report misclassification nor is there a government agency able to conduct comprehensive research. Accordingly, one must examine both state and federal estimates to get an idea of the widespread nature of misclassification. As state audits generally only target two percent of employers and many cases of misclassification occur in the “underground” economy, estimates likely underrepresent the actual number of misclassified workers.<sup>20</sup>

- According to a 2012 list of state audits compiled by the National Employment Law Project, by extrapolating from audit data of misclassified workers to account for employers in the entire state there were an estimated 368,685 misclassified workers in Illinois, between 125,725 and 248,206 in Massachusetts, 704,785 in New York, between 54,000 and 459,000 in Ohio, 580,000 in Pennsylvania, and 214,000 in Virginia.<sup>21</sup>
- The DOL commissioned a study in 2000 to determine the extent of misclassification in the unemployment insurance system. The study found that up to 30 percent of audited firms had employees misclassified as independent contractors.<sup>22</sup>
- Misclassification occurs in nearly all major industries, including in the delivery, trucking, building maintenance, janitorial, agricultural, home health care, and childcare industries. Misclassification rates are especially high in construction. In 2007, the Fiscal Policy Institute released a study on misclassified construction workers in New York City, estimating that 50,000 (one in four) workers were misclassified as independent contractors or employed by construction companies completely off the books.<sup>23</sup>
- The IRS Form SS-8, “Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding,” provides employers and workers with an

opportunity to receive IRS guidance or an internal audit of the business. The IRS estimates as many as 85 percent of all Form SS-8 filers submit the form because they want to contest their treatment as independent contractors.<sup>24</sup>

## **The Costs and Consequences of Employee Misclassification**

Employee misclassification robs individual workers of their rights and benefits, adversely impacts the effective administration of many federal and state programs, and creates unfair competition for law-abiding employers. The resulting costs and consequences of employee misclassification are therefore wide reaching.

- Using an IRS estimate from 1984, the U.S. Government Accountability Office estimated that employer misclassification cost the federal government \$2.72 billion in 2006.<sup>25</sup> Nearly 60 percent of lost revenue was attributable to misclassified individuals failing to pay income taxes. The remaining losses stemmed from the failure of employers and misclassified workers to pay taxes for Social Security and Medicare and the failure of employers to pay federal unemployment taxes.<sup>26</sup>
- A 2000 study commissioned by the DOL found nearly \$200 million in lost UI tax revenue per year through the 1990s due to misclassification.<sup>27</sup> The study also found that misclassifying employees as independent contractors resulted in lost UI benefits for roughly 80,000 workers annually.<sup>28</sup>
- A federal loophole, known as the “safe harbor provision” (Section 530 of the Revenue Act of 1978), 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 rules that were more workable were created but the provision was extended indefinitely in 1982. Thus, any employer with a *reasonable* explanation is relieved from having to pay back taxes and the IRS cannot correct the misclassification in future tax years.<sup>29</sup> About 40 percent of unpaid taxes and penalties cannot be assessed because of Section 530 restrictions. The Congressional Research Service estimated that a modification to the “safe harbor” rules would yield \$8.71 billion from 2012 to 2021.<sup>30</sup>
- States also suffer losses in UI tax revenue due to misclassification. In Pennsylvania and New York, state task forces estimated annual UI revenue loss to be \$200 million and \$198 million, respectively. Massachusetts estimated a loss to the state UI fund of \$35 million annually.<sup>31</sup>
- In 2010, Virginia estimated they had roughly 40,000 employers misclassifying their employees, potentially shorting the state \$28 million in general fund revenue.<sup>32</sup>
- Companies that misclassify their workers have an advantage over law-abiding competitors because they can lower their labor costs by as much as 40 percent. This uneven playing field means that lawful employers are underbid and lose business, wages and labor standards are depressed across the board, and ultimately lawful employers subsidize the freeloaders in the form of increased workers’ compensation and health insurance premiums.<sup>33</sup>

- Additionally, workers misclassified as independent contractors typically have lower incomes and little economic security. A 2008 report found that port truck drivers misclassified as independent contractors in New York and New Jersey earned a median annual wage of \$28,000. This amounted to just under \$10 per hour and because they were misclassified as independent contractors they did not receive employer sponsored health benefits or a pension.<sup>34</sup>

## **State and Federal Government Action to Combat Misclassification**

In today's strained fiscal environment, both federal and state governments are taking enhanced steps to combat employer misclassification. On the federal level, the IRS audits employers for unreported federal taxes stemming from misclassification. States, meanwhile, are passing initiatives and laws to protect employees and crack down on unlawful employers.

- The DOL launched the "Misclassification Initiative" in 2010 as part of Vice President Biden's Middle Class Task Force. This initiative seeks to combat misclassification and FLSA violations through the DOL's Wage and Hour Division.<sup>35</sup>
- While the IRS is responsible for auditing employers, the DOL, under the Obama Administration, has taken steps to increase employer accountability. In September 2011, former Secretary of Labor Hilda Solis announced the signing of a Memorandum of Understanding (MOU) between the DOL and IRS. Under the agreement, the agencies will work together and share information to reduce the misclassification of employees, to reduce the tax gap, and to improve compliance with federal labor laws.<sup>36</sup>
- In September of 2014, Labor Secretary Thomas Perez announced that the U.S. Department of Labor awarded \$10.2 million in grants to 19 states to assist in their efforts to combat employee misclassification.<sup>37</sup>
- President Obama's 2017 budget request includes \$10 million in funding to revive a DOL grant program to help states combat worker misclassification. This program was first introduced in 2014 but was cut in 2016 in the face of industry opposition.<sup>38</sup>
- In 2015, DOL's Wage and Hour Division released memorandum of guidance on worker classification.<sup>39</sup> Though not an official change in policy, the guidance is an attempt to provide a more detailed interpretation of how to classify workers under the Fair Labor Standards Act.<sup>40</sup>
- In January 2016, Bureau of Labor Statistics, an agency under DOL, announced that it will be working with the Census Bureau to bring back the Contingent Workers Supplement to the Current Population Survey starting May 2017.<sup>41</sup> This is expected to provide valuable insights into the nature of the contingent workforce, such as the size and scope of independent contractors, temporary workers, and those holding more than one job at the same time.

**What can a worker do if they believe they have been misclassified as an independent contractor? Find a complete list of state resources on DPE's website here:**

<http://goo.gl/xc9Cpj>.



- Labor commissioners and other agency leaders representing 29 states have signed MOUs with the DOL. These MOUs will enable the DOL to share information and to coordinate enforcement efforts with participating states to ensure that employees receive the protections to which they are entitled under federal and state law.<sup>42</sup>
- Many states have also taken the initiative to combat employee misclassification. At least 19 states, including New York, Massachusetts, Michigan, New Jersey, and Iowa have created inter-agency task forces to study the magnitude of the problem and coordinate and strengthen enforcement mechanisms.<sup>43</sup>
- The efficacy of these task forces is apparent. In 2013, the Massachusetts Joint Task Force on the Underground Economy and Employee Misclassification recovered over \$15.6 million through its enforcement efforts.<sup>44</sup> That same year, New York's Joint Enforcement Task Force on Employee Misclassification identified over 24,000 instances of misclassification, discovered over \$333.4 million in unreported wages, and assessed over \$12.2 million in unemployment taxes.<sup>45</sup>
- In terms of legislation, states are beginning to pass laws creating a "presumptive employee status." These laws presume that workers are employees of an employer, not independent contractors, and therefore it is the responsibility of the employers to overcome this presumption by proving that their workers are instead genuinely independent. 27 states have some version of such laws, including California, Florida, Illinois, New Jersey and Wisconsin. Other states, such as Pennsylvania and Minnesota, have laws that only apply to specific sectors.<sup>46</sup>
- As of 2016, thirty-five states have laws against misclassification of employees, up from thirty states in 2013.<sup>47 48</sup>

### **Legal Victories for Misclassified Workers**

Both federal and state agencies and workers themselves are seeking legal action against misclassification. A number of these suits resulted in positive outcomes for the workers, establishing both correct classification and winning retroactive compensation for overtime and other lost benefits.

For up-to date information on federal and state laws, as well as news of successful DOL investigations, visit the U.S. Department of Labor, Wage, and Hour Division's page on Misclassification of Independent Contractors: <http://www.dol.gov/whd/workers/Misclassification/index.htm>

- In April 2016, Uber decided to settle a class action lawsuit for brought against it by drivers in California and Massachusetts for \$100 million. Because the case did not go to trial, the independent contractor dispute question has not yet been resolved.<sup>49</sup>
- In April 2015, DOL announced that it recovered \$700,000 in back wages, damages, and penalties for over 1,000 misclassified construction industry workers in Utah and Arizona.<sup>50</sup>
- In September 2014, a Sacramento Superior Court in California ruled that The Sacramento Bee misclassified over 5,100 newspaper carriers as independent contractors.<sup>51</sup>

- In May 2013, the DOL helped 196 employees at a Kentucky based cable installer recover over \$1 million in retroactive overtime pay and other benefits.<sup>52</sup>
- In 2012 and 2013, after having hired 300 additional investigators,<sup>53</sup> the DOL collected more than \$18.2 million in back wages on behalf of 19,000 employees who had been misclassified.<sup>54</sup>
- Two separate class action lawsuits launched by exotic dancers resulted in multi-million dollar settlements for the employees long misclassified as independent contractors. The litigation in both cases was lengthy; however, this could prove useful in establishing precedent for other misclassified employees in an industry where it appears misclassification is common practice. Going forward the employers involved in the suits will no longer classify dancers as independent contractors, but as either employees or shareholders.<sup>55</sup>

<sup>1</sup> “Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings.” Treasury Inspector General for Tax Administration, June 14, 2013. Retrieved from <http://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf>

<sup>2</sup> “Independent Contractor Defined.” Internal Revenue Service. Retrieved from <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-Defined>

<sup>3</sup> “Independent contractor.” West’s Encyclopedia of American Law, The Gale Group, 2008. Retrieved from <http://legal-dictionary.thefreedictionary.com/independent+contractor>

<sup>4</sup> “Independent Contractor (Self-Employed) or Employee?” Internal Revenue Service, October 2, 2014. Retrieved from <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-Self-Employed-or-Employee>; “Independent Contractor Defined,” Internal Revenue Service, October 2, 2014. Retrieved from <http://www.irs.gov/businesses/small/article/0,,id=179115,00.html>

<sup>5</sup> “Independent Contractor (Self-Employed) or Employee?” Internal Revenue Service, October 2, 2014. Retrieved from <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-Self-Employed-or-Employee>

<sup>6</sup> *Ibid.*

<sup>7</sup> “Fact Sheet 13: Am I an Employee?: Employment Relationship Under the Fair Labor Standards Act (FLSA).” Department of Labor, Wage and Hour Division, May 2014. Retrieved from <http://www.dol.gov/whd/regs/compliance/whdfs13.htm>

<sup>8</sup> *Ibid.*

<sup>9</sup> “Independent Contractor Tests.” Texas Workforce Commission. Retrieved from [http://www.twc.state.tx.us/news/eft/independent\\_contractor\\_tests.html](http://www.twc.state.tx.us/news/eft/independent_contractor_tests.html)

<sup>10</sup> “Statement of Seth D. Harris Deputy Secretary U.S. Department of Labor Before the Committee on Health, Education, Labor, and Pensions U.S. Senate.” U.S. Senate. Committee on Health, Education, Labor, and Pensions, U.S. Department of Labor, June 17, 2010. Retrieved from [http://www.dol.gov/\\_sec/newsletter/2010/20100617-2.htm](http://www.dol.gov/_sec/newsletter/2010/20100617-2.htm)

<sup>11</sup> “Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings.” Treasury Inspector General for Tax Administration, June 14, 2013. Retrieved from <http://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf>

<sup>12</sup> “Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification.” United States Government Accountability Office, May 8, 2007. Retrieved from <http://www.gao.gov/new.items/d07859t.pdf>

<sup>13</sup> “Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention.” United States Government Accountability Office, September 9, 2009. Retrieved from <http://www.gao.gov/products/GAO-09-717>

<sup>14</sup> “Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification.” United States Government Accountability Office, May 8, 2007. Retrieved from <http://www.gao.gov/new.items/d07859t.pdf>

<sup>15</sup> Greenhouse, Steve. “Drivers may not join union at FedEx Home, Court Rules.” New York Times, April 22, 2009. Retrieved from [http://www.nytimes.com/2009/04/23/business/23fedex.html?\\_r=1](http://www.nytimes.com/2009/04/23/business/23fedex.html?_r=1); Reibstein, Richard J.



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<sup>16</sup> “FedEx lawsuits challenging the misclassification of delivery drivers as independent contractors.” Lichten and Liss-Riorden, P.C. Retrieved from [http://www.llrlaw.com/ca\\_fedex.htm](http://www.llrlaw.com/ca_fedex.htm)

<sup>17</sup> “Court finds that workforce of FedEx Ground drivers are employees, not independent contractors, says Leonard Carder.” The New York Times, August 28, 2014. Retrieved from [http://markets.on.nytimes.com/research/stocks/news/press\\_release.asp?docTag=201408271458PR\\_NEWS\\_USPRX\\_\\_\\_\\_\\_DC99199&feedID=600&press\\_symbol=105814](http://markets.on.nytimes.com/research/stocks/news/press_release.asp?docTag=201408271458PR_NEWS_USPRX_____DC99199&feedID=600&press_symbol=105814)

<sup>18</sup> Sherman, Erik. “Kansas Supreme Court: FedEx Ground Drivers Not Contractors.” Forbes, October 3, 2014. Retrieved from <http://www.forbes.com/sites/eriksherman/2014/10/03/kansas-supreme-court-fedex-ground-drivers-not-contractors/>

<sup>19</sup> Wood, Robert W. “FedEx Settles Independent Contractor Mislabeling Case for \$228 Million” Forbes, June 16, 2015. Retrieved from: <http://www.forbes.com/sites/robertwood/2015/06/16/fedex-settles-driver-mislabeling-case-for-228-million/#7e022c55f5aa>

<sup>20</sup> “Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries.” National Employment Law Project, July 2015. Retrieved from <http://www.nelp.org/content/uploads/Independent-Contractor-Costs.pdf>

<sup>21</sup> *Ibid.*

<sup>22</sup> “Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs.” Planmatics, Inc., United States Department of Labor, February 2000. Retrieved from <http://wdr.doleta.gov/owsdrr/00-5/00-5.pdf>

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<sup>24</sup> “Independent Contractor (Self-Employed) or Employee?” Internal Revenue Service, October 2, 2014. Retrieved from <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-Self-Employed-or-Employee>; “Independent Contractor Defined,” Internal Revenue Service, October 2, 2014. Retrieved from <http://www.irs.gov/businesses/small/article/0,,id=179115,00.html>

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<sup>31</sup> *Ibid.*

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For more information on professional and technical workers, check DPE’s website:  
[www.dpeaflcio.org](http://www.dpeaflcio.org).

*The Department for Professional Employees, AFL-CIO (DPE) comprises 22 AFL-CIO unions representing over four million people working in professional and technical occupations. DPE-affiliated unions represent: teachers, college professors, and school administrators; library workers; nurses, doctors, and other health care professionals; engineers, scientists, and IT workers; journalists and writers, broadcast technicians and communications specialists; performing and visual artists; professional athletes; professional firefighters; psychologists, social workers, and many others. DPE was chartered by the AFL-CIO in 1977 in recognition of the rapidly growing professional and technical occupations.*

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- Professionals in the Contingent Workforce;
- Recourse for Employees Misclassified as Independent Contractors;
- The Future of Work and Workers in Professional and Technical Occupations; and
- The Young Professional Workforce

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