

Employee Misclassification & Unemployment Insurance Audits



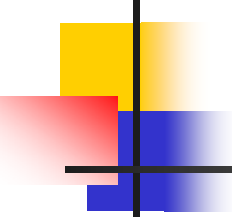
2009 National Unemployment Insurance Conference

Tom Crowley, UI Tax Chief

USDOL/ETA/OUI

Urban Myths

Dispelling Falsehoods, Rumors & Innuendo

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- Employers are often perceived to be the bad guy
 - Should not be - Most employers classify their employees properly and file & pay their taxes on-time
 - Independent Contactors are inherently bad
 - False – Properly classified ICs play a crucial role in a vibrant and dynamic US economy
 - Employee Classification is easy
 - False – Employers, Congress, Federal and state employment tax officials struggle to define “employee” and “employment”
 - Abusers of Employee Misclassification will be targeted more in the future
 - True

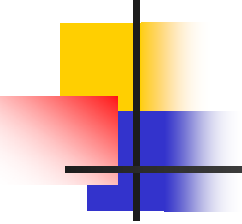


Auditing and Employee Misclassification

- Employee Misclassification
 - What is it?
 - Why do we care?
- Employer Audits
 - What are they?
 - How do we measure results?
 - Future measures?
- State Task Force Initiatives
- Sharing Information

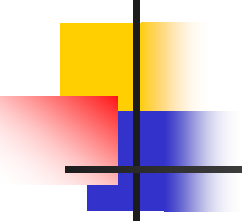
Employee Misclassification

What is it?

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- Misclassification occurs when a worker's employment status is incorrectly classified
 - In the context of this discussion, we assume the worker was incorrectly classified as an independent contractor, instead of as an employee

Worker Classification

Consequences of Abuse

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- Employers gain unfair competitive advantage
 - Workers denied access to:
 - Affordable health care and retirement plans
 - UI benefits
 - Labor law protections afforded to “employees”
 - Independent Contractors (IC) pay higher:
 - FICA
 - Quarterly estimated payments for federal & state taxes
 - Health care costs
 - Workers’ Compensation premiums
 - If the IC unable to pay the above:
 - Forces eligible workers out of the system
 - Lowers tax revenue
 - Further degrades UI coverage

Employee Defined

At the State UI Level

- Common Law, conjunctive “ABC test” for UI
 - A - Direction and control, and
 - B - Outside usual course / place of business, and
 - C - Worker in an independent trade or business
- Used by the majority of states
- Many states use only A & C
- Others look to the IRS for guidance





Common Law

- Often stated – what does it mean?
 - A system of law that is derived from judges' decisions, which arise from the judicial branch of government, rather than statutes or constitutions, which are derived from the legislative branch of government.
- Statutes trump common law – until the statutes are litigated in court and become common law



Employee Defined

At the Federal Level

- FUTA 3306(i) defines employee by reference, under IRC 3121(d)
 - “employee” means – (2) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of employee;”
- By Regulation in 26 CFR 31.3121(d)-1
 - An employer / employee relationship exists when the employer “has the right to control and direct the individual who performs the services ...”
 - “It is sufficient if the employer has the right to do so.”
- To determine direction and control, IRS initially used a 20 factor test, as described in Revenue Ruling 87-41
- 20 Factor Test evolved into three types of evidence
 - Behavioral – a right to direct or control, instructions or training
 - Financial – worker opportunity for profit / loss, unreimbursed expenses
 - Relationship – right to terminate, permanency, benefits

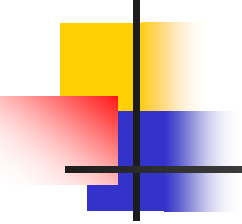


IRS 20 factors

- Instructions
- Training
- Integration
- Service rendered personally
- Hiring, supervising, and paying assistants
- Continuing relationship
- Set hours of work
- Full-time work required
- Doing work on business owner's premises
- Accomplishing work in certain order or sequence
- Submission of oral or written reports
- Method of payment
- Payment of business or traveling expenses
- Furnishing tools and equipment
- Significant investment
- Realization of profit or loss
- Work for one entity at a time
- Offer their services to the general public
- Right to discharge
- Right to terminate

Employee Misclassification

Employer – Employee Consequences

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- Employer substantially reduces costs by offloading employment tax and worker's compensation costs to the I.C.
 - Misclassified employee's income substantially reduced by the amount of the increased employment tax responsibilities, unless employer subsidizes the taxes by increasing pay

Employee Misclassification

Impact on Unemployment Insurance (UI)

- Taxes – Reduced tax revenue for state and federal UI. Every 200,000 workers misclassified = \$11 million lost FUTA and significantly more lost to state UI trust funds
- Benefits – The de facto loss of UI coverage. Employee entitlement to UI, however, is based on the circumstances of their employment and their job separation, NOT the employer's UI reporting and payment history.

The Field Audit Function

Citation from the Employment Security Manual (ESM)

- 3670 Objectives of a Field Audit Program.

“A comprehensive field audit program is vital to the administration of a State unemployment compensation (UC) system. A well-planned and cost effective field audit program, executed in coordination with central office activities and other unemployment insurance field undertakings, is an efficient means of ensuring compliance with State UC law and timely collection of taxes on an equitable basis.”

ESM Audit Requirements



An audit must include the following minimum requirements:

1. Commence with an opening interview with the employer or a designated representative;
2. Cover a minimum four calendar quarters;
3. Verify the business entity as a sole proprietor, partnership, corporation, joint venture, or other;
4. Document records examined and evidence obtained in tests used to verify payroll procedure, accuracy, and completeness;
5. **Document records available and examined and the evidence obtained in the search for misclassified workers and payments;**
6. Conclude with a closeout conference with the employer or a designated representative. If closure is not possible, explain in the report; and
7. Include a written report stating the auditor's final determination and all facts contributing to or supporting that determination.

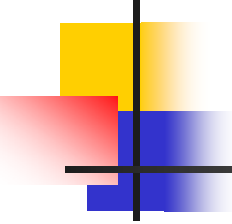
What Is Important?



- Verify the employer (no fictitious employer - ID fraud)
- Verify employer reports all wages properly
- Verify employer classifies employees properly
- Validate reporting (do the math – excess wage calculation)
- Investigate hidden wages (this is not misclassification)
- Bottom line – Ensure wages reported properly to enable accurate tax payments and UI benefit payments (ultimately – Job # 1)

Tax Performance System (TPS)

(How We Currently Measure Audit Performance)

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- TPS: A systematic review of state UI tax operations that occurs annually in every state. The field audit program is one of the areas that undergo examination every year.
 - Primary objective: “to promote and verify employer compliance with State laws, regulations and policies.”
 - Systems Review: An assessment of internal controls and systems
 - Computed Measures
 - % change in total wages resulting from audit – Not benchmarked (no requirement)
 - % of contributory employers audited – 2% required
 - % of total wages audited. (Annualized) – Not benchmarked (no requirement)

Audit Selection Alternatives



- Random Selection
 - Impartial – Every employer has an equal chance of being selected
 - Far-Reaching – Outreach opportunity for all employers
 - Thorough – Randomization could select employers that would otherwise be omitted
 - Most employers comply with the law → most audits will be uncomplicated and without adjustments
- Targeted Selection
 - Focused on employers more likely to be problematic
 - Maximizes resources on areas likely to yield results
 - Profile by Industry, Location, Past History, IRS leads
 - Emphasizes search for misclassified employees
 - Emphasizes enforcing UI coverage provisions
 - Trying to select employers likely to be problematic → most audits will be complicated and require adjustments
 - Labor-intensive – Less audits conducted using same resources

ESM – Audit Selection Criteria

EMPLOYMENT SECURITY MANUAL

Part V

Unemployment Insurance Program

3000-3999 Contributions R-1/99

3677 **Subject Employer Audit Penetration.** The number of audits to be conducted each calendar year (CY) represents two (2) percent of contributory employers at the end of the immediately preceding September.

Reimbursable and governmental entities Should be excluded from the universe of employers to be audited. For example, the audit count for CY 1999 will be two (2) percent of the number of contributory employers as of September 30, 1998.

3679 **Selection of Employers for Audit.** States are encouraged to maintain audit selection criteria that include indices that reflect potential noncompliance such as high employee turnover, sudden growth or Decrease in employment, type of industry, location (geography) of employers, prior reporting history, results of prior audits and adjudicated determinations.

To ensure that all employers are included in the audit selection process, States are encouraged to randomly select 10% or more audit assignments from the total universe of contributory employers.

3681 **Large Employers.** To assure inclusion of large employers in the audit program, one (1) percent of total audits required to meet the audit penetration rate must be large employers. All States must include at least

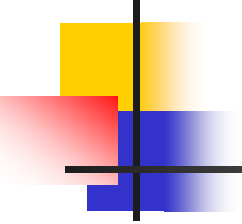


Audit Penetration Rate

- ESM – “Subject Employer Audit Penetration. The number of audits to be conducted each calendar year (CY) represents two (2) percent of contributory employers at the end of the immediately preceding September.”

Penetration Rate

Truth or Consequences

- 
- MD - 140,000 employers X 2% = 2,800 audits required annually
 - Audit 1 – Granny with a domestic
 - Audit 2 – Landscaper with 10 employees, 20 “permanent” 1099 ICs, and 150 workers not included in any employer accounting records
 - Audit 3 - Boeing – 158,000 employees
 - Each of these 3 audits counts equally
 - MD has about 35 auditors – auditing 2,400 grannies each year is easy, but what about the landscaper and the big employer?

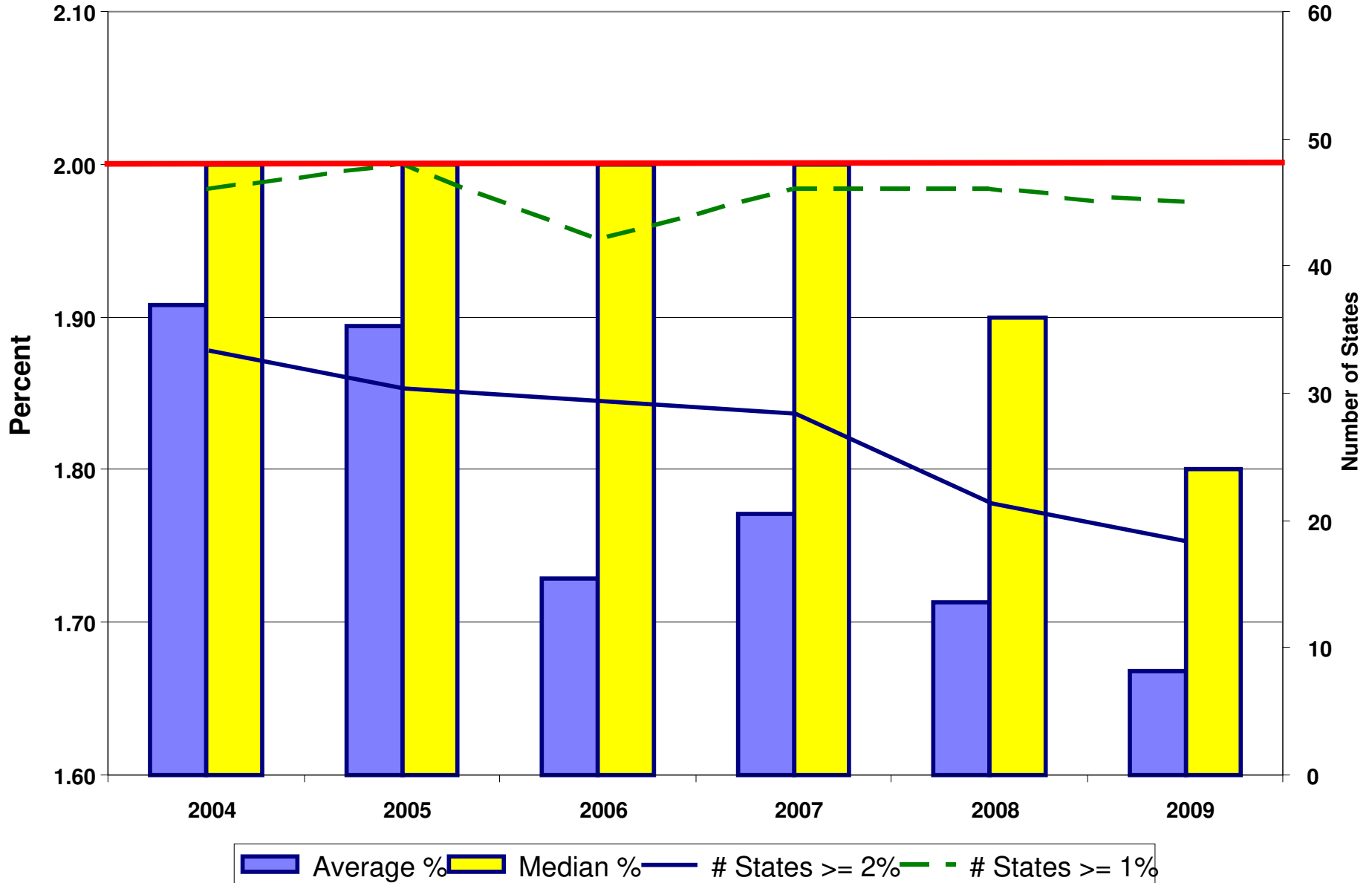


Performance Consequences

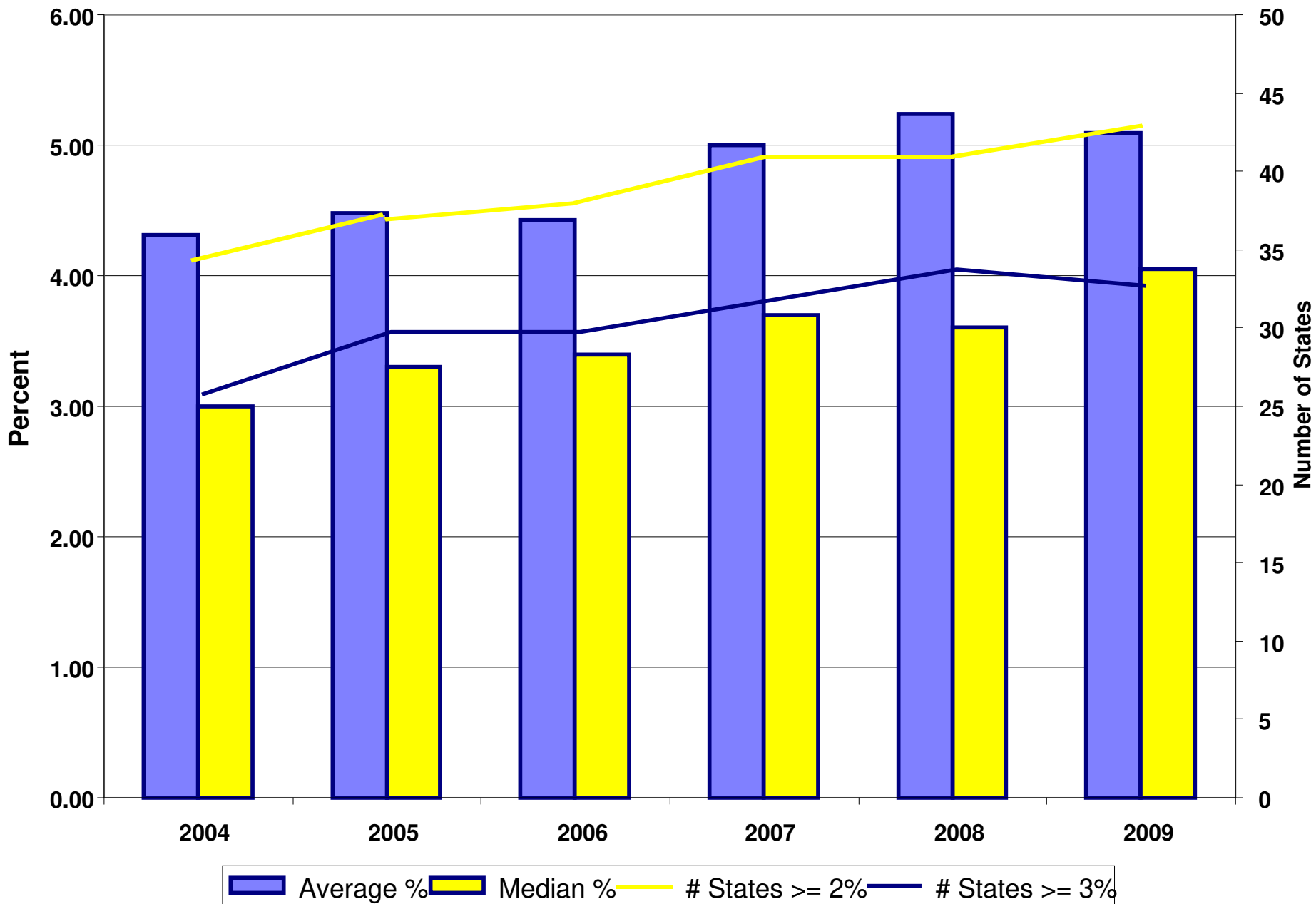
- TPS Program Review (System Review & Acceptance Sample) – failing 3 or more consecutive years requires corrective action plan
- Audit Penetration Rate – State notified of failure each quarter by USDOL
- % Wage Change – No benchmark (yet)
- % Wages Audited – No benchmark (yet)

National Total for UI Tax Employer Audit Penetration Rate

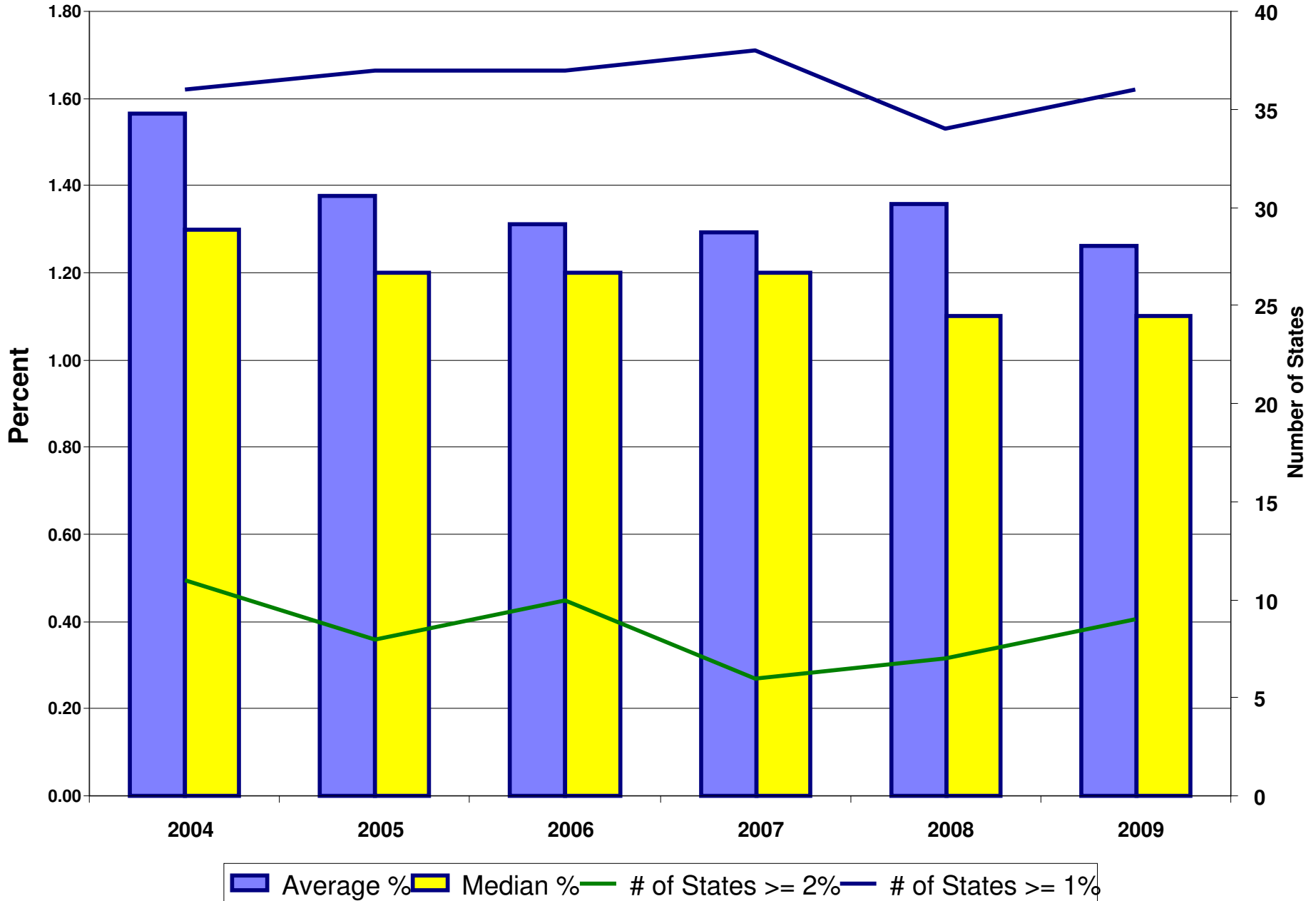
(Percent of Contributory Employer Audited Annually - 2% Required)



US Total Wage Change From UI Employer Audits



US Total - Annualized % of Total Wages Audited





Field Audit Measurement Team

- Comprised of USDOL and State UI tax administrators
 - CA, CT, FL, MI, PA, TX, WV
- 1st Meeting Nov. 2009
- Questions to be answered:
 - “What tells you that you have conducted a successful audit?”
 - “How would you measure that?”

Field Audit Measurement Team




- Team members care passionately about the employer audit program
- State members work hard to fulfill the program's mission
- Computed Measures are valuable, but they do not measure the # of employee misclassifications detected
- Need to not only define **how** we measure, but also define **what** we measure. A basic, but key question:
 - What is an audit? When states do audit work that does not meet ESM definitions, that data is not reported to USDOL
 - Work is still being done, but it is not counted
- More to come

State UI Tax Enforcement Activity

| Year | # Audits | # Misclassified Workers | Total Wages Discovered | % Audits Resulting in Change |
|------|----------|-------------------------|------------------------|------------------------------|
| 2002 | 113,395 | 125,262 | \$1,815,968,012 | 39.90% |
| 2003 | 118,896 | 123,044 | \$2,022,483,640 | 40.30% |
| 2004 | 123,402 | 139,064 | \$2,242,798,141 | 41.80% |
| 2005 | 119,614 | 132,809 | \$2,235,658,270 | 42.70% |
| 2006 | 116,311 | 157,998 | \$2,570,351,349 | 43.30% |
| 2007 | 117,486 | 151,039 | \$9,290,360,049 | 42.60% |
| 2008 | 110,956 | 189,109 | \$3,072,609,885 | 46.10% |

- National summary of State UI audit activity
- On average, UI tax audits detect 1.35 worker misclassifications per audit

State Task Force Initiatives



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an official **NEW HAMPSHIRE** government website

Task Force FOR THE MISCLASSIFICATION OF NH WORKERS

[Department of Labor](#) | [Department of Employment Security](#) | [Department of Revenue Administration](#) | [Department of Insurance](#)

Task Force for the Misclassification of NH Workers

[Report suspected misclassification](#)

We are committed, through education and enforcement of New Hampshire laws and rules, to promoting a state wide community where all New Hampshire businesses are treated equally and expected to pay their fair share and New Hampshire workers are guaranteed appropriate pay and protections.

If you think an employer is committing fraud by misclassifying its workers or is committing violations of New Hampshire State laws related to the employment of workers, it is important that you let us know about it. All allegations of fraud and violations are taken seriously, and while your name can be withheld as an informant, you must identify yourself and give your personal information so that we can follow-up with you directly on the tip if necessary. Please include as much information as possible. All information will be maintained in a fully secure environment.


The Task Force's strong emphasis on fraud prevention, and the detection of violations, helps reduce opportunities for fraud and abuse. In addition, its fraud deterrence activities persuade individuals and companies that they should not commit fraud because of the likelihood of detection and punishment.

The Task Force will make every effort to protect your identity. We will not reveal the source of these allegations to the employer in the course of our investigation.

The Task force is made up of the following State regulatory agencies, [Department of Labor](#), [Department of Employment Security](#), [Department of Revenue](#) and the [Department of Insurance](#). Each of these agencies is committed to ensuring that NH businesses pay their fair share to work in New Hampshire and that all NH workers are treated fairly.

A tip made through this website will be reported simultaneously to all four Department's engaged in the Task Force so you do not need to report a tip to each agency individually. Someone from the Task Force will contact you if we need further information. If you provide us with enough information we will begin our investigations. In most instances we will not contact an informant to provide any information on any open investigation unless we need information as our agencies investigations are not considered public to protect the rights of the accused in case of false accusations or misunderstandings.

Task Force for the Misclassification of NH Workers

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State Task Force Initiatives

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Misclassification of Workers

[Report of the Joint Enforcement Task Force on Employee Misclassification to Governor Spitzer \(2008\)](#)

[Annual Report of the Joint Enforcement Task Force on Employee Misclassification \(2009\)](#)

[Governor's Press Release](#)

[NY Times Article](#)

In September 2007, [Governor Spitzer](#) signed an [Executive Order](#) creating an interagency strike force to address the problem of employers who inappropriately classify employees as independent contractors or pay workers off the books as part of the underground economy.

Misclassification of workers occurs when an employer improperly treats an individual as an independent contractor instead of as an employee. Because of this labeling, some employers attempt to avoid complying with unemployment insurance, workers' compensation, social security, tax withholding, temporary disability, and minimum wage and overtime laws that protect workers. Paying workers off the books also fraudulently deprives workers of the protections they deserve. These practices also put law-abiding business at a competitive disadvantage because of the significant unemployment insurance and workers' compensation expenses they incur for their employees.

The Joint Enforcement Strike Force includes staff from: the Department of Labor, the Attorney General's Office, the Department of Taxation and Finance, the Workers' Compensation Board and the New York City Comptroller's office.

If you believe that you have been misclassified by your employer and want to file a complaint, please contact the Task Force in the department's Employer Fraud Unit, 24-hours a day at 1-866-435-1499. You may also contact the Task Force, weekdays at 518-485-2144 between 8am and 4pm or send us an [email](#). Please complete the [Tip Sheet](#) and fax it to 518-485-6172 or mail it to:

New York State Department of Labor
Liability and Determination, Fraud Unit
W.A. Harriman State Office Campus
Building 12 - Room 356
Albany, New York 12240

If you think an employer is committing fraud by misclassifying its workers or is committing violations of New York State laws related to the employment of workers, it is important that you let us know about it. All allegations of fraud and violations are taken seriously, and you can remain anonymous. Please include as much information as possible. All information will be maintained in a fully secure environment.

New York Task Force Results

*****Joint enforcement sweeps:** 46 joint enforcement sweeps have been conducted to date: 20 in the Metropolitan New York City area and 26 in Upstate New York. These sweeps, which have primarily involved the construction industry, have resulted in investigations of 291 business entities. Completed unemployment insurance audits in 163 of these investigations show 7,789 misclassified workers and over \$86 million in unreported remuneration and has resulted in the assessment of over \$2.5 million in additional unemployment taxes and over \$1 million in unemployment insurance fraud penalties.

*****Main Street Sweeps:** The Task Force has conducted a series of door to door “Main Street” sweeps to investigate compliance with employment laws in retail and commercial strips. Teams of unemployment insurance, labor standards and workers compensation investigators went door-to-door to businesses in retail strips in four localities and visited a total of 304 businesses. In 67% of the businesses visited, investigators saw evidence of violations requiring follow-up enforcement action. Over 11% of the businesses were not registered at all for Unemployment Insurance and 23 stop work orders were issued by the Workers’ Compensation Board for lack of workers compensation coverage. ¹

UI Tax Data-Sharing Efforts



- Historically, each state operated within their own silo
- Now, reaching out to include:
 - IRS – Questionable Employment Tax Practices (QETP), 1099-MISC
 - HHS/SSA – National Directory of New Hires (NDNH)
 - Intra-state agencies (revenue, workers' compensation, wage & hour, licensing, etc.)
 - Interstate Efforts – Considering data sharing among states for SUTA dumping violators
- Issues to Consider:
 - Confidentiality and Disclosure rules
 - Secure PII information from unauthorized and malicious access



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