

PERFORMANCE AUDIT

Regulation of Independent Contractors

Department of Labor and Industry

MAY 2016

15P-02

REPORT SUMMARY

Independent contractors are a growing segment of the national workforce and this working arrangement can have many benefits for both individuals and businesses. However, independent contractor status can be abused through misclassification of employees as independent contractors, which can have negative effects on individuals, state revenues and programs, and business competition. The Department of Labor and Industry regulates the independent contractor designation in Montana and can improve its efforts to identify and prevent misclassification of employees as independent contractors.

## Context

Most definitions identify independent contractors as individuals who work for themselves. Audit assessment activities found that Department of Labor and Industry (DOLI) has established procedures to implement the Independent Contractor Exemption Certificate and the Contractor Registration programs. Following audit assessment work, we determined further evaluation of DOLI activities to identify and prevent misclassification of employees as independent contractors was warranted.

Businesses that hire independent contractors are not required to have unemployment insurance or workers' compensation insurance for these individuals, and are not required to withhold federal or state taxes. Because of the potential cost savings to businesses that legitimately use independent contractors, there is also a potential that some businesses will inappropriately classify (misclassify) employees as independent contractors. The practice of misclassifying employees as independent contractors can have significant repercussions for state programs, for the competitive marketplace, and for the misclassified employees.

State law includes civil penalties for employers who misclassify employees as independent contractors. DOLI takes its responsibilities in this regard seriously and has successfully prosecuted cases where misclassification has occurred. However, most informed parties also agree that although misclassification can be a serious problem, it is also very difficult to identify, deter, or prevent.

Employee misclassification involves consideration of the complex landscape of modern employment practices in what is often referred to as the 'contingent workforce.' The concept of the contingent workforce includes workers in many different nontraditional roles, such as independent contractors. This report addresses the ability of DOLI to effectively coordinate resources and information used in regulating to the employer-employee relationship, as it relates to independent contractors.

## Results

Identifying and preventing employer misclassification of employees as independent contractors is a difficult endeavor. Other states and the federal government have found that to successfully identify employee misclassification requires improving data analysis and information sharing between programs and levels of government. Our work identified opportunities for DOLI to improve the state's ability to identify situations where employees are being misclassified as independent contractors. In many cases, identifying employee misclassification does not require DOLI to collect more information, but rather share it between programs. Information sharing has proven to be key for numerous other states that have addressed these same issues. The end result for other states has been to focus on increasing access to data and strengthening collaboration within and between state agencies. As a result of this audit, we make three recommendations to DOLI to improve its efforts to identify and prevent misclassification of employees as independent contractors:

- ◆ Integrating existing sources of data within DOLI and implementing analytical methods to identify situations where misclassification may be occurring.
- ◆ Formalizing communications between audit and compliance functions to improve information sharing and enforcement efforts.
- ◆ Ensuring access to more relevant data from other agencies, primarily the Montana Department of Revenue.

| Recommendation Concurrence                                     |   |
|--|---|
| Concur   | 3 |
| Partially Concur   | 0 |
| Do Not Concur  | 0 |
| <b>Source: Agency audit response included in final report.</b> |   |

For a complete copy of the report (15P-02) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to [lad@mt.gov](mailto:lad@mt.gov); or check the web site at <http://leg.mt.gov/audit>  
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