LEGISLATIVE AUDIT DIVISION

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MEMORANDUM

TO:	Legislative Audit Committee Members
FROM:	Alyssa Sorenson, Performance Auditor
CC:	Glen Hollenbaugh, Commissioner, Department of Labor and Industry Brenda Nordland, Administrator, Unemployment Insurance Division Eric Strauss, Administrator, Employment Relations Division
DATE:	April 2018
RE:	Performance Audit Follow-Up (18SP-02): Regulation of Independent Contractors (15P-02)
ATTACHMENTS:	Original Performance Audit Summary

Introduction

The *Regulation of Independent Contractors* (15P-02) report was issued to the Legislative Audit Committee in May 2016. The audit included three recommendations to the Department of Labor and Industry (DOLI). We conducted follow-up work to assess implementation of the report recommendations. This memorandum summarizes the results of our follow-up work.

Overview

Audit work found DOLI should create and improve processes for identifying noncompliance and the misclassification of independent contractors. Our performance audit included three recommendations to DOLI. These were to conduct analysis of data to identify potential misclassification of independent contractors, increase communication between different functions involved with identifying and preventing employee misclassification, and obtain access to and use tax data to identify misclassification of employees. DOLI concurred with all three recommendations. Based on our follow-up work, DOLI has implemented one recommendation and partially implemented two recommendations. They have increased collaboration and sharing of information between different units within DOLI. They also increased efforts to identify potential noncompliance with independent contractor requirements. However, there has not been progress in identifying individuals that have been improperly issued independent contractor exemption certificates (ICECs).

Background

Independent contractors are individuals who work for themselves. Instead of working for the same employer all the time, an independent contractor is free to work for any business and choose their own work hours. Businesses choose to hire independent contractors for a variety of reasons, such as adding a specialized skillset to its workforce for a temporary period or providing for flexibility in allocating resources. In Montana, DOLI registers independent contractors and provides them with exemption certificates from unemployment and worker's compensation requirements. There were over 19,000 independent contractors certified by DOLI as of 2014. 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. There is potential that some businesses will inappropriately classify (misclassify) employees as independent contractors because of the potential cost savings. 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.

Audit Follow-Up Results

Follow-up work included:

- Interviewing DOLI management and staff,
- Examining a recently established Memorandum of Understanding between DOLI and the Department of Revenue (DOR) regarding data sharing,
- Reviewing meeting minutes between DOLI functions involved with independent contracting,
- Examining documentation of recent Unemployment Insurance (UI) audit processes used to produce leads from tax data to search for compliance issues,
- Reviewing planned process to automate the use of data to produce UI audit leads, and
- Reviewing correspondence regarding DOLI participation in the United States Internal Revenue Service (IRS) Questionable Employment Tax Practices (QETP) program.

The following sections summarize the progress toward implementation of the report recommendations.

RECOMMENDATION #1

We recommend the Department of Labor and Industry develop procedures to ensure programs conduct frequent and systematic analysis of data to identify anomalies or potential noncompliance relating to misclassification of employees as independent contractors.

Implementation Status – Partially Implemented

The audit found the department did not have procedures in place to proactively identify potential misclassification of employees as independent contractors. They did not conduct frequent or systematic analysis of data to identify potential anomalies or noncompliance. In particular, the audit pointed to a lack of sharing relevant data sets between different programs within DOLI. Historically, DOLI has relied on complaints from the public to identify potential noncompliance and misclassification. Follow-up work found that DOLI has increased sharing of data across different programs, in particular between the UI audit program and the Independent Contractor Central Unit (ICCU), which is responsible for certifying independent contractors that meet the requirements for exemption from certain employment benefits. The UI audit function uses data to identify leads for potential noncompliance by employers not paying UI for employees who do not have independent contractor exemption certificates (ICECs). If an audit confirms that UI was not paid for an employee, UI will pursue back payment and fines from employers.

In response to the audit, ICCU now sends three years' worth of ICEC data to UI to upload into their data warehouse and include in developing UI audit leads. Once the data is uploaded by the department's information technology function into the warehouse, UI uses this data to cross-reference with their Status, Tax Accounting, Audit and Rating System (STAARS) database and DOR tax data sets to identify noncompliance relating to independent contractors. STAARS includes information provided by

employers on employees who are covered by UI. An example of possible cross-referencing of data by UI includes identifying employers who pay individuals on 1099 MISC tax forms and are not paying UI for these individuals according to STAARS data. DOLI can now cross-reference ICEC data to determine if any of the paid individuals did not have an ICEC exempting them from UI.

UI is not, however, conducting analysis to identify employees potentially misclassified as independent contractors who have exemption certificates. During follow-up work, there was confusion between UI and ICCU staff regarding which unit should be conducting this type of analysis. UI does not believe identifying misclassified independent contractors is under their jurisdiction and stated that ICCU should be responsible for this type of analysis. UI staff indicated individuals with ICECs are exempt from UI insurance according to statute; so even if the ICEC was obtained under false pretenses, UI cannot require the employer to back pay UI. They indicated they can only refer potential misclassification cases to ICCU for review to revoke the exemption or not renew the exemption. Similarly, ICCU staff is also not identifying potentially misclassified independent contractors who have obtained ICECs. They indicated they currently do not have increased access to data to conduct their own analysis. UI said they are considering providing ICCU access to STAARS and DOR tax data, but they have not done so at this time. Identifying misclassified independent contractors is the responsibility of DOLI and the department should internally determine which units are responsible for this analysis and provide them with the necessary access to data to complete it.

RECOMMENDATION #2

We recommend the Department of Labor and Industry develop processes to provide for regular and structured communication between audit and compliance functions involved in identifying and preventing employee misclassification.

Implementation Status – Implemented

The audit identified a need for better communication between audit and compliance staff due to a lack of coordinated regulatory response to misclassification. Suggestions in the audit included creating protocols for sharing tips or leads, email or messaging groups, or periodic meetings between audit and compliance staff from different divisions. Follow-up interviews found that DOLI incorporated this recommendation into an existing meeting forum. They have had long-standing quarterly meetings between units to update each other and discuss administrative issues. Though some department staff claimed that communication has always been good between the different functions, others believe there has been an increase in collaboration and coordination in these meetings. Department staff also described these meetings as being more regular and structured than they were prior to the audit recommendation. DOR is also now included in these meetings due to their interest in ensuring employers are withholding state income tax from individuals that should count as employees. Follow-up work reviewed meeting minutes of these meetings and identified agenda items that indicated coordination was occurring between units to pursue compliance issues. For example, in the December meeting the Wage and Hour unit and ICCU discussed a joint case, possibly including UI, on a business that had multiple complaints submitted to ICCU.

RECOMMENDATION #3

We recommend the Department of Labor and Industry:

A. Revise and maintain its memorandum of understanding with the Department of Revenue to provide access to relevant state-collected tax data.

B. Identify and implement processes to integrate tax data in analysis of issues relating to the misclassification of employees as independent contractors.

C. Review its participation in the Questionable Employment Tax Practices program.

Implementation Status – Partially Implemented

The audit identified the importance and need for the department to incorporate individual and business tax data in their efforts in identifying potential misclassification of employees. Our audit recommended DOLI obtain tax data from DOR, integrate this information into their analysis of potential misclassification, and determine if participating in the Questionable Employment Tax Practices program would be beneficial for them. Follow-up work found the department has successfully revised its Memorandum of Understanding with DOR to obtain access to state collected tax data. The export format of this data is still being adjusted, so DOLI has not yet implemented automated processes to integrate tax data in UI. They currently have created a tool in their system to analyze tax data to identify potential employers not paying unemployment or workers comp insurance for employees that do not have ICECs. This tool does not yet create automated audit leads in their system, but they are currently being manually added. As of 2017, DOLI has used this tool to identify 11 workers incorrectly being treated as independent contractors without ICECs, resulting in around $94,000 of wage change.

UI staff stated they do not intend to identify employees misclassified as independent contractors with ICECs. This is because once an ICEC is issued, the employer is exempt from UI tax and DOLI cannot recoup wage loss. They also do not have plans to run any similar type of analysis to identify these issues and alert ICCU. The audit identified many ramifications of widespread misclassification of independent contractors and potential means of identifying employees who have inappropriately received ICECs. Follow-up work determined that while UI may not be able to recoup wage loss associated with employees inappropriately receiving ICECs, they could use their data to identify and flag employees with ICECs for possible revocation or additional scrutiny upon renewal.

The department has fully implemented the final portion of this recommendation, which suggested they review their participation with the Questionable Employment Tax Practices program with the IRS. This program is intended to initiate collaboration between states and the federal government in identifying employment tax schemes and illegal practices. It allows the IRS and the state to exchange audit reports and participate in side-by-side examinations. Department staff reached out to their IRS liaison to discuss the possibility of participation. Their subsequent discussion determined that because there is not an IRS tax auditor in Montana the IRS would not provide reciprocal information. The one major benefit they could obtain from this relationship would be access to 1099-MISC tax forms that they determined they already have access to through DOR. Therefore, DOLI staff indicated there are minimal benefits to DOLI to participate in the Questionable Employment Tax Practices program at this time.