

Employee or independent contractor?

State audits to heat up

The EY logo, consisting of the letters 'EY' in a bold, white, sans-serif font.

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Unemployment insurance worker classification audits expected to rise under federal funding incentives

The U.S. Department of Labor's Employment and Training Administration (ETA) recently notified state workforce agencies of a supplemental funding opportunity to address worker misclassification within the federal-state unemployment insurance (UI) program and to provide guidance on how states can submit funding requests. (UIPL #18-14.)

The Consolidated Appropriations Act of 2014 authorizes grants to states for the administration of state UI laws, including \$10 million for "activities to address the misclassification of workers."

Factors motivating improved enforcement efforts

Worker misclassification occurs when a business unlawfully treats a worker meeting a law's employment test as an independent contractor. As compared to independent contractors, employees are generally protected by various labor laws, and payments made to them are covered wages for income tax, unemployment insurance and other payroll taxes.

Worker misclassification occurs not only when an employer erroneously classifies an employee as an independent contractor, but also when the worker is not classified at all and becomes part of the underground economy.

Misclassified and "underground" workers reduce revenues necessary for paying unemployment benefits while adversely affecting an employee's ability to receive UI benefits, workers' compensation coverage, Social Security benefits, health insurance coverage, retirement benefits, and protection under the federal, state and local wage-hour laws.

Additionally, businesses that don't properly treat workers as employees unfairly compete against those businesses that do.



Ernst & Young LLP insights



Federal and state agencies continue to expand their efforts to combat worker misclassification, particularly when it adversely affects a worker's coverage under state unemployment insurance laws.

Employers may unwittingly face stiff penalties when misclassifying their workers as independent contractors.

Businesses should re-evaluate the population of workers they treat as independent contractors with an eye to the state guidelines that are sometimes more stringent than the IRS common-law test.

For more on federal and state unemployment insurance, see the Ernst & Young LLP's *Guide to unemployment insurance in 2014*.

For more information concerning the U.S. Department of Labor's efforts to curtail worker misclassification, see its [website](#).

Unemployment insurance worker classification audits expected to rise under federal funding incentives

Continued

Influence of federal funding on the states

This fiscal year 2014 appropriation earmarks \$10 million for two initiatives focused on increasing the states' capacity to address worker misclassification:

1. ETA's Office of Unemployment Insurance (OUI) will make \$8 million in competitive grants available to states to increase their capacity for preventing and detecting worker misclassification and enforcing their state UI laws and policies.
2. OUI will also award \$2 million to states that have demonstrated a high level of performance or significant improvement in detecting and prosecuting employers that fail to pay their fair share of taxes due to worker misclassification.

FY 2014 funding for state unemployment worker classification enforcement

\$8 million

Competitive grants to increase capacity for preventing and detecting worker misclassification and enforcing state UI laws and policies

\$2 million

Awards for demonstrating a high level of performance or significant improvement in detecting and prosecuting employers that fail to pay their fair share of taxes due to worker misclassification

State grants are available to:

- ▶ Improve systems that will enable sharing and analysis of data from federal and state agencies that will enhance identifying employers more likely to misclassify employees
- ▶ Implement targeted audit strategies to focus on those employers most likely to misclassify workers
- ▶ Establish a statewide task force to target egregious worker misclassification schemes
- ▶ Develop education and outreach programs for employers to help prevent worker misclassification

How states define "independent contractor"

Rather than the IRS common-law ("20-factor") test, states frequently provide their own guidelines for distinguishing employees from independent contractors. These state tests can be more stringent in favor of employment.

The ABC test

A large number of states (e.g., Connecticut, Nebraska and New Jersey) use what is referred to as the "ABC test" to determine whether an individual is an independent contractor or an employee.

An individual meeting the all of the following three criteria of the ABC test can generally be considered an independent contractor:

- (a) The individual has been and will continue to be free from control or direction over the performance of their service, both under their contract of service and in fact.

- (b) The service is either outside of the usual course of the business for which such service is performed, or such service is performed outside of all the places of business of the enterprise for which such service is performed.

- (c) The individual is customarily engaged in an independently established trade, occupation, profession or business.

If the individual fails to meet any part of the ABC test, the individual is considered an employee.

Other states may build additional criteria onto the ABC test or use a more detailed method of determining whether an individual is an employee or an independent contractor.

For Connecticut's worker misclassification efforts, click [here](#).

For Nebraska's worker classification rules, click [here](#).

For New Jersey's worker classification rules, click [here](#).

Wisconsin's two-part test

The Wisconsin Department of Workforce Development uses a two-part test to determine worker status. The first part of the test determines whether a worker is free of direction and control by the business. The second part of the test requires that a worker meet six out of nine conditions to be considered an independent contractor.

For more information on the Wisconsin test, see the Department's [website](#).

Texas' common-law test

Texas unemployment law does not directly define "independent contractor." Instead, it sets forth a broadly inclusive test, known as the "direction or control" or "common law" test. To aid in application of the common-law test, the Texas Workforce Commission has adapted the old IRS 20-factor test for use by the agency.

For more information, see the agency's website [here](#) and [here](#).

State task force approach another enforcement trend

Many states have put a task force in place, allowing various state agencies to work together to combat worker misclassification.

For example, recently enacted Rhode Island legislation requires that a task force be established, the members of which to include the Tax Administrator, the director of the Department of Labor and Training (DLT), the director of the Department of Business Regulation, the head of the DLT's Workforce Regulation and Safety Division, the Attorney General, the Commissioner of the State Department of Public Safety, and the chief judge of the Workers' Compensation Court, or their designees. The task force must submit a report by March 15, 2015, to the governor and to the chairs of the House Finance Committee and Senate Finance Committee summarizing the task force's activities during the preceding calendar year. (*HB 7133A, signed by the governor on June 19, 2014.*)

Employer exposure increases under federal-state agreements

In 2011, the U.S. Department of Labor and the IRS signed a memorandum of understanding (MOU) providing that the agencies work together and share information to reduce the misclassification of employees, to help reduce the tax gap and to improve compliance with labor laws.

Fifteen states so far – California, Colorado, Connecticut, Hawaii, Illinois, Iowa, Louisiana, Maryland, Massachusetts, Minnesota, Missouri, Montana, New York, Utah and Washington – have also signed MOUs with the U.S. Department of Labor to partner in combating worker misclassification.

The MOUs enable the U.S. Department of Labor to share information and coordinate enforcement efforts with the participating states.

Pennsylvania senator proposes jail time for worker misclassification



Citing the poor performance of state regulators, Pennsylvania state Senator Mike Stack [announced](#) on August 12, 2014, that he introduced legislation that would allow local district attorneys to investigate and prosecute violations of state law regarding exploitation of the "independent contractor" class of employees.

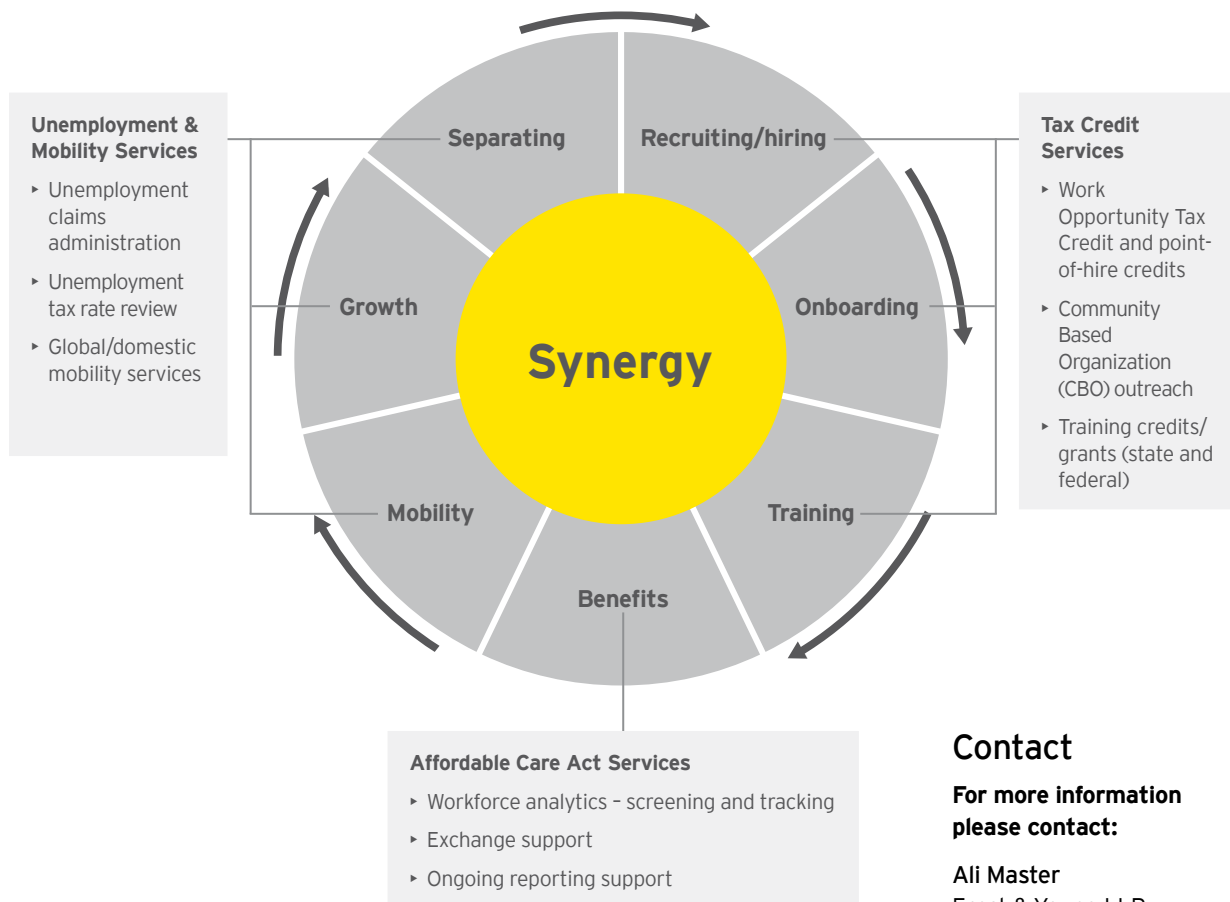
"When it comes to protecting workers and taxpayers from employer manipulation, the state Department of Labor is not up to the job," Stack said. "It's time to give local law enforcement the tools to prosecute when they uncover violations of state labor law."

Senator Stack has introduced Senate Bill 1454 to authorize district attorneys to prosecute violations of law governing the classification of workers and reimburse counties for the expense.

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