

# Unemployment Insurance Audit Realities

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# Topics to Cover

- ▶ Payroll Verification Audits
  - ▶ Why
  - ▶ How
  - ▶ Who
  - ▶ Where
  - ▶ What Can An Employer Expect
  - ▶ What Do We Find
    - ▶ Misclassifications
    - ▶ Independent Contractors
    - ▶ Controlling Statutes/Definitions

# All UI Tax Functions May Lead To An Audit

## ▶ Liability

- ▶ All aspects of determining if an employer is liable to the state unemployment system

## ▶ Collections

- ▶ All activity related to the collection of delinquent tax reports and delinquent taxes, penalty, and interest

## ▶ Investigate obstructed claims for claimants

- ▶ Claimant filed for benefits and no record of earnings exist

## ▶ Perform payroll verification audits to insure compliance and a level playing field

# Why Are Payroll Audits Done?

A comprehensive field audit program is vital to the administration of a State unemployment compensation 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 Unemployment compensation law and timely collection of taxes on an equitable basis.

# Statutory Authority For An Audit

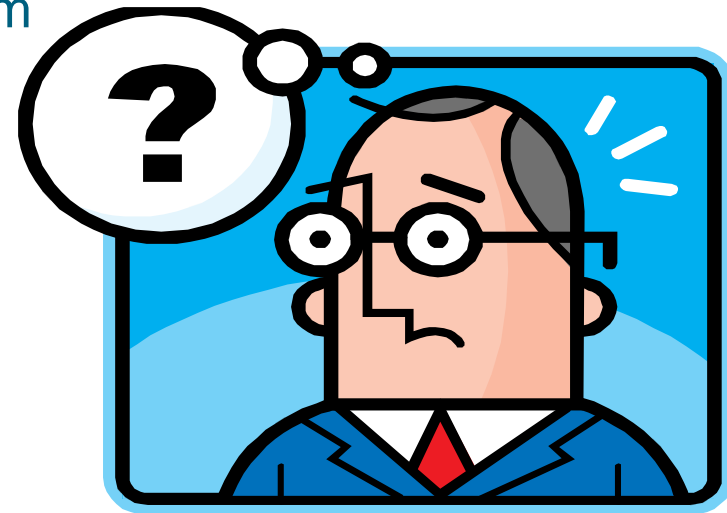
- ▶ Title 221 of Administrative Code which requires appropriate record keeping
- ▶ Section 48-612 of Nebraska Revised Statutes that reinforces record keeping requirement
- ▶ Section 48-603 which defines liability
- ▶ Section 48-602 (29) which defines wages
- ▶ Section 48-664 regarding the making of false statements or representation
- ▶ Section 48-666 speaks to willful violations

# What Does 48-664 Say In It's Entirety

- ▶ **48-664. Benefits; false statements by employer; penalty; failure or refusal to make combined tax payment.** Any employer, whether **or** not subject to the Employment Security Law, **or** any officer **or** agent of such an employer **or** any other person who makes a false statement **or** representation knowing it to be false, **or** who knowingly fails to disclose a material fact, to prevent **or** reduce the payment of benefits to any individual entitled thereto, to obtain benefits for an individual not entitled thereto, to avoid becoming **or** remaining subject to such law, **or** to avoid or reduce any contribution **or** other payment required from an employer under sections 48-648 and 48-649, **or** who willfully fails or refuses to make any such contributions **or** other payment **or** to furnish any reports required under the Employment Security Law **or** to produce **or** permit the inspection **or** copying of records as required under such law, shall be guilty of a Class III misdemeanor. Each such false statement **or** representation **or** failure to disclose a material fact **and** each day of such failure **or** refusal shall constitute a separate offense. An individual employer, partner, corporate officer, **or** member of a limited liability company **or** limited liability partnership who willfully fails **or** refuses to make any combined tax payment shall be jointly and severally liable for the payment of such combined tax and any penalties and interest owed thereon. When an unemployment benefit overpayment occurs, in whole **or** in part, as the result of a violation of this section by an employer, the amount of the overpayment recovered shall not be credited back to such employer's experience account.

# How Do Agencies & Employers Determine Who Is An Employee?

- ▶ IRS → Common Law
  - ▶ 20 Factor Test
  - ▶ 3 Tests → Behavioral Control, Financial Control, and Relationship of the Worker and the firm
  - ▶ IRS Form SS-8
- ▶ State UI
  - ▶ ABC Test (next slide)
  - ▶ A and/or B and/or C
  - ▶ IRS rules
  - ▶ Other
- ▶ USDOL W&H – “Economic Reality” Test



# State Statutory Test

- ▶ So what controls the classification of workers who perform services and are paid for these services?
  - ▶ **48-604-5** of the Nebraska Employment Security Law reads as follows: Services performed by an individual for wages, including wages received under a contract of hire, shall be deemed to be employment unless it is shown to the satisfaction of the commissioner that (a) such individual has been and will continue to be free from control or direction over the performance of such services, both under his or her contract of service **and** in fact, (b) such service is either outside 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, **and** (c) such individual is customarily engaged in an independently established trade, occupation, profession, or business. The provisions of this subdivision are not intended to be a codification of the common law and shall be considered complete as written.



# Worker Misclassification

## What is It?

- ▶ Two common types of misclassification:
  - ▶ Classify employee as independent contractor (on IRS form 1099)
  - ▶ Unreported worker (off the books)
- ▶ Consequences
  - ▶ Employee excluded from UI system
  - ▶ UI taxes underpaid
  - ▶ Other employment taxes underpaid
  - ▶ Employers not treated or competing equally
  - ▶ Probably illegal
  - ▶ Excludes workers from protection under FLSA & W&H
  - ▶ Fosters illegal alien activity

## Based on Employee Earning \$15 / Hour (\$31,200 Annually)

SUTA Wage Base =\$10,000

FUTA Wage Base =\$7,000

Self-Employment Rate = 15.30%

Workers Compensation (Construction) =12.30%

SUTA Tax Rate =2.50%

Federal Withholding Rate =19.00%

FICA Rate =7.65%

Description	Employer Costs		Employee Costs	
	Covered	I/C	Covered	I/C
Federal Income Tax Withholding	\$0.00	\$0.00	\$5,928.00	\$0.00
Federal Estimated Tax Payments	\$0.00	\$0.00	\$0.00	\$5,928.00
Federal Unemployment Tax	\$56.00	\$0.00	\$0.00	\$0.00
State Unemployment Insurance	\$250.00	\$0.00	\$0.00	\$0.00
Workers Compensation (constr)	\$3,837.60	\$0.00	\$0.00	\$3,837.60
Health Care Coverage	\$5,000.00	\$0.00	\$1,000.00	\$6,000.00
FICA	\$2,386.80	\$0.00	\$2,386.80	\$4,773.60
Total Employment Costs	<b>\$11,530.40</b>	<b>\$0.00</b>	<b>\$9,314.80</b>	<b>\$20,539.20</b>
CO			\$21,885.20	<b>\$10,660.80</b>

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# Employer Incentives to Misclassify

- ▶ Competition – Locally, Regionally, Nationally & Globally
- ▶ Un-Level the playing field among competing employers
- ▶ Regulatory and taxation reporting
- ▶ Costs above labor rates
  - ▶ Employment taxes (FICA & UI)
  - ▶ Withholding taxes (Federal/State/Local)
  - ▶ Health Care
  - ▶ Workers' Compensation
  - ▶ No employee benefit packages
- ▶ Few workplace injury disputes and lawsuits
- ▶ Try out potential new employees

# How Misclassification Affects Workers

- ▶ Workers may receive a higher rate of pay but:
  - ▶ Responsible for Self Employment Tax (Equivalent to employer share and employee share of FICA)
- ▶ No benefits
- ▶ No workers' compensation protection
- ▶ No unemployment benefits

# Where Are We Finding Misclassified Workers

## ▶ Traditional Leads:

### ▶ Obstructed Benefit Claims

▶ Initial Liability and Transfer of Ownerships

▶ Other State Agencies

▶ Other Federal Agencies (SS-12, and 1009 Extract)

▶ Fraud Line

## ▶ Non-Traditional Leads

▶ Labor Unions

▶ Elected Officials

▶ Health care

# Edits Built Into 1099 Extract File

- ▶ NAICS Codes of Construction and Transportation
- ▶ Tax Rate of at least 1%
- ▶ Between 5 and 50 1099's issued
- ▶ Nebraska Employers with Nebraska UI Account Number
- ▶ 20% drop in number of workers reported from prior year to audit year

# Why Does It Seem Some Industries Are Prone to More Audits?

- ▶ UIPL 30-10 (Unemployment Insurance Program Letter)
  - ▶ Change in Audit Measures beginning September 2010
  - ▶ Became a Core Measurement 2013
- ▶ If measures not met a CAP(Corrective Action Plan) had to be written for SQSP (State Quality Service Program)
- ▶ Lets briefly look at the requirements

# Summary of UIPL 30-10

<https://wdr.doleta.gov/directives/attach/UIPL/UIPL30-10.pdf>

States are responsible for administering effective employer audit programs that verify employers are reporting wages properly and paying the appropriate amount of UI taxes.

Employer compliance with regard to these two activities promotes accurate UI benefits and UI trust fund solvency. This background section describes the existing Tax measures and introduces the worker misclassification initiative. The proposed changes to the measurement of the employer audit program take into account the following considerations related to how audits are conducted and issues of worker misclassification.



# Reason For The Changes

- ▶ TPS Tax Quality didn't adequately measure state's audit effectiveness
- ▶ No CAP was in place if states failed to achieve 2% penetration
- ▶ Worker Misclassification became a focal point of all audit programs
- ▶ Targeted Audit Selection
  - ▶ Office of Inspector General report *Adopting Best Practices Can Improve Identification of Noncompliant Employers for State UI Field Audits* made the following recommendation: “modify existing performance measures by establishing new benchmarks that measure the effectiveness of states in selecting noncompliant employers for audit and identifying hidden wages.”

# What Changed

- ▶ Per cent of Contributory Audits **changed** from 2% to 1%
- ▶ Percent of Total Wage Change from each audit **targeted** at 2%
- ▶ Percent of Total Wages audited **targeted** at 1%
- ▶ Average number of misclassified workers detected **targeted** at 1 per audit

# Score Card

Example	Factors #'s (Minimum Scores)				Total (Min = 7)	Achieved Minimum for all 4 Factors?	Pass/Fail	Reason
	1 (1)	2 (2)	3 (1)	4 (1)				
State 1 Scores	1	2	1	1	<b>5</b>	<b>Y</b>	<b>Fail</b>	State failed to attain minimum overall score of 7
State 2 Scores	2	2	<b>0.9</b>	10	14.9	<b>N</b>	<b>Fail</b>	State failed to pass all four factor minimum scores
State 3 Scores	1	2	1	3	7	<b>Y</b>	<b>Pass</b>	State passed each factor minimum score and attained minimum overall score of 7
State 4 Scores	2	3	1	3	9	<b>Y</b>	<b>Pass</b>	State passed each factor minimum score and exceeded minimum overall score of 7

# What Can An Employer Expect Before, During, and After An Audit

- ▶ Auditors routinely examine the accuracy of gross wages, exclusions and other reported information to verify that payroll is correctly reported for UI purposes. A variety of accounting documents and records are reviewed that contain payments for services rendered. These documents are requested at the time the auditor contacts the employer and followed up by a confirmation when setting the appointment for the audit.
- ▶ The employer may choose to be present during the audit or delegate a representative to provide the necessary documentation requested.
- ▶ The length of time of the audit will vary on size of business and condition of records (two-four hours).
- ▶ Any Findings will be discussed with the employer and the appeal process explained.

# Unemployment Insurance Fraud

The Nebraska Department of Labor (NDOL) is committed to assuring compliance with all requirements for unemployment insurance by fostering a culture of integrity.

Whether you are an employer, worker, or citizen of Nebraska, everyone has a role in protecting the integrity of the Unemployment Insurance program.

# What is UI Fraud?

- ▶ Anyone who receives unemployment benefits or pays a lower unemployment tax rate based on **false information** that they **intentionally** provide to the NDOL is committing fraud. Unemployment insurance fraud is a crime and is punishable by law.
- ▶ <http://www.dol.nebraska.gov>
- ▶ My focus will be within the context of the statutory authority of the Nebraska Employment Security Law (NESL). Specifically how this relates to employers.

# How About Some Examples

- ▶ Paying "off the books" or "under the table" wages
- ▶ Not reporting wages to the Nebraska Department of Labor
- ▶ Misclassifying workers who are employees as independent contractors
- ▶ Committing a Class III misdemeanor by making a false statement or representation to:
  - ▶ Prevent or reduce the payment of benefits to any individual eligible for these benefits
  - ▶ Obtain benefits for an individual not eligible for benefits, or
  - ▶ Avoid or reduce any contribution or other payment required from an employer under sections [48-648](#) and [48-649](#) of the Nebraska Employment Security Law

# Transfer of Ownership Process

An employer who deliberately violates or attempts to violate the Nebraska Employment Security Law regarding the transfer of employer experience accounts may be required to:

- ▶ Pay the highest combined tax rate for the year of the violation and for the next three years
- ▶ Pay a penalty of 2% of taxable wages for the year of the violation and for the next three years
- ▶ Be subject to a civil penalty of up to \$5,000
- ▶ Be charged with a Class IV felony



# Real Life Examples

- ▶ Used car dealer
- ▶ Detail person
- ▶ Internet car dealer
- ▶ Transportation
  - ▶ Courier
  - ▶ Over the road
  - ▶ Moving companies
- ▶ Health care
  - Veterinarians, dentist, chiropractors, nurses
- ▶ Drywallers, roofers, flat workers, carpenters, painters

# Used Car Dealer

- ▶ Referred by claim for benefits, no wages on file
- ▶ Interviewed Claimant said he served jail time with owner
- ▶ Research with DMV that convicted felons can't have dealers license
- ▶ Who was running the place
- ▶ Multiple attorneys
- ▶ Records subpoenaed
- ▶ Assessments made
- ▶ Tried to change name and ownership which were denied
- ▶ Employer now o/b liens remain intact

# Detail Person

- ▶ Discovered during payroll verification
- ▶ Discovery stage revealed detail person and staff did not meet all three parts of the ABC test.
  - ▶ Contract had too many restrictive covenants that demonstrated a lot of control
  - ▶ Services not outside the usual course of business
  - ▶ Detail person did not have his own independently established trade
- ▶ Employer appealed, department decision was upheld

# Internet Car Sales

- ▶ Referred as claim for benefits revealed no wage on file
- ▶ Discovery stage indicated that corporate officers reported but internet sales people were not
- ▶ Owner refused to provide any viable records at the **advice** of his attorney
- ▶ Records subpoenaed and assessments made
- ▶ Employer appealed and department was affirmed
- ▶ Employer appealed to district court then withdrew
- ▶ Assessments continued which were appealable but were not appealed
- ▶ Collections department went after the corporate officers and all tax penalty and interest paid and up to date.

# Transportation

- ▶ Many examples in this industry mostly from claims for benefits and the 1099 Extract File from IRS
- ▶ Examples are similar in that the three part test of the ABC test not met
  - ▶ Contract of hire is too restrictive (can only work for this employer)
  - ▶ Services performed not outside the usual course of business
  - ▶ Worker not independently established

# Moving Companies

- ▶ Recent case referred by Workers Compensation Court
- ▶ Discovery stage revealed lot of workers getting hurt but employer alleges he has no workers thus no worker comp benefits available.
- ▶ Similarly no liable UI account number existed
- ▶ Investigation found the employer, uncooperative, abusive, threatening
- ▶ Strategy was to bring him into the office after he refused and continued his rant and abuse we discovered an outside bookkeeper who acted as his agent
- ▶ Documents reviewed and 40 workers were picked up each year for the last four years
- ▶ Liens are in place and his bank account will be levied
- ▶ Information has been shared with all other state and federal taxing authorities

# Health Care

- ▶ All cases very similar. Sources have come from multiple sources
  - ▶ Obstructed Benefits Claims
  - ▶ 1099 Extract File
  - ▶ Fraud Line
- ▶ Again their understanding of the ABC test left something for the imagination
- ▶ In the employers defense they solicited professional advice from their attorneys and CPA's so the assumption was they were in the right
- ▶ This gets a little more complicated to resolve when egos get in the way

# Dentist

- ▶ A dentist complained about his business partner no less
- ▶ Letters were sent to the Governor, Attorney General, Department of Revenue, Department of Labor, IRS, Workers Compensation Court, and Department of Labor(national office)
- ▶ Discovery was the business partner and his childhood friend, who is a prominent tax attorney, came up with a business model that would make the business partner a lot of money by classifying a whole bunch of dentists as I /C
- ▶ Again the ABC test was interpreted for the business partner
- ▶ After many interviews with the dentist who complained we were able to approach the tax attorney and secure the appropriate documents to make the proper assessments for UI Tax, penalty and interest



# Dentist Saga Continued

- ▶ Out of the blue I received a call from the office of the inspector general's regional office in Kansas City
- ▶ She was building a case against the business partner and the tax attorney for misappropriating 401k contributions
- ▶ All our discovery information was turned over and as we speak the case is in litigation

# All Construction Related Trades

- ▶ Too Much direction and control
- ▶ Not outside the usual course of business
- ▶ No independently established trade occupation or business
- ▶ Method of payment doesn't make someone independent
  - ▶ Foot, square, commission
- ▶ Contracts vs reality
  - ▶ Substance over Form

# So What Is the Message

- ▶ We continue to do outreach to the employer community but often times the concept of compliance falls on deaf ears
- ▶ Many employers are just not up to speed on what they should be doing and shoot themselves in the foot by following some bad information from someone they trust
- ▶ There are some employers who are always looking for ways to circumvent the system - this will continue to be a challenge for all of us

# Latest Challenges

- ▶ Individuals attempting to set up employer accounts in other states
- ▶ Once the accounts are set up, the perpetrators file the tax and wage reports with either fictitious names and social security numbers or stolen ones
- ▶ File claims for UI Benefits
- ▶ Start drawing benefits
- ▶ Big scheme uncovered on west coast that got to Missouri who alerted the national office
- ▶ Nebraska has also experienced the same and did not set accounts up as we couldn't verify that the business existed

# Thank You

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