

JOINT COMMITTEE ON GOVERNMENT AND FINANCE
WEST VIRGINIA OFFICE OF THE LEGISLATIVE AUDITOR

POST AUDIT DIVISION

LEGISLATIVE AUDIT REPORT

WorkForce West Virginia - Worker Misclassification

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GENERALLY ACCEPTED GOVERNMENT
AUDITING STANDARDS STATEMENT

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards (**GAGAS**). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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WORKFORCE WEST VIRGINIA: WORKER MISCLASSIFICATION

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Foreword

In August 2019, the Legislative Auditor initiated the present audit of WorkForce West Virginia. Throughout the audit process, WorkForce provided its full cooperation with the audit team, responding to documentation requests, granting interviews, and sharing their technical expertise when asked questions by the Legislative Auditor's staff.

In March of this year, the COVID-19 pandemic significantly altered the normal state of operations at WorkForce West Virginia. According to data from the Governor's Office and WorkForce, beginning in late-March/early-April, the number of initial claims for unemployment benefits in West Virginia reached historically high levels in a span of just a few short weeks. The number of unemployed West Virginians at the end of March stood at over 67,000; one month later the number would nearly double with over 117,000 unemployed West Virginians. In total, Governor Jim Justice reports that it has processed in excess of 200,000 claims for unemployment related to the COVID-19 pandemic.

This unprecedented influx of claims understandably exceeded WorkForce's operational capacity by many orders of magnitude. As Governor Justice has indicated on numerous occasions, the West Virginia National Guard was activated to assist WorkForce in handling in-take and questions related to jobless claims.

Despite the challenges presented to WorkForce over the past several months, the Legislative Auditor wants to acknowledge WorkForce for its continued cooperation and assistance in the audit process. WorkForce has continued to communicate and work collaboratively with the Legislative Auditor to fulfill information requests, respond to inquiries, and discuss the audit's findings, recommendations, and conclusions. Without ongoing cooperation from the audited entity, it becomes difficult, if not impossible, to provide audits that are both impactful and useful for all the key stakeholders. As such, the Legislative Auditor's Office would like to commend WorkForce for its efforts in assisting the many West Virginians adversely affected by this pandemic, and extend a thanks for its continued cooperation and assistance with our audit process during these times.

EXECUTIVE SUMMARY

The Legislative Auditor conducted this audit on WorkForce West Virginia (WorkForce) pursuant to W. Va. Code §4-2-5. The objective of this review was to determine whether WorkForce West Virginia (WorkForce) has implemented adequate and effective processes for detecting and preventing worker misclassification.

Frequently Used Acronyms in This Report

DOT: Department of Transportation

EAMs: Effective Audit Measures

ETA: Employment Training Administration

FICA: Federal Payroll Tax Withholdings

FTEs: Full-Time Equivalents

NAICS: The North American Industry Classification System

UI: Unemployment Insurance

U.S. DOL: United States Department of Labor

Report Highlights:

ISSUE 1: From 2014-2018, WorkForce West Virginia Received a “Fail” Rating from the U.S. Department of Labor for Its Efforts in Detecting Misclassified Employees. While Significant Staff Reductions Have Contributed to Receiving This Rating, Changes in Its Audit Selection Process Could Improve Overall Effectiveness.

- From 2014 through 2018, WorkForce received a “fail” rating from the U.S. Department of Labor (DOL) in meeting the Effective Audit Measures (EAMs).
- WorkForce has expressed their difficulties when it comes to filling positions, which would have hindered their ability to conduct the amount of UI audits required in order to meet the Effective Audit Measures (EAMs).
- WorkForce does not maintain and use aggregated data from prior years’ audits to calibrate its audit selection process toward risk based on available data from prior years, nor does it track or analyze the data source used in UI audits.

Issue 2: West Virginia Could Strengthen Its Efforts to Prevent Worker Misclassification by Authorizing Penalties as A Deterrent for Misclassification.

- The Legislative Auditor determined that approximately half of the U.S. states implement some form of administrative penalty on employers who intentionally misclassify their employees.
- Currently in West Virginia, the offending employer of the misclassified employee must only pay the outstanding tax liabilities, plus interest.

Recommendations

1. The Legislative Auditor recommends that WorkForce and the Division of Personnel work together to address persistent issues faced by WorkForce in recruiting and retaining qualified audit staff.
2. The Legislative Auditor recommends that WorkForce West Virginia begin tracking and routinely analyzing additional data, such as the source of audit initiation and NAICS codes to gear the audit selection process towards identified risk areas.
3. The Legislative Auditor recommends that WorkForce West Virginia continue to seek out data-sharing agreements with other state agencies, such as the Department of Transportation, that receive certified wage reports from employers in the State.
4. The Legislative Auditor recommends the Legislature consider authorizing WorkForce to administer penalties against employers who fail to cooperate in the audits or fail to provide WorkForce with the required documentation needed to conduct the audit.
5. The Legislative Auditor recommends the Legislature consider authorizing WorkForce West Virginia to administer administrative penalties on employers who misclassify employees as independent contractors.

Notation of Agency Response to Report

The Legislative Auditor transmitted a draft copy of the report to WorkForce West Virginia on June 30, 2020. While WorkForce did not provide a formal written response to the report, it did verbally indicate that, *“we are very satisfied with the legislative audit and are working to implement the recommendations and working on a recruiting and hiring plan to increase staffing levels as recommended.”*

Issue 1: From 2014-2018, WorkForce West Virginia Received a “Fail” Rating from the U.S. Department of Labor for Its Efforts in Detecting Misclassified Employees. While Significant Staff Reductions Have Contributed to Receiving This Rating, Changes in Its Audit Selection Process Could Improve Overall Effectiveness.

Background

WorkForce West Virginia (WorkForce) is a state government agency, funded through the U.S. Department of Labor (U.S. DOL), that oversees West Virginia’s unemployment insurance program. WorkForce is a one-stop center for workforce resources, including job opportunities, unemployment compensation, training, tax incentives, and labor market information.

WorkForce also audits contributory employers¹ based on their reported quarterly wage data. WorkForce is responsible for performing professional audit work by examining the accounting systems, accounts, journals, invoices, inventories, and budget and financial records of businesses, corporations, or local government entities. These audits seek to ensure that employers have remitted the appropriate amounts for unemployment insurance and that workers are appropriately classified as employees or independent contractors. On an annual basis, U.S. DOL measures effectiveness of each state’s unemployment insurance agency’s audit process using its Effective Audit Measures (EAMs), a federal criterion that ranks each state with either a “Pass” or “Fail” rating.

The Legislative Auditor reviewed Workforce’s processes for its audits of the State’s unemployment insurance program. This review determined that West Virginia has received a “fail” rating in meeting the EAMs set by U.S. DOL from calendar years 2014 to 2018. The Legislative Auditor sought to determine the causes for this outcome. The Legislative Auditor’s review identified the following primary causes:

- WorkForce does not track the basis for initiating each individual audit.
- WorkForce does not maintain and use aggregated data from prior years’ audits to calibrate its audit selection process toward risk based on available data from prior years.
- Over the scope of the audit, WorkForce lost a significant number of audit staff, with full-time equivalents (FTEs) dropping from seven in 2014 to just one at the beginning of 2019.

Worker Misclassification is a Pervasive Issue Across the U.S., Resulting in Billions of Dollars in Lost Revenues.

Worker misclassification is a persistent and well documented problem throughout the U.S. economy. State-level task forces, commissions, and research teams have used agency audits along with unemployment insurance and workers’ compensation data to document the scope of worker misclassification.

West Virginia uses the three-pronged “ABC test” to determine if an individual should be considered an employee or independent contractor. Companies must demonstrate that workers

¹ Contributory employers pay unemployment insurance contributions based on a contribution rate and taxable wage base paid to each employee each calendar year.

classified as independent contractors are indeed contractors by establishing the following three factors to be true:

- A. The worker is free from the employer's control and direction in connection with performing the work, both under contract and in fact.
- B. The worker performs work that is outside the usual course of the employer's business.
- C. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

Worker misclassification occurs when an employer improperly classifies a worker as an independent contractor instead of an employee. This distinction in employment status creates significant differences in the obligations and costs to the employer with respect to worker's compensation insurance, unemployment insurance, and payroll tax withholding. The following are some of the common consequences of worker misclassification:

- Worker misclassification can lead to nonpayment of state and federal unemployment taxes, income taxes, and payroll taxes that employers are required to automatically withhold (or pay) from the earnings of employees, but not for independent contractors.
- Worker misclassification can lead to a direct loss of funds for a state's unemployment trust fund.
- Employees who are misclassified as independent contractors have less access to worker's compensation insurance coverage for qualifying workplace injuries.
- Certain occupational health and safety laws, such as the Fair Labor Standards Act apply to employees but not independent contractors. Thus, misclassification of workers can cost workers certain employment rights.
- Worker misclassification can also have ramifications on competitive procurement for government contracts due to the higher labor costs that are associated with paying all the applicable taxes for an employee versus an independent contractor.

USDOL commissioned a study in 2000 in which it identified that between 10 and 30 percent of employers who were audited misclassified their workers. USDOL further determined that certain industries, such as construction, transportation, and home health care, were at a higher risk of worker misclassification. Moreover, the economic impact of worker misclassification results in a significant loss of tax revenues. A 2013 report from the U.S. Treasury Department estimated that effective prevention of worker misclassification could generate upwards of \$8.3 billion in federal revenue over 10 years.

This loss of revenue occurs because employers are generally responsible for collecting (or paying) various taxes and other withholdings from the earnings of their employees. Employers generally withhold state and federal income taxes, as well as federal payroll taxes associated with Medicare and Social Security (FICA withholdings). In addition, employers are assessed an additional FICA tax rate for each employee and are responsible for paying state and federal unemployment insurance and workers compensation insurance taxes for each employee.

However, when a worker is classified as an independent contractor, much of the burden for the collection and payment of taxes is shifted from the employer to the worker. The difference in tax responsibilities between an employee and an independent contractor can be seen in Figure 1.

Figure 1
Difference Between General Tax Responsibilities of an Employee Versus an Independent Contractor

Type of Tax	Employees		Independent Contractors	
	Employer	Worker	Employer	Worker
Federal Income Tax	Withhold tax from employees' pay	Pay full amounts owed through withholdings	Generally, none	Pay full amounts owed, through estimated payments
Social Security and Medicare Taxes	Withhold half of tax through employees' pay and pay the other half	Pay half of total amounts owed, generally through withholding	None	Pay full amounts owed
Federal Unemployment Tax	Pay full amount	None	None	None
State Unemployment Tax	Pay full amount	None	None	None

Source: U.S. GAO Report on Employee Misclassification. August 2009.

While some worker misclassification is unintentional, many employers have an incentive to misclassify their workers in order to reduce their labor costs. The Legislative Auditor estimated the payroll taxes and other withholdings for an employee whose annual earnings are \$60,000. Figure 2 demonstrates the difference in total labor costs associated with one worker based upon that worker's classification as an employee versus an independent contractor. As is shown, an employer can save thousands of dollars per year for each employee that is misclassified as an independent contractor.

Figure 2 Difference in Labor Cost for an Employer Misclassifying an Employee as an Independent Contractor (Annualized)		
	Employee	Independent Contractor
Annual Base Salary	\$60,000	\$60,000
WV Unemployment Insurance Tax	\$900	-
U.S. Unemployment Insurance Tax	\$42	-
FICA Tax	\$4,590	-
Worker's Compensation Insurance	\$864	-
Subtotal Payroll Costs	\$6,396	-
Total Base Salary + Payroll Costs	\$66,396²	\$60,000
Source: <i>Legislative Auditor's calculations based on current tax and contribution rates.</i>		

As the example above demonstrates, intentional worker misclassification can put employers who follow the law at a competitive disadvantage by way of higher labor costs for their workers.

Since 2010, The U.S. Department of Labor Has Placed an Increased Emphasis on States' Efforts to Detect and Prevent Worker Misclassification.

Because of both the pervasiveness of worker misclassification and its negative effects, USDOL placed a heightened emphasis on preventing misclassification. In 2010, the USDOL's Employment Training Administration (ETA) formed a team of Federal and state unemployment insurance tax experts to determine whether a more effective audit measure could be developed that would capture state efforts to detect worker misclassification. Unemployment Insurance Program Letter No. 30-10, which was issued by U.S. DOL on September 2, 2010, informed states that the federal-state team recommended certain changes regarding how the unemployment insurance employer audit program would be evaluated and established the Effective Audit Measures (EAM) that states would be required to comply with.

The EAM is a measure comprised of four factors: 1) Percent of Contributory Employers Audited Annually, 2) Percent of Total Wage Change from Audit, 3) Percent of Total Wages Audited, and 4) Average Number of Misclassifications Detected Per Audit. The acceptable levels of performance for each of the four factors were established after USDOL examined six years of historical state data and through consultation with the federal-state team. These minimum scores for each factor was set well below both the average and mean national scores. Each year, USDOL evaluates each state's efforts at detecting worker misclassification using these criteria and rate the

² The labor costs above are not all-inclusive. Rather, the Legislative Auditor included those costs that were easily quantified. Employer-provided health and retirement benefits, if provided, could significantly increase the labor costs to an employer, but due to their variable nature, are not included in this analysis.

states as either “Pass” or “Fail.” The Figure 3 below provides a breakdown of the EAM used to evaluate states’ efforts at detecting worker misclassification.

Figure 3 Effective Audit Measures			
<u>Factor 1</u> Contributory Employers Audited	<u>Factor 2</u> Change in Total Wages from Audits	<u>Factor 3</u> Total Wages Audited	<u>Factor 4</u> Avg. Number of Misclassified Workers Identified
Pass if $\geq 1\%$	Pass if $\geq 2\%$	Pass if $\geq 1\%$	Pass if $\geq 1\%$
2 Additional Points Required Across Any Categories			
Source: USDOL’s Unemployment Insurance Program Letter No. 30-10			

Each of the four factors has a minimum standard score that states must attain to receive a “Pass” rating for that factor. In addition, states must also attain a minimum overall combined score of at least seven. The measure requires states to direct additional emphasis to the factor(s) that they deem important to their state. The additional two points must be earned among any of the four factors to attain the overall minimum passing score of seven.

States are required to submit corrective action plans to USDOL when their annual performance on the EAM does not meet the minimum scores. In addition, states are required to provide quarterly updates regarding their corrective action plans. USDOL will strive to attain uniform administration of corrective action plan requirements among the states and regions.

From 2014 through 2018, WorkForce West Virginia Received a “Fail” Rating from the U.S. Department of Labor in Meeting the Effective Audit Measures.

The Legislative Auditor reviewed data from the U.S. DOL regarding WorkForce’s performance in meeting the EAMs from 2014 through 2018. Over this time frame, WorkForce West Virginia conducted 3,390 unemployment insurance audits which comprised an aggregate total of approximately \$1.6 billion in total wages.

According to data provided by U.S. DOL, West Virginia did not meet the EAMs in any year between 2014 to 2018. Overall, 26 U.S. States (or territories) received a “fail rating” in 2014. In subsequent years, overall compliance with the EAMs improved and the number of states receiving a “fail” rating dropped to 19 by 2017. The Legislative Auditor has determined that only 12 other states have received a “fail” rating in each year over this time period. The following Figure 4 shows West Virginia’s performance in meeting the EAMs from 2014-18.

Figure 4					
West Virginia EAMs 2014-18					
Factors	2014	2015	2016	2017	2018
Factor 1 (Pass if 1+)	2.9*	2.6*	2.2*	1.4	0.6
Factor 2 (Pass if 2+)	1.6	2.0	1.5	3.0*	4.3*
Factor 3 (Pass if 1+)	2.5*	2.5*	1.5	0.8	0.4
Factor 4 (Pass if 1+)	0.7	0.9	0.8	0.7	1.2
Total	7.7	8.0	6.0	5.9	6.5

*Denotes an area of additional emphasis by WorkForce WV
Source: *Effective Audit Measures as reported by U.S. DOL from 2014-2018.*
Red text denotes a score that does not meet the acceptable level of performance for a particular EAM factor.

WorkForce came closest to receiving a “pass” rating in 2015, having achieved an acceptable score in three out of four factors measured, and missing the minimum score in factor four by one-tenth of one percent. In each of the other four years, WorkForce was unable to meet the minimum score for two or more factors.

In addition, the Legislative Auditor notes that performance in two factors have steadily decreased each year from 2014 to 2018. Factor 1, which measures the percent of contributory employers audited during a calendar year, has decreased from 2.9 percent in 2014 to just 0.6 percent in 2018. Similarly, Factor 3, which measures the percent of total wages audited, also saw a steep drop from 2.5 percent to 0.4 percent in 2018.

Finally, the Legislative Auditor notes that WorkForce West Virginia received a “fail” rating in Factor 4 (average number of misclassified employees identified per audit) in four out of five years from 2014 to 2018. In total, WorkForce identified 2,706 misclassified employees as a result of its unemployment insurance audits. Overall, this ranks West Virginia 48th out of 52 states and territories for the total number of misclassified employees detected. Moreover, the Legislative Auditor determined that the average number of misclassified employees per audit (0.8) ranked 51st overall during this time period.

Steep Declines in Staff Levels have Negatively Impacted WorkForce’s Ability to Detect Worker Misclassification and Meet the Effective Audit Measures.

WorkForce indicated to the Legislative Auditor that it has experienced staffing difficulties over the scope of this audit which have hindered its ability to conduct UI audits and meet the EAMs. The Legislative Auditor obtained staffing level numbers from WorkForce from 2014 through 2018. In 2014, WorkForce reported that it had 7 full-time equivalents (FTEs) conducting unemployment audits. However, by the beginning of calendar year 2019, WorkForce was down to just 1 FTE conducting these audits. Figure 5 provides a breakdown of FTEs over this period.

Figure 5 FTEs Conducting Unemployment Audits at WorkForce West Virginia Calendar Years 2014-2019	
Calendar Year	FTEs
2014	7
2015	7
2016	4.5
2017	3.5
2018	3.5
2019	1*

*Denotes the number of FTEs at the beginning of the year.
Source: FTEs provided by WorkForce West Virginia.

In addition, WorkForce indicates that it has had difficulties in filling vacancies as they arise. According to the Acting Director of WorkForce:

There were no positions approved for posting in 2014, 2015 or 2016. In 2017, a tax examiner position was posted and interviews conducted in May. An internal candidate was offered the position and declined. No other suitable applicants were interviewed. The position was posted again and interviews conducted in September 2017. The highest scoring candidate was offered the position and declined stating he was offered more money at his current position to stay. The 2nd highest scoring applicant was offered the position but failed to respond. Since then the unit has posted [an] EP Tax Examiner, EP Tax Examiner trainee and Financial Reporting Specialist I with limited success of finding interested and qualified applicants.

WorkForce attributes some of its issues with recruiting qualified staff to low salary levels and cumbersome minimum qualifications compared to comparable positions in other state agencies. For example, WorkForce cites that a successful job candidate for the EP Tax Examiner position must have a bachelor’s degree with 24 hours in accounting and will earn a starting salary of \$27,729. However, a comparable job classification for a Tax and Revenue Auditor 1 requires half as many hours in accounting and allows a starting salary of \$31,146.

Despite this, WorkForce must operate within the West Virginia Division of Personnel’s guidelines, which it says provide little opportunity for adjusting minimum job qualifications or augmenting starting salary levels.

The effects of WorkForce’s decline in audit staff and difficulties in filling these vacancies manifest themselves in the State’s performance in meeting the EAMs. As indicated earlier, West Virginia’s performance in Factor 1, requiring the State to audit at least 1 percent of contributory employers, declined each year between 2014 and 2018. This decline in the number and overall percent of employers audited correlates with WorkForce’s decline in audit staff over the same period.

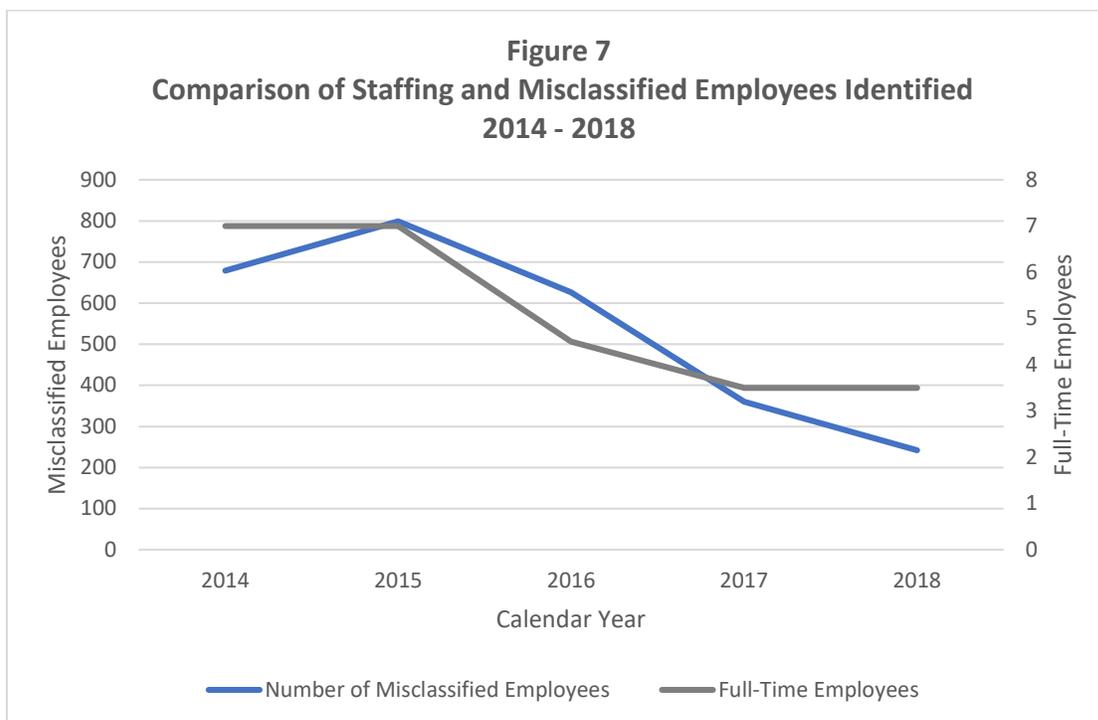
The Legislative Auditor calculated the total number of audits conducted by WorkForce in each year between 2014 and 2018. WorkForce conducted just over 1,000 audits in 2014, accounting for approximately 30 percent of the total audits conducted over the scope of this review.

By 2018, when WorkForce’s audit staff-levels dropped from 3.5 FTEs to 1 at year’s end, WorkForce reported that it had only conducted 210 audits. Figure 6 below provides a breakdown.

Figure 6 Total Unemployment Audits Conducted Calendar Years 2014-2018	
Calendar Year	Audits
2014	1,006
2015	919
2016	772
2017	483
2018	210

Source: Numbers reported by WorkForce to the U.S. DOL. 2014-2018.

Further, the decline in the number of staff conducting unemployment audits at WorkForce has likely impacted the number of misclassified workers detected. In 2015, WorkForce identified nearly 800 misclassified employees through its unemployment audits. By 2018, this number had dropped to just 242, a 70 percent decrease. Figure 7 tracks the decreases in both FTEs and misclassified employees identified per year.



As the number of audit staff at WorkForce decreases, the odds of detecting worker misclassification also decrease. Unemployment audits not only help individual employees by identifying misclassification, but also increase the amount of revenues recovered by the State.

Between 2014 and 2018, WorkForce identified over \$27.4 million in underreported wages. This included over \$410,000 in underreported contributions to the State’s unemployment insurance program. **Based on the \$27.4 million in underreported wages, the Legislative**

Auditor estimates that the State lost, at a minimum, \$824,000 – \$1.1 million in personal income tax revenues from 2014-18. Therefore, the Legislative Auditor recommends that WorkForce and the Division of Personnel work together to address persistent issues faced by WorkForce in recruiting and retaining qualified audit staff.

By Tracking, Analyzing, and Using Available Data, WorkForce West Virginia Could Improve Its Audit Selection Process by Using a Risk Based Selection Approach.

The Legislative Auditor evaluated the process by which WorkForce selects employers for audit to determine if areas for process improvement exists. Currently, WorkForce can initiate an unemployment insurance audit from a variety of sources. According to WorkForce, some of the common “leads” include referrals from other units; tips, which can be phoned, emailed, or reported via WorkForce’s website; random selection from IRS 1099 Misc Extract reports; or referrals from the West Virginia Division of Labor resulting from routine inspections of in-state employers.

In reviewing the audit selection process employed by WorkForce, the Legislative Auditor also reviewed data from other states with respect to unemployment audit, particularly as it relates to detecting worker misclassification. Specifically, the Legislative Auditor asked WorkForce to explain the extent to which it uses two readily available sources of data in its audit selection process: the source of audit initiation for audits it has already performed which identified employee misclassification and the North American Industrial Classification System (NAICS) codes.

While WorkForce must select some employers for audit at random—U.S. DOL requires that at least 10 percent of all unemployment audits be selected randomly—WorkForce has relatively broad discretion for how it selects most employers for audit

In response, WorkForce indicated that it does not maintain data related to the source of its audits (i.e., whether the audit was from a tip, a 1099 Misc Extract, etc.). Currently, this information is only tracked in a management document and is not maintained and analyzed by WorkForce.

However, the Legislative Auditor notes that maintaining and analyzing such data could be a valuable tool for WorkForce. For example, the Louisiana Office of the Legislative Auditor issued an audit report in 2019 wherein it evaluated the results of unemployment audits conducted in Louisiana based on the source of initiation. The results of this analysis in Louisiana indicated that its unemployment insurance agency conducted approximately 42 percent of all audits based on randomly selected wage data. However, audits chosen from this source only yielded an average of one misclassified employee per audit, whereas audits sourced from tips or referrals, which made up just 2.3 percent of all audits conducted in the state, identified an average of 35 misclassified workers per audit.

Thus, tracking and analyzing the results of unemployment audits based upon their source of initiation could aid WorkForce by identifying the sources of audits that will have the largest impact and allow it to devote limited staff resources accordingly.

With respect to NAICS codes, WorkForce indicated that it has used NAICS codes in its audit selection process in the past, but often only when specific guidance comes from U.S. DOL. NAICS codes group employers together under broad industrial categories such as “construction,” “retail,” or “manufacturing,” among many others. Research from other states and U.S. DOL indicates that worker misclassification is more prevalent among certain economic sectors, with

construction being an oft-cited example. In Louisiana, the Office of the Legislative Auditor was able to analyze its unemployment agency's audits based on NAICS codes to again determine which industries provided the best return per audit.

WorkForce, however, does not track and analyze the results of its audits using NAICS codes. When asked, WorkForce was able to provide the codes only for audits conducted in 2018 and 2019. In the opinion of the Legislative Auditor, WorkForce could benefit from tracking and analyzing NAICS and source of initiation data, as it would further allow WorkForce to select employers for audit based on known risks. **Therefore, the Legislative Auditor recommends that WorkForce West Virginia begin tracking and routinely analyzing additional data such as the source of audit initiation and NAICS codes to gear the audit selection process towards identified risk areas.**

In addition, the Legislative Auditor asked WorkForce if it has any data-sharing agreements in place with other state agencies. Data sharing among state agencies that receive certified payroll from employers could be used by WorkForce to match against the wage data reported to it on a quarterly basis to identify employers who fail to report wages to WorkForce. For example, the Department of Transportation (DOT) also receives certified payroll reports from construction contractors employed on projects subject to the Federal Davis-Bacon Act, which requires such payroll reports. However, WorkForce indicated that it does not currently have any data-sharing agreements in place with agencies such as the DOT.

Finally, WorkForce indicated an additional hinderance to its audit process. Currently, WorkForce does not have authority to penalize employers who fail to cooperate with the audit process or provide required documentation. WorkForce indicated:

One difference between WorkForce and other similar agencies from surrounding states, or even other West Virginia agencies, is that WorkForce has no provision in the law that allows for penalties or consequences when audit records are not provided. Similar agencies of other states contacted by WorkForce, have monetary fines or other consequences for employers that fail to produce records for audits.

Therefore, the Legislature could consider authorizing WorkForce to administer penalties against employers who fail to cooperate in the audits or fail to provide WorkForce with the required documentation needed to conduct the audit.

Conclusion

Worker misclassification not only has a negative impact on the individual employees but can potentially cost the State millions of dollars in lost revenue from income taxes, worker's compensation premiums, and unemployment insurance taxes, among others. As efforts to detect and prevent worker misclassification have garnered increased emphasis across the country, West Virginia has struggled. Between 2014 and 2018, WorkForce West Virginia was consistently rated as having "failed" to meet federal criteria related to its unemployment program audits and ranked 51st in the country in the average number of misclassified employees identified per audit.

Over this same time period, WorkForce notes that the number of FTEs conducting unemployment audits decreased from seven in 2014 to just one at the start of 2019. In addition, WorkForce has indicated that it has had numerous job candidates turn down job offers as it has tried to fill these vacancies.

It is the opinion of the Legislative Auditor that WorkForce's decreasing staff levels and struggles to fill vacancies have certainly contributed to its inability to meet the requirements set forth by U.S. DOL. However, the Legislative Auditor notes that WorkForce did not meet the minimum scores related to identifying worker misclassification even when its staff levels allowed it to conduct three times the required number of annual audits. While increased staff levels would undoubtedly help WorkForce in its efforts to detect and prevent worker misclassification, the Legislative Auditor concludes that WorkForce must also consider changes to its audit selection process to achieve this goal.

The Legislative Auditor further notes that while worker misclassification is not an issue unique to West Virginia, neither are these conclusions. Legislative audit reports in Louisiana, Vermont, Maryland, Minnesota, and others reached similar conclusions regarding ways to improve the unemployment insurance audits in their respective states. By tracking and analyzing additional data, much of which is readily available, the Legislative Auditor believes that WorkForce could significantly increase the effectiveness of its unemployment audit program.

Recommendations

1. The Legislative Auditor recommends that WorkForce and the Division of Personnel work together to address persistent issues faced by WorkForce in recruiting and retaining qualified audit staff.
2. The Legislative Auditor recommends that WorkForce West Virginia begin tracking and routinely analyzing additional data such as the source of audit initiation and NAICS codes to gear the audit selection process towards identified risk areas.
3. The Legislative Auditor recommends that WorkForce West Virginia continue to seek out data-sharing agreements with other state agencies, such as the Department of Transportation, that receive certified wage reports from employers in the State.
4. The Legislative Auditor recommends the Legislature consider authorizing WorkForce to administer penalties against employers who fail to cooperate in the audits or fail to provide WorkForce with the required documentation needed to conduct the audit.

Issue 2: West Virginia Could Strengthen Its Efforts to Prevent Worker Misclassification by Authorizing Penalties as a Deterrent for Misclassification.

Introduction

During our audit of WorkForce West Virginia (WorkForce), the Legislative Auditor was informed by WorkForce that West Virginia does not currently assess any additional administrative penalty for employers who misclassify employees. The Legislative Auditor sought to determine how West Virginia compares with other states regarding how identified employee misclassification is handled. The Legislative Auditor's review identified the following:

1. Twenty-four (24) U.S. States administer additional administrative penalties for employers who misclassify their workers as independent contractors. Penalties range from a simple warning for a first offense to upwards of \$25,000 for repeat offenders.
2. In West Virginia, an employer who is determined to have misclassified workers must only pay the outstanding tax liability, plus interest, that he/she would have paid had the employee been properly classified.
3. As the number of unemployment auditors at WorkForce West Virginia has decreased, so have the number of audits, leading to a decrease in the likelihood of detecting worker misclassification

As a result, the Legislative Auditor recommends that the Legislature consider amending W.Va. Code to authorize WorkForce West Virginia to administer additional penalties for worker misclassification as a deterrent to employers who would do so.

In Nearly Half of U.S. States, Employers Who Misclassify Their Employees May Be Subject to Administrative Penalties, In Addition to Paying the Taxes Owed.

The Legislative Auditor sought to determine how other states handle instances of employee misclassification. The Legislative Auditor obtained information from the Louisiana Office of the Legislative Auditor indicating that approximately half (24) of U.S. states assess some form of administrative penalty on employers who misclassify their employees. Penalties range from a warning letter for a first offense to more than \$25,000 for repeat offenders. In addition, a number of states employ a variable penalty structure that assess a fixed fine-amount per employee misclassified. Figure 8 provides a breakdown of the penalties assessed on employers by other states.

Figure 8
Administrative Penalties for Misclassifying Workers in Other States

Maximum First Offense Penalty	No. of States	Maximum Subsequent Offense Penalty	No. of States
\$500 or Under*	4	\$2,500 or Under	3
\$501 - \$1,000	2	\$2,501 - \$5,000	4
\$1,001 - \$2,500	2	\$5,001 - \$15,000	0
\$2,501 - \$5,000	7	\$15,001 - \$20,000	2
\$5,001 - \$10,000	2	\$20,001 - \$25,000	2
Over \$10,001	2	Over \$25,001	1
Variable**	5	Variable	2
		N/A*	10
Total	24		24

* Ten states do not specify additional penalties for subsequent offenses.
Source: Prepared by staff at the Louisiana Office of the Legislative Auditor using Westlaw; corroborated by the West Virginia Legislative Auditor's staff.

Louisiana is the only state out of 24 states with statutory worker misclassification penalties that mandates warning letters to be sent on the first offense. The mandate of a warning letter means that Louisiana Workforce Commission must conduct follow-up audits of the same employer before being able to impose penalties.

The Legislative Auditor was informed by WorkForce that when its audits identify employee misclassification, the offending-employer must pay the outstanding tax liabilities, including state and federal unemployment insurance contributions, workers compensation contributions, and FICA taxes for the misclassified employee. In essence, the only penalty for an employer who misclassifies employees as independent contractors is that the employer must pay the taxes, plus interest, that they were required to pay under the law. As the number of auditors at WorkForce conducting unemployment insurance audits has declined, the Legislative Auditor concludes that the risk of employers being detected in misclassifying their employees has also dropped. The result of this combination of factors could create a low-risk incentive for employers to misclassify their employees as independent contractors.

Conclusion

The Legislative Auditor concluded in Issue 1 that employers have a financial incentive to misclassify their workers as independent contractors. In fact, employers in West Virginia can save in excess of \$6,000 per employee³ misclassified as a result of not being assessed payroll taxes for those workers.

While employers who are caught misclassifying their employees are required to repay the amount of these taxes owed, plus interest, the Legislative Auditor is concerned about the steep decline in WorkForce West Virginia's ability to detect this misclassification. With decreasing staff levels, WorkForce has been able to conduct far fewer audits and thus, identify less worker

³ See Figure 2

misclassification. The existing financial incentives for employers to misclassify their employees are now coupled with a lower chance of detection.

While approximately half of states assess penalties for identified misclassification, in addition to requiring employers to repay the amount of taxes owed, West Virginia currently has no additional penalties. The Legislative Auditor concludes that assessing penalties for worker misclassification could have a deterrent effect on misclassification.

Recommendations

1. The Legislative Auditor recommends the Legislature consider authorizing WorkForce West Virginia to administer administrative penalties on employers who misclassify employees as independent contractors.

Appendix A

WEST VIRGINIA LEGISLATIVE AUDITOR'S OFFICE

Post Audit Division

1900 Kanawha Blvd. East, Room W-329
Charleston, WV 25305-0610
(304) 347-4880



Justin Robinson
Director

June 30, 2020

Scott Adkins, Acting Executive Director
WorkForce West Virginia
State Capitol Complex
Building 3, Suite 300

Dear Acting Director Adkins,

This is to transmit a draft copy of our audit report on WorkForce West Virginia. This report will be issued and presented during an interim meeting of the Post Audits Subcommittee. Currently, there is no meeting date set, but we will inform you of the exact time and location of this interim meeting once the information becomes available. We recommend that a representative from your agency be present at this meeting to respond to the report and answer any questions committee members may have during or after the meeting.

If you would like to schedule an exit conference to discuss this draft report or any concerns you may have, please notify Adam R. Fridley, CGAP, Audit Manager, at 304-347-4880 or adam.fridley@wvlegislature.gov at your earliest convenience. We may arrange this meeting through video or teleconference to practice good social distancing and will work with you to arrange something that best suits everyone. Thank you for your cooperation and assistance throughout this audit process.

Sincerely,

A handwritten signature in blue ink, appearing to read "Justin Robinson".

Justin Robinson
Director

Enclosure

Appendix B

Objective, Scope, and Methodology

The Post Audit Division within the Office of the Legislative Auditor conducted this review as authorized by Chapter 4, Article 2, Section 5 of the *West Virginia Code*, as amended.

Objectives

The objective of this review was to determine whether WorkForce West Virginia has implemented adequate and effective processes for detecting and preventing worker misclassification. In addition, this objective seeks to provide background information concerning the monies collected and audit process from the UI Audits performed by WorkForce West Virginia auditors.

Scope

The scope of this review consists of data collected from WorkForce West Virginia, U.S. DOL, and Louisiana Workforce Commission (LWC) to provide a detailed review of WorkForce's audit process as well as in comparison to other states. The scope will involve interviewing WorkForce staff and documentation retrieved from LWC. The audit staff will not attempt to determine penalty fees for misclassified employees' employers, as these costs do not fall within the Legislative Auditor's statutory authority under W. Va. Code §4-2-5.

Methodology

Post Audit staff gathered and analyzed several sources of information and assessed the sufficiency and appropriateness of the information used as evidence. Testimonial evidence was gathered through interviews with various agencies that oversee, collect, or maintain information. The purpose for testimonial evidence was to gain a better understanding or clarification of certain issues, to confirm the existence or non-existence of a condition, or to understand the respective agency's position on an issue. Such testimonial evidence was confirmed by either written statements or the receipt of corroborating or physical evidence.

Audit staff analyzed various source documents that were either provided to us by WorkForce, the Louisiana Office of the Legislative Auditor, or publicly on the web. Documentation retrieved from the Louisiana Office of the Legislative Auditor was then deemed appropriate for use under the Government Auditing Standards (GAGAS) 8.81.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Legislative Auditor's staff would like to extend a special thanks to our peers in Louisiana for their assistance and courtesy.

Appendix C

OTHER STATES' PENALTIES FOR MISCLASSIFIED WORKERS

State	First Offense	Subsequent Offenses	Legal Citation	Comments
1 Alaska	Variable	N/A	AK Statutes §23.30.250	Alaska treats misclassification as theft by deception. Civil penalties may include a penalty of up to three times the workers' compensation premium that would have been originally paid if the employee was properly classified.
2 California	\$5,000 - \$15,000	\$10,000 - \$25,000	CA Labor Code §226.8	For each violation
3 Colorado	Up to \$5,000	Up to \$25,000	CO Revised Statutes (R.S.) §8-72-114	For each misclassified employee
4 Connecticut	Variable	N/A	CT General Statutes (G.S.) §31-69a	Connecticut has a penalty of \$300 per day per individual for each violation and employers that knowingly misclassify are guilty of a felony.
5 Delaware	\$1,000 - \$5,000	\$20,000	DE Code 19 §3505	For each misclassified employee. Subsequent offense fine applies if employer misclassifies twice in a two-year period.
6 Florida	\$2,500 or \$5,000	N/A	FL Administrative Code Rule 69L-6.018	\$2,500 per misclassified employee for the first two misclassified employees per site; and \$5,000 per misclassified employee after the first two misclassified employees per site.
7 Illinois	Up to \$1,000	Up to \$2,000	IL Compiled Statutes 820 §185/40	Subsequent offense penalties apply to repeat violations found within a five year period.
8 Kansas	Variable	Variable	KS Statutes 44-766; 79-3228	First violations result in civil penalties contingent on income tax owed, and subsequent violations result in civil penalties and misdemeanor criminal conviction.

State		First Offense	Subsequent Offenses	Legal Citation	Comments
9	Louisiana	Warning Letter	Up to \$1,500	LA R.S. 23:1711	Penalty for second offense is up to \$250 per individual found to be misclassified; third and all subsequent offense is up to \$500 per individual found to be misclassified. After the third offense, the employer may be subject to additional fines of between \$100 and \$1,000, or imprisoned for 30-90 days, or both.
10	Maine	\$2,000 - \$10,000	N/A	ME R.S. 26 § 591-A	For each violation
11	Maryland	Up to \$5,000	Up to \$20,000	MD Labor and Employment Code §3-909	For each employee who was knowingly not properly classified. Penalty with prior violation is double the first offense penalty and penalty for three or more violations is up to \$20,000 for each employee.
12	Massachusetts	Up to \$25,000	Up to \$50,000	MA General Laws 149 §27C	Massachusetts has different penalties, including criminal, for willful and unwillful violators. First offenses punished with fine up to \$25,000 or up to one year in prison for willful violators; up to \$10,000 or up to six months in prison for unwillful violators. Subsequent offenses are punished at a maximum of \$50,000 for willful violations and/or up to two years in prison; up to \$25,000 and/or up to one year in prison for willful violations.
13	Missouri	Variable	N/A	MO Statutes 285.515	Missouri allows a court to determine that an employer has knowingly misclassified a worker. If a court determines that misclassification is knowingly, it shall enter a judgment in favor of the state and award penalties in the amount of \$50 per day per misclassified worker up to a maximum of \$50,000.
14	Nebraska	\$500	\$5,000	NE R.S. §48-2907	Per each misclassified individual
15	New Jersey	Up to \$2,500	Up to \$5,000	NJ Statutes 34:20-5	Per violation
16	New Mexico	Up to \$5,000	N/A	NM Statutes §60-13-3.1	New Mexico's penalty statute is specific to the construction industry and only applies to misclassification by contractors.

State		First Offense	Subsequent Offenses	Legal Citation	Comments
17	New York	Up to \$2,500 (civil) Up to \$25,000 (criminal)	Up to \$5,000 (civil) Up to \$50,000 (criminal)	NY Labor Law §861-e	New York has both civil and criminal penalties. Upon conviction, criminal penalties for first offense are prison for no more than 30 days or a maximum fine of \$25,000 and prison for no more than 60 days or a maximum fine of \$50,000 for subsequent offenses.
18	North Carolina	Variable		NC G.S. §143-788	North Carolina passed the Employee Fair Classification Act to organize reporting and information sharing of misclassification issues between state agencies. While the Act does not impose any classification penalties, the various independent agencies have their own individual penalty structures.
19	Pennsylvania	Up to \$1,000	Up to \$2,500	PA Statutes §933.6	Per violation
20	Rhode Island	\$1,500 - \$3,000	Up to \$5,000	RI General Laws §28-14-19.1	For each misclassified employee
21	Texas	\$200	N/A	TX Labor Code §213.008	For each misclassified individual
22	Utah	Up to \$10,000	N/A	UT Labor Code §34A-2-110; UT Criminal Code §76-3-203, 204, 301	Utah's degrees of criminal offenses are dependent on the number of misclassified individuals. Criminal penalties range from fines up to \$2,500 and up to one year imprisonment for misdemeanors and fines up to \$10,000 and up to 15 years imprisonment for felonies.
23	Vermont	Up to \$5,000	N/A	VT Statutes §1314a	For each misclassified employee
24	Wisconsin	\$500	N/A	WI Statutes 108.221	Wisconsin's penalties for employers engaged in the painting or drywall finishing of buildings or other structures that intentionally misclassify employees is \$500 for each employee who is misclassified, but not to exceed \$7,500 per incident.

Source: Prepared by staff from the Louisiana Office of the Legislative Auditor, using Westlaw.



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