**State of Utah**
GARY R HERBERT
*Governor*
GREG BELL
*Lieutenant Governor*

**Labor Commission**
SHERRIE HAYASHI
*Commissioner*

October 17, 2011

Governor Gary R. Herbert
Senator John L. Valentine
Representative James A. Dunnigan

To Governor Herbert, Senator Valentine, Representative Dunnigan, and the members of the Business and Labor Interim Committee:

We are writing to provide the annual report from the Worker Classification Enforcement Council ("Council") pursuant to U.C.A. § 34-47-202, enacted earlier this year by S.B. 11. As background, S.B. 11 created within the Labor Commission the four member Council consisting of representatives from 1) the Labor Commission, 2) the Department of Commerce, 3) the Department of Workforce Services, and 4) the State Tax Commission. Nonmember Office of the Attorney General is assigned to work cooperatively with the Council. The Council is directed to meet at least quarterly to coordinate regulatory and law enforcement efforts related to employee misclassification.

Following the passage of S.B. 11, the Council held its first meeting in April 2011 and has met at least monthly since then. In just a short time since S.B. 11 was enacted we have been busy and achieved concrete results. Members of the public have been invited and have attended Council meetings. The Council has discussed various ways employees are misclassified and methods to estimate the extent of misclassification in Utah. The Council has received reports from member agencies on enforcement efforts, and has discussed the ability to, and the current restrictions on, sharing information between member agencies. Representatives from the Internal Revenue Service and the United States Department of Labor have also been invited to Council meetings and have made presentations regarding the federal government's efforts to address the misclassification of workers and the issue of restrictions on sharing information between federal and state agencies. The Council has also engaged in discussions with the Workers Compensation Fund.

160 East 300 South, 3rd Floor • PO Box 146600 • Salt Lake City, Utah 84114-6600 • Telephone (801) 530-6953
Facsimile (801) 530-6390 • Toll Free (800) 530-5090 • www.laborcommission.utah.gov

As outlined by U.C.A. § 34-47-202, this report will cover four areas: (1) the nature and extent of misclassification in Utah; (2) the results of regulatory and law enforcement efforts related to the Council; (3) the status of sharing information by member agencies; and (4) recommended legislative changes.

**The Nature and Extent of Misclassification in Utah**

Pursuant to other legislation passed earlier this year (S.B. 191), the Labor Commission has assumed the responsibility for issuing workers' compensation waivers. The Council anticipates being able to report in the future whether this change will make an impact on the number of waivers issued or will otherwise impact the market or reduce misclassification.

The Unemployment Insurance Division of the Department of Workforce Services completes both "random" and "targeted" audits of Utah employers. In the three and one-half year period between January 1, 2008 and June 30, 2011, the division completed 4,022 "random" audits, covering $3.6 billion in total reported wages. The random audits identified $25.4 million in total unreported wages to 7,380 workers who were misclassified as "independent contractors." The random audits revealed a variance of only 0.7% (.007).

During the same time period the division completed 598 "targeted" audits of Utah employers, covering $541 million in total reported wages. Targeted audits, which primarily use IRS form 1099 information to identify potential unreported workers, yield different results. The targeted audits identified $112 million in total unreported wages to 13,229 workers who were misclassified as "independent contractors." The targeted audits revealed a variance of almost 21% (.21).

The results of the random and targeted audits demonstrate that while the vast majority of registered Utah employers are reporting workers properly, a significant number of Utah employers are misclassifying their workers.

Department of Commerce employees met throughout 2011 with many industry groups attempting to identify construction companies engaged in a worker-owner model, which was identified by separate legislation (S.B. 35) as an area where the Department should focus. To date, approximately ten companies have been identified. Two allowed their business registrations and contractor licenses to expire; six companies are affiliated with common management and have a pending notice of agency action issued against them by the Department; and two companies are currently under investigation. Commerce employees hope that November's contractor renewal cycle will better identify the extent of the problem.

S.B. 35 requires detailed reporting from construction companies utilizing the worker-owner model. The Council had hoped those reports would provide useful data, but to date those businesses are viewing S.B. 35 differently from the Department of Commerce and have not yet provided the anticipated reports. It is likely that over the course of the next year the current administrative proceedings should clarify some of the disputed issues.

In looking at the nature and extent of misclassification in Utah, the Tax Commission is looking at tax compliance. The LLCs organized as a worker/owner LLC model and addressed in S.B. 35 are taxed as partnerships and would have filed a TC-65 tax return and completed and submitted with the TC-65 a State of Utah Schedule K-1 (Partner's Share of Utah Income, Deductions and Credits) and a State of Utah Schedule K (Partners' Distributive Share Items) for 2010 filings submitted in 2011.

For the 2010 tax filing year the Tax Commission has extracted limited liability companies (LLCs) and the associated Utah Ks and K-1s and taken a random sample of these LLCs to evaluate the state K-1s from a tax perspective. There were 11,400 LLCs that filed a TC-65 in 2010; the Tax Commission has pulled a random sample of 201 of these LLCs. From these 201 LLCs, 701 state K-1s were filed and issued. Over the next several months the Tax Commission will be evaluating how many of those who were issued these 701 state K-1s have filed tax returns.[1]

While the Tax Commission cannot share taxpayer specific information (only results in aggregate of ten or more) the agency believes this review of tax compliance and the aggregate information from this random sample will assist the Council in its regulatory efforts. In terms of receiving information, any non-compliance can be an audit lead; the Tax Commission can use the information, but cannot share back any results specific to a taxpayer.

---

[1] Below is a summary of data on the Utah Schedule K and K-1 the Tax Commission will examine from a random sample of 2010 state K-1s to see if those issued state K-1s have filed tax returns.

**Utah Schedule K:** The information on the Schedule K is an aggregate of the information reflected on each K-1. The Ks have a line that indicates how many K-1s the entity is attaching to the return. A K-1 is issued to each partner by the LLC. The Ks have the aggregate of the LLC's partners' distributive share items, which is what was paid out to the partners (a worker/owner under the LLC model the Legislature addressed in S.B. 35. The distributive shares to LLC members can be ordinary business income, guaranteed payments, dividends, or other income.

**Utah Schedule K-1:** A separate K-1 is issued to each member indicating the partner's share of Utah income, deductions and credits. The K-1s include the same information on the Schedule K except that it applies specifically to each member and states the company's income distributed to that particular member. The K-1s include the name, address and telephone number of the person to which the K-1 is issued, the name of the entity issuing the K-1, the Employer Identification Number, Social Security Number or Individual Tax Identification Number of the person to whom the K-1 is issued, that person's percent of ownership in the entity and the amount of Utah ordinary business income, Utah guaranteed payments, Utah ordinary dividends, and Utah other income. A partner under the worker/owner LLC model addressed in S.B. 35 could have income noted in any of those areas: Utah ordinary business income, Utah guaranteed payments, Utah ordinary dividends, and Utah other income.

Definitions:

- % of ownership or the percentage of the entity owned by the member. This is important because the ownership agreement or % of ownership does not necessarily equate to the distributive share of the income. There could be an agreement that an owner has .00005 % ownership, but receives no profits, dividends, other income based on ownership.
- Utah Ordinary Business Income, i.e. the total Utah amount made by the company after tax deductions.
- Guaranteed payments, i.e. what a member of an LLC gets regardless of the profit or loss of the company

The State of Utah Schedules K and K-1 forms can be viewed at http://tax.utah.gov/forms/current/tc-65.pdf.

**The Results of Regulatory and Law Enforcement Efforts Related to the Council**

The Labor Commission identified one company misclassifying its employees as members with no workers' compensation coverage. The Commission's noncompliance penalty and reimbursement for injury totaled approximately $40,000. The company paid $17,000 and has gone out of business. The Commission has also initiated over 75 wage payment cases involving companies using an LLC structure to classify workers as owners; many of them have been closed due to the company going out of business.

Six affiliated companies with common management received a notice of agency action from the Department of Commerce. The notice was issued for a failure to comply with the statutory requirements from S.B. 35 for auditing and quarterly reporting. Among the items found in an initial review were:

- More than 25% of workforce had purported social security numbers that were either falsified, duplicated, or ITIN numbers.
- Nearly half of the owners had substantial judgments, tax liens, and child support liens. Of the remaining owners, Commerce employees found thousands of potential legal actions but were unable to confirm responsibility because of insufficient personal identifying information.
- More than half of the owners were found to potentially have some form of criminal history but Commerce employees were unable to confirm responsibility because of insufficient personal identifying information.

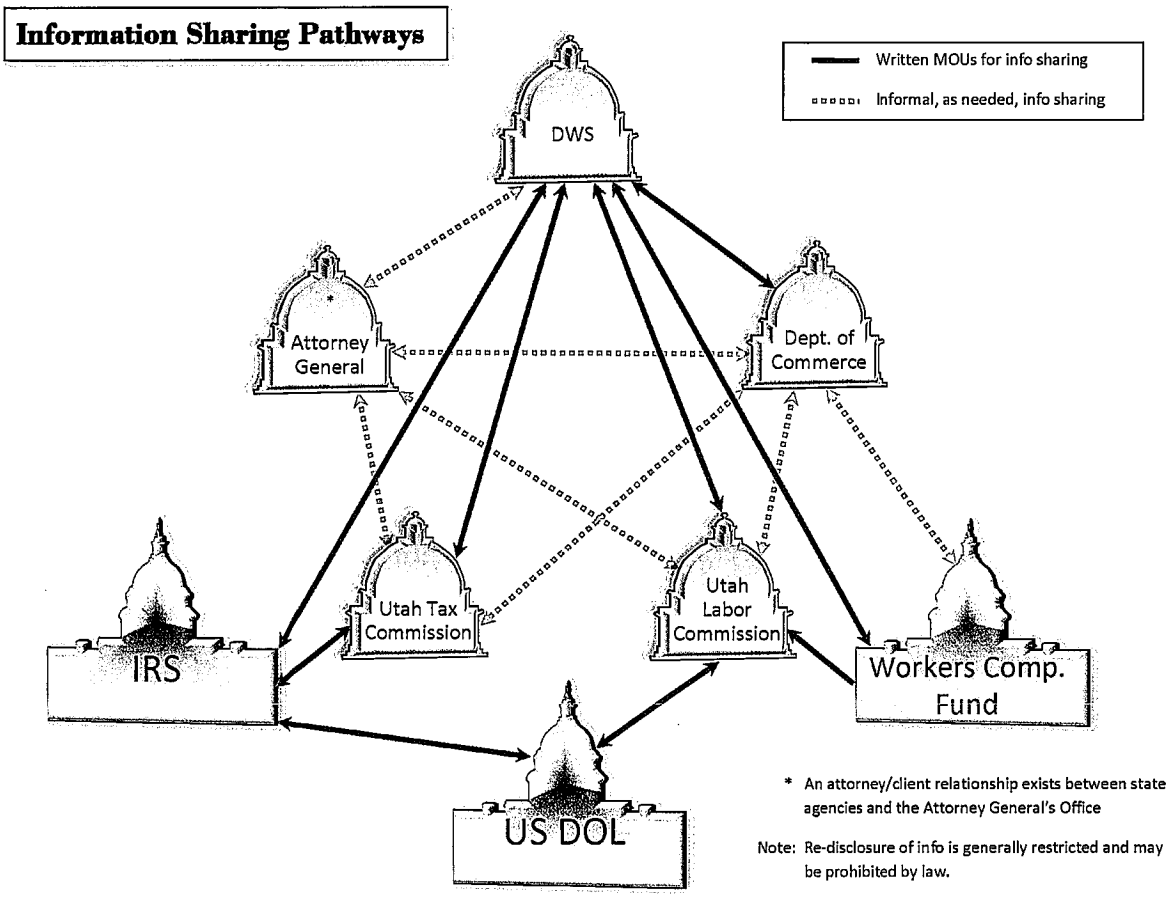
Commerce investigators have responded to numerous complaints and industry leads to determine misclassification violations. Those investigations have resulted in at least two other company evaluations. Investigators have found that when they visit a job site, workers often disappear and are working with other agencies to better coordinate investigations.

**The Status of Sharing Information by Member Agencies**

After the 2011 Legislative Session, Commerce employees worked with Workforce Services employees to expand access to the Unemployment Insurance database. Commerce employees will now be able to more effectively coordinate investigations when contractors are violating unemployment insurance laws. Workforce Services employees have referred dozens of unemployment insurance cases to Commerce. Many have resulted in agency actions for both unemployment insurance violations and other financial responsibility violations.

Commerce investigators are now coordinating investigations of selected companies with the Labor Commission and Department of Workforce Services. The Department of Workforce Services is in the process of expanding their information sharing agreement with the Workers Compensation Fund to further leverage resources and help ensure compliance with applicable unemployment insurance and workers' compensation laws.

The chart below gives a visual representation of the current information sharing pathways:




**Recommended Legislative Changes**

The Council has discussed and recommends two legislative changes. The Council had previously discussed a third (eliminating unintended consequences from S.B. 35 regarding workers compensation insurance for LLC owners), but that change was already made by the Legislature in a recent Special Session. The remaining recommendations are:

1. Reduce quarterly reporting requirement for contractor companies with fewer than five owners who own less than 8%. Some companies provide to a family member or other key individual limited ownership while learning the business or purchasing it over time. The current reporting requirements seem onerous for those situations
2. Clarify the auditing authority of the Division of Occupational and Professional Licensing. The six companies with a current notice of agency action are making the legal argument that DOPL doesn't have the auditing authority DOPL believes SB 35 provided.

**Conclusion and Outlook for Future Action**

The Council has been in existence for a short time, but we believe its results so far are real and have already made a difference in the marketplace. Looking at S.B. 11 and S.B. 35 in concert, it was clear to the Council that the Legislature wanted the construction trades to be an initial focus of the Council. The Council has focused its work in that area with good results so far.

The Council has already begun to engage in joint targeted investigations, and will continue to explore joint criminal prosecution where circumstances warrant. The Council is hopeful some of the current, pending administrative cases will clarify the reporting and auditing requirements of S.B. 35 and provide the Council with more concrete data in the future. However, it is worth noting that S.B. 35 also appears to have had the effect of significantly reducing the use of worker owners in the construction trades, so it is still unclear how much data will become available.

The Council is looking forward to continuing to explore ways to gain further data from the Labor Commission's authority over insurance carriers and employers, and to find ways to initiate public outreach and education. Agendas and Minutes for all Council meetings are available on Utah's Public Notice Website. I look forward to continuing to report annual progress, and I am glad to provide any other requested information or answer any questions.

Sincerely,

ALAN HENNEBOLD
CHAIR, WORKER CLASSIFICATION ENFORCEMENT COUNCIL
DEPUTY COMMISSIONER, UTAH LABOR COMMISSION

DOLORES FURNISS
DISCLOSURE OFFICER, UTAH STATE TAX COMMISSION

THAD LEVAR
DEPUTY DIRECTOR, UTAH DEPARTMENT OF COMMERCE

PHIL LOTT
ASSISTANT ATTORNEY GENERAL

BILL STARKS
UNEMPLOYMENT INSURANCE DIRECTOR,
DEPARTMENT OF WORKFORCE SERVICES

cc: Senator Karen Mayne