

**U.S. Department of Labor**  
Office of Inspector General—Office of Audit

**EMPLOYMENT AND  
TRAINING ADMINISTRATION**



**USE OF IRS FORM 1099 DATA TO  
IDENTIFY MISCLASSIFIED WORKERS**

**Date Issued: September 30, 2005  
Report Number: 03-05-005-03-315**

**U.S. Department of Labor  
Office of Inspector General  
Office of Audit**

## **BRIEFLY...**

Highlights of Report Number: 03-05-005-03-315, to the Assistant Secretary for Employment and Training.

### **WHY READ THE REPORT**

The Federal-state Unemployment Compensation (UC) program, created by the Social Security Act of 1935, offers the first economic line of defense against the effects of unemployment. The Employment and Training Administration's (ETA's) Office of Workforce Security (OWS) administers the program. The UC program is almost totally funded by employer taxes.

In a March 1999 Office of Inspector General (OIG) audit on best practices of State Workforce Agencies (SWA) UI field tax audits, we reported that the 1099-MISC Income Data, supplied by the Internal Revenue Service (IRS), can be used as a tool to identify misclassified employees. Employers who misclassify employees as independent contractors reduce tax liability by not paying state and Federal Unemployment Insurance, Social Security, and Medicare taxes. We recommended that OWS work with the IRS to develop an extract tape of the IRS Form 1099 tailored for use SWAs. The IRS first permitted SWAs to apply for the IRS 1099 data in October 2001

### **WHY OIG DID THE AUDIT**

We conducted this audit to answer the following questions: (1) How many SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors? (2) What were the obstacles that influenced the SWAs not to apply for and use the 1099 data? (3) What were the methods and strategies used by the SWAs that were successful in obtaining and using the 1099 data? and (4) What results were achieved by SWAs using the 1099 data since the IRS made it available in 2001?

### **READ THE FULL REPORT**

To view the report, including the scope, methodology, and full agency response, go to:  
<http://www.oig.dol.gov/public/reports/oa/2005/03-05-005-03-315>.

**September 2005**

## **State Workforce Agencies Use of IRS Form 1099 Data To Identify Misclassified Workers**

### **WHAT OIG FOUND**

The OIG found that only nine SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors.

Based on our contacts with the SWAs, we identified five common obstacles to the SWAs' application for and use of the 1099 data. (See page 9).

We found that communication with the IRS was the key to successfully obtaining and using the 1099 data. We also found that SWAs may be further ahead in meeting the IRS application and safeguard requirements if they are already receiving other IRS tax information. Representatives from SWAs using the 1099 data identified several extract criteria to make the 1099 data useful. Finally, we found that the age of the 1099 data was a perceived obstacle because the age of the data does not affect its usefulness in identifying potential employers who may be misclassifying employees.

As of December 2004, we found that 7 of the 9 SWAs reported that they identified misclassified employees. The seven SWAs started reporting results at staggered quarters beginning with the 4th quarter of calendar year 2002. As of December 2004, seven SWAs reported that they identified 7,118 misclassified employees, recovered \$1,492,521 in underreported UI tax contributions, and adjusted \$328,634 for overreported UI tax contributions associated with these workers

### **WHAT OIG RECOMMENDED**

We recommended that the Assistant Secretary for Employment and Training: provide assistance and guidance to the SWAs applying for the 1099 data to increase the possibility that they are successful in obtaining and using the data; communicate to these SWAs how to overcome obstacles in obtaining and using the data; and encourage SWAs before the start of the 2006 IRS enrollment period to apply for and use the 1099 data in their UI field tax audit program.

ETA agreed with, and has already taken action to implement, our recommendations.

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## Executive Summary

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The U.S. Department of Labor (DOL), Office of Inspector General (OIG), has cited that enhancing the integrity and solvency of the Unemployment Compensation program is a challenge facing DOL. The Unemployment Compensation program is mostly funded by employer taxes.

According to the IRS, as a general rule, an independent contractor is an individual who has the right to control the means and the method of accomplishing the results of the work to be done, whereas an employee performs services that are controlled by the employer. Payments to independent contractors are reported to the IRS on the Form 1099-MISC Income. Employers who misclassify employees as independent contractors avoid their tax obligations by not paying state and Federal Unemployment Insurance (UI), Social Security, and Medicare taxes.

In a March 1999 audit (Report No. 03-99-006-03-315) on best practices of State Workforce Agencies (SWA) UI field tax audits, we reported that the 1099-MISC Income Data, (1099 data) supplied by the Internal Revenue Service (IRS), can be used as a tool to identify misclassified employees. We recommended that the Employment and Training Administration's (ETA's) Office of Workforce Security (OWS) encourage the IRS to develop an extract of the 1099 data tailored for use by SWAs in UI field tax audits. The IRS first permitted SWAs to apply for the 1099 data in August 2001 as part of its annual application process for the exchange of Federal tax information with government entities.

We conducted this audit to assess the extent of SWAs using the 1099 data to identify potential employers misclassifying employees as independent contractors. Specifically, we wanted to answer the following questions.

1. How many SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors?
2. What were the obstacles that influenced the SWAs not to apply for and use the 1099 data?
3. What were the methods and strategies used by the SWAs that were successful in obtaining and using the 1099 data?
4. What results were achieved by SWAs using the 1099 data since the IRS made it available in 2001?

### Results

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We found that:

1. Only nine SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors. Since 2002 when the IRS first made 1099 data available to SWAs for use in their UI field tax audits, we found that only 19 SWAs had applied to the IRS to receive it. We contacted these 19 SWAs and found that only 9 were using the 1099 data as of December 2004. The remaining 10 SWAs encountered obstacles that prevented them from obtaining and using the 1099 data. We found that 3 of these 10 SWAs applied for the 1099 extract tape but were unsuccessful in obtaining it and the remaining 7 received the tape but decided not to use the data. The IRS informed us that 25 SWAs applied to receive the 1099 data in 2005. This consisted of 16 SWAs that had not previously applied or used the 1099 data and 9 SWAs that are currently using the data.
2. Based on our contacts with the 33 SWAs that did not participate in the 2001 IRS application process and the 10 SWAs that applied for the 1099 data but did not obtain it, or obtained but did not use it, we identified five common obstacles to the SWAs' application for and use of the 1099 data. (See page 9)
3. Communication with the IRS was the key to successfully obtaining and using the 1099 data. SWA representatives told us that establishing effective communication with the IRS Government Liaisons helped them to successfully complete the application and safeguard requirement process. We also found that SWAs may be further ahead in meeting the IRS application and safeguard requirements if they are already receiving other IRS tax information. Representatives from SWAs using the 1099 data identified several extract criteria to make the 1099 data useful. Finally, we found that the age of the 1099 data was a perceived obstacle because the age of the data does not affect its usefulness in identifying potential employers who may be misclassifying employees.
4. The results from UI field audits in which the SWAs used the 1099 data identified misclassified employees, recovered underreported UI tax contributions, and adjusted overreported UI tax contributions. As of December 2004, we found that 7 of the 9 SWAs reported that they identified misclassified employees. While the other two SWAs said they used the 1099 data, they did not identify for audit any employers who had the potential of misclassifying employees. The seven SWAs started reporting results at staggered quarters beginning with the 4th quarter of calendar year 2002. As of December 2004, seven SWAs reported that they identified 7,118 misclassified employees, recovered \$1,492,521 in underreported

UI tax contributions, and adjusted \$328,634 for overreported UI tax contributions associated with these workers<sup>1</sup>.

## Recommendations

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We recommend that the Assistant Secretary for Employment and Training:

1. Provide assistance and guidance to the 16 new SWAs that applied for the 1099 data during the 2004 IRS application period to increase the possibility that they are successful in obtaining and using the data.
2. Communicate to the SWAs interested in applying for and using the 1099 data how to overcome: the complexity of the IRS application process; the difficulty in meeting the IRS safeguard requirements; obtaining the IT resources needed to make the 1099 data useful; and the perception that the age of the 1099 data is an obstacle to using it.
3. Send a notification, along with a copy of this report, to SWAs before the start of the 2006 IRS enrollment period, encouraging them to apply for and use the 1099 data in their UI field tax audit program.

## Agency Response

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ETA concurred with our recommendations and responded that they have already taken corrective action. The response is attached as Appendix D.

## OIG Conclusion

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Recommendations 1 and 2 are resolved and closed and recommendation 3 is resolved and can be closed when we receive documentation that the notification and audit report have been sent out to each SWA.

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<sup>1</sup> Overreported UI tax contributions represent incidents when mistakes are made and employers overpay their UI tax contributions. These overpayments result in adjustments.

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**U.S. Department of Labor**

Office of Inspector General  
Washington, DC. 20210



## **Assistant Inspector General's Report**

Ms. Emily DeRocco  
Assistant Secretary  
for Employment and Training  
U.S. Department of Labor  
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According to the IRS, as a general rule, an independent contractor is an individual who has the right to control the means and the method of accomplishing the results of the work to be done, whereas an employee performs services that are controlled by the employer. Payments to independent contractors are reported to the IRS on the Form 1099-MISC Income. In many cases, employers have misclassified their employees as independent contractors to avoid their UI and other tax obligations.

In a 1999 audit of SWAs' best practices to improve the effectiveness of UI field tax audits, OIG found the use of 1099 data to be an effective tool for identifying employers misclassifying workers as independent contractors. OIG recommended that ETA's OWS encourage the IRS to develop an extract of the 1099 data tailored for the SWAs so that it can be used in UI field tax audits. The IRS first permitted SWAs to apply for the 1099 data in August 2001.

We conducted this audit to assess the extent of SWAs use of 1099 data in UI field tax audits. Specifically, we wanted to answer the following questions.

1. How many SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors?
2. What were the obstacles that influenced the SWAs not to apply for and use the 1099 data?
3. What were the methods and strategies used by the SWAs that were successful in obtaining and using the 1099 data?
4. What results were achieved by SWAs using the 1099 data since the IRS made it available in 2001?

We conducted the audit in accordance with Government Auditing Standards. Our scope and methodology are detailed in Appendix B.

Objective 1 – How many SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors?

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**Finding - Only nine SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors.**

Only 9 SWAs are using the 1099 data to identify potential employers misclassifying employees as independent contractors. Since 2002 when the IRS first made 1099 data available to SWAs for use in their UI field tax audits, we found that only 19 SWAs had applied to the IRS to receive it. We contacted these 19 SWAs and found that only 9 were using the 1099 data as of December 2004. The remaining 10 SWAs encountered obstacles that prevented them from obtaining and using the 1099 data. We found that 3 of these 10 SWAs applied for the 1099 extract tape but were unsuccessful in obtaining it and the remaining 7 received the tape but decided not to use the data. The IRS informed us that 25 SWAs applied to receive the 1099 data in 2005. This consisted of 16 SWAs that had not previously applied or used the 1099 data and 9 SWAs that are currently using the data.

In August 2004, OWS and IRS intensified their outreach efforts by conducting telephone conference calls with SWAs to encourage them to apply to the IRS for the 1099 data. OWS and IRS conducted 2 telephone conferences with officials from 27 SWAs who expressed an interest in applying for and using the 1099 data. The purpose of the telephone conferences was to discuss how to overcome obstacles that SWAs faced in the application process and in using 1099 data in the UI field tax audits. OIG also participated in the telephone conference calls to present the preliminary results of our work concerning the obstacles and strategies for overcoming the obstacles. The IRS informed us these telephone conferences resulted in 25 SWAs applying to receive 1099 data in 2005. The 25 SWAs consisted of 16 that had not previously applied or used the 1099 data and the 9 that are currently using the data.

It is our position that use of 1099 data is an effective tool for identifying employers misclassifying workers as independent contractors and targeting these employers for audits would result in recoveries that would enhance the solvency and financial condition of the state unemployment trust funds.

**Recommendation**

1. We recommend that the Assistant Secretary for Employment and Training provide assistance and guidance to the 16 new SWAs that applied for the 1099 data during the 2004 IRS's application period to increase the possibility that they are successful in obtaining and using the data.

**Agency Response**

ETA officials responded that they have taken action to implement the recommendation. Beginning with conference calls in August of 2004, personnel from the Office of Workforce Security (OWS) worked very closely with the IRS, OIG and SWAs to help ensure successful use of these data. OWS coordinated a follow up conference call on March 23, 2005, specifically for the benefit of the new states requesting the data from IRS. The objective of this call was to provide guidance to state information technology staff responsible for receiving, sorting, and manipulating the 1099-MISC data. In advance of the call, each participating state was given a sample data record in ASCII format, and a COBOL picture of the data. An IRS programmer participated and explained each of these information items and answered technical questions. In addition, tax and technical staff from states that had been successful in obtaining and using the data participated in the call to share their knowledge and experience with it.

**OIG Conclusion**

The recommendation is resolved and closed. ETA’s March 23, 2005, conference call with the newly enrolled SWAs is sufficient to address the recommendation.

**Objective 2 – What were the obstacles that influenced the SWAs not to apply for and use the 1099 data?**

**Result - There were five common obstacles that influenced the SWAs not to apply for and use the 1099 data.**

There were five common obstacles that influenced the SWAs not to apply for and use the 1099 Data. See chart below. In September and October 2001 we contacted the UI field tax audit representatives for the 33 SWAs that did not participate in the 2001 IRS application process and identified common obstacles that influenced their decision not to apply for the 1099 data. In June 2002, we also interviewed UI field tax audit representatives from the 10 of the 19 SWAs that applied for the 1099 data, but were either not successful in obtaining the data, or if they obtained the data, they decided not to use it. The 10 SWAs provided similar obstacles as the 33 SWAs that did not participate in the 2001 IRS application process. The following chart provides the five common obstacles provided to us by the SWAs contacted, the frequency of the SWAs’ responses to the obstacles, and a description of each obstacle.

Obstacle	Number of SWA Responses	Description
Other Priorities	21	SWA officials told us major changes to systems and/or other priorities made it an obstacle to apply for the 1099 data in the IRS’s initial application process in August 2001.
Meeting IRS Safeguards	14	In meeting the IRS requirements for securing 1099 data, SWAs perceived that the time and cost of the IT resources required and possible security upgrades would be significant and difficult to meet.

Obstacle	Number of SWA Responses	Description
Age of the Data	8	SWAs perceived that the age of the 1099 data from the IRS would not be useful because it was outdated, i.e., receiving 2002 data in 2004.
IRS Application Process	7	SWA officials told us they had experienced difficulties in contacting the IRS Government Liaisons to obtain information on the application process and assistance in completing the required documentation. Therefore, many SWA officials were unaware of the specifics of the IRS application process.
Lack of IT Resources	7	SWA officials told us they experienced difficulties in obtaining IT resources needed to be able to analyze and make the IRS 1099 extract data useful for their audits.

*Note: Some SWAs experienced more than one obstacle.*

**Objective 3 – What were the methods and strategies used by the SWAs that were successful in obtaining and using the 1099 data?**

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**Finding - Communication with the IRS was the key to successfully obtain and use the 1099 data.**

Communication with the IRS was the key to successfully obtain and use the 1099 data. SWA representatives told us that establishing effective communication with the IRS Government Liaisons helped them to successfully complete the application and safeguard requirement process. We also found that SWAs may be further ahead in meeting the IRS application and safeguard requirements if they are already receiving other IRS tax information. Representatives from SWAs using the 1099 data identified several extract criteria to make the 1099 data useful. Finally, we found that the age of the 1099 data was a perceived obstacle because the age of the data does not affect its usefulness in identifying potential employers who may be misclassifying employees.

To identify the strategies successful SWAs used to overcome the obstacles, in November and December of 2003, we visited four SWAs that were successful in applying, obtaining, and using the 1099 extract tape. The four successful SWAs provided similar responses about how they overcame the obstacles encountered by the unsuccessful SWAs. Additionally, during telephone conferences in August 2004 with officials from the OWS and IRS, the SWAs provided us methods and strategies to address both the real and perceived obstacles.

Overall, the SWAs that were successful in applying for, obtaining, and using the 1099 data expressed that communication with the IRS was the deciding factor that assisted them in overcoming the obstacles identified by the unsuccessful SWAs. The sections below describe the obstacles encountered by the unsuccessful SWAs and the strategies and methods to successfully overcome the obstacles for obtaining and using the 1099 data. We did not identify any strategies or methods to address the other priorities obstacle. SWA officials told us major changes in their automated tax system

and/or other priorities made it an obstacle to apply for the 1099 data in the IRS' initial application process in August 2001.

## 1. IRS Application Process for 1099 Extract Tape

Before an entity can receive Federal tax information, the IRS requires the entity to annually complete a Data Extract Enrollment Form. This form is generally due by the end of September. In addition to the Data Extract Enrollment Form, the IRS requires the entity to complete and execute a Basic Agreement. The Basic Agreement provides the basis for coordinating the exchange of Federal tax information between the IRS and receiving agency. The receiving agency may supplement this Basic Agreement with an Implementing Agreement that prescribes the nature, quantity, and mechanics for the continuous exchange of tax information provided for in the Basic Agreement.

The initial obstacle for SWAs to overcome in the application process is contacting their IRS Government Liaisons. The Government Liaisons are responsible for assisting the SWAs in the application process. The successful SWAs told us that establishing an effective relationship with their IRS Government Liaison helped them to expedite the application process.

To illustrate the benefit of establishing an effective relationship with the IRS Government Liaison, we found the SWAs may currently have an executed Basic Agreement and Implementing Agreement with the IRS if their state is receiving other Federal tax information. The IRS informed us that 37 SWAs had an executed Basic Agreement and 26 had an Implementing Agreement. The IRS said that its Government Liaisons are aware of this information, and will assist SWAs in determining whether their state currently has an executed Basic Agreement and Implementing Agreement with the IRS.

During the August 2004 telephone conferences, IRS officials informed the SWA representatives that they are directing their Government Liaisons to be more pro-active in working with SWAs to obtain the 1099 data.

## 2. Meeting the IRS Safeguard Requirements

After an entity completes the enrollment process, a key IRS requirement for an entity to receive Federal tax information is completing the Safeguard Procedures Report (SPR). While an entity can start the Federal tax information application process without an approved SPR, the IRS will not provide the data until they approve the SPR. The SPR describes the procedures the entity will use to safeguard the confidentiality of the IRS data and protect it against unauthorized use. The entity has to submit a new SPR every six years or whenever significant changes occur in their safeguard program. IRS officials told us that the Government Liaison is responsible for assisting entities in completing the SPR. The level of assistance needed will depend on whether or not the entity has previously prepared an SPR.

A major obstacle identified by the SWAs was meeting the IRS safeguard requirements. Representatives from the SWAs that were successful in obtaining and using the 1099 data informed us that they did not have to make significant changes to their IT processes and audit operations to meet the safeguard requirements. SWA representatives told us that their state's centralized mainframe computers usually already met the IRS security requirements because other state agencies or units were receiving other Federal tax information.

The SWA representatives also informed us that the IRS Government Liaisons were very helpful in assisting them to meet the safeguard requirements for the 1099 data.

According to IRS officials, if multiple state agencies use the same centralized mainframe computer, and a safeguard review certified the system as being secure, then its not necessary to re-certify the computer system for the purpose of the SWA obtaining the 1099 data. IRS officials told us they estimate that 90 percent of the states with shared and centralized computer facilities comply with the IRS safeguard requirements.

During the August 2004 telephone conferences, the IRS officials informed the SWAs of the availability of IRS Publication 1075, *Tax Information Security Guidelines for Federal, State, and Local Agencies*. Sections 7.1 through 7.3 of the publication provides information regarding requirements for preparing the SPR. The IRS informed SWA representatives they can obtain IRS Publication 1075 through the Governmental Liaison or via the Internet at [www.irs.gov/pub/irs-pdf/p1075.pdf](http://www.irs.gov/pub/irs-pdf/p1075.pdf).

Additionally, as a result of the telephone conferences, the IRS officials provided participants with a copy of the SPR along with suggestions and tips on how to complete it. (See Exhibit A.) The IRS officials also provided a SPR checklist to assist the SWAs in ensuring their SPR contains the required information. (See Exhibit B.)

### 3. IT Resources

Another obstacle that SWA's faced in using the 1099 data was obtaining IT resources needed to make the data useful for UI field tax audits. Of the 7 SWAs that told us this was an obstacle, 4 received the 1099 data extract tape, but decided not to use it.

Officials from SWAs that were successful in using the 1099 data told us that because of its size, they had to load the 1099 extract tape on their mainframe computers, which required IT resources. The SWA officials told us they also needed IT resources to perform the crossmatch of the Federal Employer Identification Number with the state Employer Identification Number. The SWA officials also said they needed IT resources to convert the data to a media (compact disk, etc.) so they could provide it to the UI field tax auditors for direct access.

Officials from SWAs that were successful in using the IRS Form 1099 told us that they used minimal IT staff time and cost to develop the necessary programming on the 1099

extract tape. The SWA officials told us that they consider the following factors to reduce the universe of employers for potential audit to a manageable quantity.

- employer UI experience rating
- number of 1099s issued by employers
- payments over predefined levels
- industries that historically misclassify workers

#### 4. 1099 Data is Over 2 Years Old

SWAs identified the data time lag as an obstacle for not applying for and using the 1099 data. The 1099 data is 2 years old when the SWAs receive it.

SWAs that were using the 1099 data told us the fact that the data is 2 years old does not hinder its effectiveness for identifying potential audit leads. The SWA officials stated that employers issuing 1099's listed on the tape in the year 2000 are more than likely still issuing 1099s to workers two years later. Also, we were told that while there is always a possibility that some employers may not be in business by the time they receive the tape, with so many 1099's associated with employers on the tape to choose from, the information (2 years old) is still very useful.

\* \* \* \* \*

We concluded that communicating the methods and strategies to the SWAs is effective when all parties are involved – the IRS, OWS, and successful SWAs.

### **Recommendation**

**2.** We recommend that the Assistant Secretary for Employment and Training communicate to the SWAs interested in applying for and using the 1099 data how to overcome:

- a. the complexity of the IRS application process;
- b. the difficulty in meeting the IRS safeguard requirements;
- c. obtaining the IT resources needed to make the 1099 data useful; and
- d. the perception that the age of the 1099 data is an obstacle to using it.

## **Agency Response**

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ETA officials responded that they have been pro-active in complying with this recommendation. On June 21, 2005, OWS coordinated a conference call with 18 states, the IRS, OIG and OWS. This call concentrated on explaining IRS safeguard requirements that states must comply with in order to receive the 1099-MISC data, the IT equipment needed, and a discussion of perceived problems in obtaining and using the data. The states of New York and Idaho discussed their experience in complying with these requirements and the benefit of using the data to uncover misclassified workers.

Finally, this matter was given a high priority at the National UI Tax Conference held in Boise, Idaho, during the week of August 2-5, 2005. An employee from the IRS made a plenary session presentation on the "New Beginning" of cooperation between the IRS and SWAs. In addition, two workshops were conducted on obtaining and using the 1099-MISC Extract Tape. The OWS, IRS, and the New Jersey SWA participated in these workshops and explained the enrollment process, safeguard requirements, and state benefits derived from using the data.

## **OIG Conclusion**

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The recommendation is resolved and closed. We determined that the action taken by ETA during the FY 2005 IRS enrollment period addresses the recommendation. ETA agreed to provide a copy of this report to those SWA's interested in applying for the 1099 data during the FY 2006 IRS enrollment period (See recommendation number 3). Therefore, no further corrective action is necessary.

## **Objective 4 – What results were achieved by SWAs using the 1099 data since the IRS made it available in 2002?**

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### **Result - SWAs using the 1099 data identified misclassified employees, recovered underreported UI tax contributions, and adjusted overreported UI tax contributions**

The results from UI field tax audits in which the SWAs used the 1099 data identified misclassified employees, recovered underreported UI tax contributions, and adjusted overreported UI tax contributions. As of December 2004, seven of the nine SWAs reported that they identified misclassified employees. While the other two SWAs said they used the 1099 data, they did not identify for audit any employers who had the potential of misclassifying employees. The seven SWAs started reporting results at staggered quarters beginning with the 4th quarter of calendar year 2002. As of December 2004, 7 SWAs reported that they identified 7,118 misclassified employees,



recovered \$1,492,521 underreported UI tax contributions, and adjusted \$328,634 overreported UI tax contributions associated with these audits<sup>2</sup>.

We requested from the SWAs the results from UI field tax audits that they conducted using the 1099 data. The following table provides the results as of December 2004:

SWA	Quarter Started Reporting Results	Number of Audits	Number of Audits Resulting in Change	Percent of Audits Resulting in Change	Number of Identified Misclassified Employees	Amount of Recovered Under-reported UI Tax Contributions	Amount of Adjusted Overreported UI Tax Contributions <sup>2</sup>
Arizona	4 <sup>th</sup> 2003	123	81	66%	1,291	\$ 74,091	\$ 905
Idaho	2 <sup>nd</sup> 2003	57	52	91%	1,434	\$ 177,500	\$ 0
Nebraska	4 <sup>th</sup> 2002	443	229	52%	557	\$ 754	\$ 33,346
New Jersey	2 <sup>nd</sup> 2004	9	6	67%	394	\$ 90,309	\$ 0
New York	1 <sup>st</sup> 2004	311	134	43%	1,510	\$ 880,278	\$ 287,020
South Carolina	2 <sup>nd</sup> 2003	97	69	71%	1,386	\$ 127,110	\$ 0
Wisconsin	2 <sup>nd</sup> 2003	164	78	48%	546	\$ 79,479	\$ 7,363
Totals		1204	649		7,118	\$ 1,492,521	\$ 328,634

The results listed in the table above demonstrate the effectiveness of the 1099 data in identifying misclassified workers as independent contractors. Based on the information provided by the SWAs, we found that continued updates on the results of SWAs using the 1099 data can be used to encourage non-using SWAs of its benefits as a tool to identifying misclassified employees and increase employer compliance with UI laws and regulations.

### Recommendation

3. We recommend that the Assistant Secretary for Employment and Training send a notification, along with a copy of this report, to SWAs before the start of the 2006 IRS enrollment period, encouraging them to apply for and use the 1099 data in their UI field tax audit program.

### Agency Response

ETA officials responded they will comply with this recommendation by sending a notification and copy of this audit report to all SWAs six months before the August 2006 enrollment period begins.

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<sup>2</sup> Overreported UI tax contributions represent incidents when mistakes are made and employers overpay their UI tax contributions. These overpayments result in adjustments.

**OIG Conclusion**

The recommendation is resolved and can be closed when we receive documentation that the notification and audit report have been sent out to each SWA.



Elliot P. Lewis  
December 31, 2004

## EXHIBITS

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EXHIBIT A

IRS Suggestions, Tips, and Examples for Preparing a Safeguard Procedures Report

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**SAFEGUARD PROCEDURES REPORT**

**NEED HELP?** The information below was written to provide suggestions, tips, and examples for use by State Employment Security Agencies in preparing a Safeguard Procedures Report (SPR). This information DOES NOT replace Publication 1075, Tax Information Security Guidelines for Federal, State, and Local Agencies, but is intended to serve as an additional tool.

You can obtain Publication 1075 via the Internet at: [www.irs.gov/pub/irs-pdf/p1075.pdf](http://www.irs.gov/pub/irs-pdf/p1075.pdf)

**SAFEGUARD PROCEDURES REPORT**

The SPR must be on an agency's letterhead, signed by the head of the agency or delegate, dated, and contain the following information:

**Suggestion:** The first page of your SPR is on your Agency's letterhead as if writing a letter to the Internal Revenue Service, Disclosure Officer. If you are not sure of the proper address, contact the IRS Governmental Liaison or Disclosure Officer in your State.

**Suggestion:** The format of your SPR can be set up with each topic as a heading, as shown below and in Publication 1075, Pages 27 and 28, OR in an out-line style specifying the safeguard requirement followed by the descriptive narrative.

**Suggestion:** See attached examples of Safeguard Procedures Reports.

***Responsible Officer(s)***

The name, title, address, and telephone number of the agency official authorized to request Federal Tax Information (FTI) from the IRS.

The name, title, address, and telephone number of the agency official responsible for implementation of the safeguard procedures.

**Tip:** Generally the employees designated by your agency to be "Responsible Officers" are also named in your Implementing Agreement. Therefore, the information for this requirement is already established

**before preparing the SPR. The “Responsible Officers” can be the same person, if desired by your Agency.**

### ***Location of the Data***

An organizational chart or narrative description of the receiving agency that includes all functions within the agency where FTI will be processed or maintained. If the information is to be used or processed by more than one function, then the pertinent information must be included for each function.

**Suggestion: An appropriate response to this SPR requirement is attaching an organizational chart of your Agency and providing sufficient narrative to describe the locations/units mentioned on the organizational chart where the Federal information will be handled.**

### ***Flow of the Data***

A chart or narrative describing the flow of FTI through the agency from its receipt through its return to the IRS or its destruction, how it is used or processed, and how it is protected along the way. (See safeguard requirements below.) Indicate if FTI is commingled or transcribed into data kept by the agency. Any data turned over to an agency contractor for processing must be fully disclosed and accounted for.

**Suggestion: The response to this SPR requirement should provide narrative describing how the information is handled from the time of receipt until it is destroyed. Using a step-by-step process makes it easier to identify the safeguard protections at each point of the processing of the data.**

### ***System of Records***

A description of the permanent record(s) used to document requests for, receipt of, distribution of (if applicable), and disposition (return to IRS or destruction) of the FTI (including tapes or cartridges). Agencies are expected to be able to provide an “audit trail” for information requested and received, including any copies or distribution beyond the original document or media.

**Suggestion: This requirement should describe the process for recording requests and receipt of Federal Tax Information. Computer or physical logs or other documentation is recommended. Who received the data, when, and in what format (tape, Prints)? When was it returned? When was it destroyed or returned to the IRS? Signatures of the employees receiving and recording destruction should be provided.**

### ***Secure Storage of the Data***

A description of the security measures employed to provide secure storage for the data when it is not in current use. Secure storage encompasses such consideration as locked files or containers, secured facilities, key or combination controls, off-site storage, and restricted areas.

**Suggestion: If your Agency has developed an internal document specifying how Agency information must be handled and it meets the requirements, it can be used for FTI. You can attach a copy of your existing procedures to the SPR, describing how it related to FTI.**

**Tip: Information regarding secure storage of Federal Tax Information is covered in Publication 1075, Sections 4.1 through 4.7 (Pages 9 through 15).**

### ***Restricting Access to the Data***

A description of the procedures or safeguards employed to ensure access to FTI is limited to those individuals who are authorized access and have a need to know.

Describe how the authorized recipient(s) will protect the information from unauthorized access when in use.

The physical barriers to unauthorized access should be described (including the security features of the facilities where FTI is used or processed) and systemic or procedural barriers.

### ***Disposal***

A description of the method(s) of disposal of the different types of FTI provided by the IRS when not returned to the IRS. The IRS will request a written report that documents the method of destruction and that the records were destroyed.

**Tip: Requirements for disposal of Federal Tax Information (FTI) are covered on Pages 31 and 32 of Publication 1075, Section 8.1 through 8.4.**

**Suggestion: An appropriate response to this requirement describes what methods your Agency will use to destroy FTI, such as: “Documents disposed of will either be returned to IRS or shredded in our (administrative) office. Shredding in our office will be witnessed by another staff person and documented in the logbook. Magnetic Tapes will be degaussed, witnessed by another staff person, and documented in the log book.”**

### ***Computer Security***

All automated information systems and networks that receive, process, store, or transmit sensitive but unclassified information (FTI) must have adequate safeguard measures in place to restrict access to sensitive data. **(See Section 5.6 – Computer Security and Section 5.7 – Common Criteria.)** These safeguards should address each applicable tier level.

#### A. Microprocessors and Mainframe Systems (Tier I)

Describe the systemic controls employed to ensure all IRS data is safeguarded from unauthorized access or disclosure. Include the procedures to be employed to ensure secure storage of the disks and the data, limit access to the disk(s), or computer screens and destruction of the data.

Additional comments regarding the safeguards employed to ensure the protection of the computer system are also appropriate including security features of the facility.

#### B. Local and Wide Area Networks, Internet, etc. (Tier II)

Describe in detail the security precautions undertaken if the agency's computer systems are connected or planned to be connected to other systems.

#### C. Personal Computer/Notebook/Laptops (Tier III)

In the event that FTI is (or is likely to be) used or processed by agency employees on personal computers, the Safeguard Procedures Report must include procedures for ensuring that all data is safeguarded from unauthorized access or disclosure. Include the procedures to be employed to ensure secure storage of the disks and the data, limit access to the disk(s), or computer screens and destruction of the data.

### ***Agency Disclosure Awareness Program***

Each agency receiving FTI should have an awareness program that annually notifies all employees having access to FTI of the confidentiality provisions of the IRC, a definition of what returns and return information is, and the civil and criminal sanctions for unauthorized inspection or disclosure. A description of the formal program should be included in the SPR.



**Tip:** Suggestions for methods to inform and educate employees regarding securing FIT are listed in Publication 1075, Page 25, starting at Section 6.2. Education for employees regarding protection of FIT can be incorporated with educating employees regarding protection of your Agency's taxpayer information.

**Suggestion:** The following is sample wording to assist Agencies in meeting the Agency Disclosure Awareness Program safeguarding requirements. See Page 28 (last paragraph) of Publication 1075 for reference to these requirements.

### **DISCLOSURE LIMITATIONS**

Unauthorized disclosure, printing, or publishing of any Federal return or return Information, or any information therefrom, is punishable by fine up to \$5,000 or imprisonment up to 5 years, or both, together with costs of prosecution. See Section 7213,

Internal Revenue Code (IRC) and 18 U.S.C. Section 1905. A person authorized to access IRS return or return information can be prosecuted under the federal "Anti-Browsing" Law, see IRC Section 7213A, if the information was accessed without a need to know. The offense constitutes a federal misdemeanor punishable by not more than 1 year in prison, or a \$1,000 fine, or both, plus cost of prosecution. In addition, IRC Section 7431 provides for civil damages of not less than \$1,000 per violation for unauthorized disclosure of such information, together with cost of prosecution.

It is unlawful for any person willfully to offer any item of material value in exchange for any return or return information and to receive as a result of such solicitation any such return or return information. Such action is punishable by fine up to \$5,000 or imprisonment up to 5 years, or both, together with costs of prosecution. See Section 7213 of the IRC and 18 U.S.C. Section 1905.

I acknowledge that I am aware of the above civil and criminal liabilities.

Name (please print) \_\_\_\_\_ Date \_\_\_\_\_

Signature \_\_\_\_\_

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**EXHIBIT B**

**SAFEGUARD PROCEDURES REPORT – CHECK LIST**

**SAFEGUARD PROCEDURES REPORT REVIEW CHECKLIST FOR STATE LABOR AGENCIES**

**AGENCY:** \_\_\_\_\_

Does the SPR contain the following information:

1. Name, title, and phone number of official responsible for implementing safeguard procedures.  
YES                      NO
2. On agency letterhead.  
YES                      NO
3. A chart or description of the organizational structure that includes all functions within the agency where federal tax information will be processed or maintained.  
YES                      NO
4. A chart or description of the flow of federal tax data through the organization from the point of receipt to its return to IRS or destruction, how it is used or processed, and how it is protected along the way (including pertinent delegation orders or equivalent authority permitting the use, handling, access, etc. at each point in the flow).  
YES                      NO
5. A determination whether federal tax data is commingled with or transcribed into data kept by the agency.  
YES                      NO
6. A description of the permanent record(s) used to document requests for, receipt of, distribution of (if applicable), and disposition (return to IRS or destruction) of the FTI (including tapes or cartridges).  
YES                      NO
7. A description of the security measures used to provide secure storage for the data when it is not in current use (locked files, containers, key or combination locks, etc.).  
YES                      NO

8. A description of the procedures or safeguards used to ensure access to federal tax data is limited to those individuals who are authorized access and have a need to know.

YES NO

9. A description of how the information will be protected from unauthorized access when in use by an authorized recipient.

YES NO

10. A description of the method(s) of disposal of the various types of FTI provided by the IRS, when not returned to IRS.

YES NO

11. A description of the safeguards in place for information systems and networks that receive, process, store, or transmit sensitive but unclassified information.

Specifically:

a. Tier 1 – describe the systemic controls employed to ensure all IRS data is safeguarded from unauthorized access or disclosure including procedures to be employed to ensure secure storage of the disks and data, limit access to the disk(s), or computer screens and destruction of the data. Also include protection of the computer system and security features of the facility.

b. Tier 2 – describe in detail the security precautions undertaken if the agency's computer systems are connected or planned to be connected to other systems.

c. Tier 3 – in the event that FTI is (or is likely to be) used or processed by agency employees on personal computers, the procedures for ensuring that all data is safeguarded from unauthorized access or disclosure. Also include procedures to be used to ensure secure storage and limit access to the disk(s) or computer screens and the destruction of the data.

YES NO (address each Tier)

12. A description of the activities of the agency to ensure that all employees having access to FTI and trained annually on the confidentially provisions of the IRC, a definition of what returns and return information is, and the civil and criminal sanctions for unauthorized inspection or disclosure.

YES NO

**REVIEWED BY:** \_\_\_\_\_

**DATE:** \_\_\_\_\_

**Revised 7/04**

## Appendices

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**BACKGROUND**

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The Federal-state Unemployment Compensation program, created by the Social Security Act of 1935, offers the first economic line of defense against the effects of unemployment. Through payments made directly to eligible unemployed workers, it ensures that at least a significant portion of the necessities of life most notably food, shelter, and clothing can be met on a week-to-week basis while a searching for work. The Unemployment Compensation program is almost totally funded by employer taxes, either Federal or state. Unfortunately, not all employers voluntarily report all UI-covered wages or pay their fair share of UI taxes as required by law.

Employers who misclassify employees as independent contractors reduce tax liability by not having to pay state and Federal UI, Social Security, and Medicare taxes. Employers also avoid the costs of withholding income taxes or providing fringe benefits as they do for employees. Other incentives for misclassifying employees include the costs associated with minimum wage laws, workers' compensation insurance, and collective bargaining. When an employee is misclassified, tax revenues are lost.

A UI field tax audit is a systematic examination of an employer's books and records using generally accepted auditing standards and procedures, and it covers a specified period of time during which the employer is liable for reporting under the law. A well-planned and cost-effective UI field tax audit program is an efficient means of ensuring compliance with state unemployment compensation law and timely collection of taxes on an equitable basis. Section 3679 of the Employment Security Manual, Selection of Employers for Audit, reads "States are encouraged to maintain audit selection criteria that include indices that potentially reflect noncompliance such as high employee turnover, sudden growth or decrease in employment, type of industry, location (geography) of employers, prior reporting history, results of prior audit, and adjudicated determinations."

OIG's 1999 report (Report Number. 03-99-006-03-315) on SWA's best practices for improving the effectiveness of UI field tax audits found the use of 1099 data to be an effective tool for identifying employers who misclassified workers as independent contractors. Believing this to be a practice that all states should be using, we conducted a survey of 52 SWAs to determine if they would be interested in using the 1099 data as a tool in audit selection. Our survey disclosed that 35 SWAs would use 1099 data if the IRS made it available.

Therefore, OWS met with IRS officials and requested them to develop a 1099 extract tailored for SWAs. After several meetings, the IRS developed the 1099-MISC Extract to provide Non-employee Compensation Federal Tax Information (Form 1099-MISC, Box 7) to the SWAs. The payment information provided on the extract is limited to 1099-MISC, Box 7 information, and the extract tape would only contain records if there was data in Box 7. Non-payment information would only include payer and payee entity information. OWS and IRS representatives introduced the 1099 extract tape to the SWAs at the UI Tax Conference in July 2001. At the conference, IRS representatives explained the process required for government entities requesting any Federal tax information.

As with any Federal tax information, to obtain 1099 data the SWA's are required to apply annually with the IRS, negotiate an individual agreement with the IRS, and meet various requirements to ensure the data is safeguarded against unauthorized use. The IRS application period is 1-2 months, usually occurs in August and September, and if all requirements are met, the data is usually provided in May of the following year. The first period to apply for the 1099 extract was August 2001, in which the IRS made the tape available in May 2002.

During the period June and July 2004, OWS and IRS officials conducted regular meetings to address their concerns about the low number of SWAs using the 1099 data. As a result, OWS and IRS initiated further outreach efforts by conducting telephone conference calls with SWAs in August 2004 to encourage them to apply to the IRS for the 1099 data.



## **OBJECTIVES, SCOPE, AND METHODOLOGY**

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### **Objectives**

The purpose of our audit was to assess the extent of SWAs use of the 1099 data. Specifically, we wanted to determine:

1. How many SWAs were using the 1099 data to identify potential employers misclassifying employees as independent contractors?
2. What were the obstacles that influenced the SWA's not to apply for and use the 1099 data?
3. What were the methods and strategies used by the SWAs that were successful in obtaining and using the 1099 data?
4. What results were achieved by SWAs using the 1099 data since the IRS made it available in 2001?

### **Scope and Methodology**

To determine the extent of SWAs using the 1099 data, we conducted telephone interviews with UI field tax audit representatives from 52 SWAs in September and October 2001, the time when the IRS first made the 1099 data available. We did not include California's SWA because it was already using 1099 data in its UI field tax audit program before our 1999 audit recommended it. This audit focused on the use and results of the 1099 data by the SWAs that enrolled to receive the data as a result of our 1999 audit recommendation.

During the telephone interviews with the representatives from the 52 SWAs, we also identified the obstacles that influenced the decisions of SWAs that decided not to apply for the 1099 data. In June 2002, the month after the 1099 extract tape was expected to be provided to the 19 SWAs that applied, we contacted officials from these SWAs to determine the status of their progress. Ten of these SWAs were either not successful in obtaining the data or they obtained the data, but decided not to use it. These SWAs also provided us obstacles in obtaining and using 1099 data.

To determine methods or strategies to overcome the obstacles, we developed a questionnaire designed to address the obstacles and visited UI field tax representatives of four SWAs that were successful in obtaining and using the IRS Form 1099 data – Nebraska, Wisconsin, South Carolina, and Idaho. We selected these SWAs because they were the earliest users of the 1099 data with results. Specifically, we interviewed the individuals responsible for preparing the IRS application, addressing the IRS security requirements, and providing the programming support necessary to properly

utilize the tape. We conducted these interviews in November and December 2003. Additionally, IRS and OWS officials invited us to participate in their monthly telephone conferences between June and August 2004 to provide the results of our interviews with the SWAs. These telephone conferences provided us additional methods and strategies that SWAs can use to overcome obstacles in obtaining and using the 1099 data.

To determine the results achieved, we contacted officials in each of the SWAs that were successful in using the 1099 data and requested for each quarter, the number of audits in which the 1099 data was used, the number of misclassified employees identified, and the effect on the UI tax. We did not perform tests to determine the accuracy of the data the SWAs provided. The reported data covered October 2002 through December 2004.

We did not contact officials from the SWA in California or use the results of their 1099 data because we wanted to measure the use and results of the data by SWAs after the 1999 audit recommended it. The 1999 audit identified the California as the only SWA using 1099 data in its UI field tax audits.

We conducted this audit in accordance with Government Auditing Standards.

**ACRONYMS AND ABBREVIATIONS**

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DOL	U.S. Department of Labor
ETA	Employment and Training Administration
FTI	Federal Tax Information
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IT	Information Technology
OIG	Office of Inspector General
OWS	Office of Workforce Security
SPR	Safeguard Procedures Report
SWA	State Workforce Agencies
UI	Unemployment Insurance
1099 data	IRS 1099-MISC Income Data

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RESPONSE TO THE DRAFT REPORT


U.S. Department of Labor

Assistant Secretary for  
Employment and Training  
Washington, D.C. 20210



SEP 30 2005

MEMORANDUM FOR: ELLIOT P. LEWIS  
Assistant Inspector General  
for Audit

FROM: EMILY STOVER DeROCCO 

SUBJECT: Audit of State Workforce Agencies'  
Use of IRS Form 1099-MISC Data to  
Identify Misclassified Workers -  
Draft Report No. 03-05-005-03-315

Thank you for the opportunity to review and comment on the draft report, "Use of Internal Revenue Service (IRS) Form 1099-MISC Data to Identify Misclassified Workers."

We agree with the overarching audit findings that communicating with the IRS and use of the IRS 1099-MISC Extract Tape are effective tools for identifying employers that misclassify workers as independent contractors. Through misclassification of workers, employers may avoid paying employment taxes and exclude workers from benefits such as unemployment insurance (UI), workers compensation, health insurance, and retirement. The Employment and Training Administration (ETA) takes this issue very seriously and offers the following comments on the audit recommendations:

- 1. Provide assistance and guidance to the 16 new State Workforce Agencies (SWAs) that applied for the 1099 data during the 2004 IRS application period to increase the possibility that they are successful in obtaining and using the data.**

Agency Response: ETA has taken action to comply with this recommendation. Beginning with conference calls in August of 2004, personnel from the Office of Workforce Security (OWS) worked very closely with the IRS, OIG and SWAs to help insure successful use of these data. OWS coordinated a follow-up conference call on March 23, 2005, specifically for the benefit of the new states requesting the data from IRS. The goal of this call was to provide guidance to state information technology staff responsible for receiving, sorting, and manipulating the 1099-MISC data. In advance of the call, each participating state was given a sample data record in ASC11 format, and a COBOL picture of the data. An IRS programmer participated and explained each of these information items and answered technical questions. In addition, tax and technical staff from states that had been successful in obtaining and using the data participated in the call to share their knowledge and experience with it.

2. **Communicate to the SWAs interested in applying for and using the 1099-MISC data how to overcome: the complexity of the IRS application process; the difficulty in meeting the IRS safeguard requirements; obtaining the IT resources needed to make the 1099 data useful; and the perception that the age of the 1099 data is an obstacle to using it.**

Agency Response: ETA has been proactive in complying with this recommendation. On June 21, 2005, OWS coordinated a conference call with 18 states, the IRS, OIG and OWS. This call concentrated on explaining IRS safeguard requirements that states must comply with in order to receive the 1099-MISC data, the IT equipment needed, and a discussion of perceived problems in obtaining and using the data. Officials from New York and Idaho discussed their experience in complying with these requirements and the benefit of using the data to uncover misclassified workers.

Finally, this matter was given a high priority at the National UI Tax Conference held in Boise, Idaho, during the week of August 2-5, 2005. An employee from the IRS made a plenary session presentation on the “New Beginning” of cooperation between the IRS and SWAs. In addition, two workshops were conducted on obtaining and using the 1099-MISC Extract Tape. The OWS, IRS, and the New Jersey Department of Labor participated in these workshops and explained the enrollment process, safeguard requirements, and state benefits derived from using the data.

3. **Send a notification, along with a copy of this report, to SWAs before the start of the 2006 IRS enrollment period, encouraging them to apply for and use the 1099 data in their UI field tax audit program.**

Agency Response: ETA will comply with this recommendation by sending a notification and copy of this audit report to all SWAs six months before the August 2006 enrollment period begins. This should allow ample time for the SWAs to contact their IRS Governmental Liaison to discuss the necessary procedures, agreements and requirements involved in obtaining and using the 1099-MISC data.