

UC MERCED AUDIT AND ADVISORY SERVICES

October 12, 2018

To: Veronica Mendez – Vice Chancellor and Chief Financial Officer

Subject: Independent Contractors Audit

Ref: Audit Report No. M19A008

At the request of Human Resources, Internal Audit has completed an audit of independent contractors at UC Merced.

We appreciate the help we received from staff in Human Resources and Procurement Services during this audit. If you have any questions, please feel free to contact me.



Todd Kucker
Director of Internal Audit

Attachment

cc Senior Vice President and Chief Compliance and Audit Officer Bustamante
Chancellor Leland
Associate Chancellor and Senior Advisor Putney
Assistant Vice Chancellor and Controller Riley
Chief Procurement Officer Dubroff
Director Elizalde
Director Ellington
Manager Patino

**UNIVERSITY OF CALIFORNIA, MERCED
AUDIT AND ADVISORY SERVICES**

Independent Contractors Audit
Report No. M19A008

October 12, 2018

Work completed by:
Brandi Masasso – Staff Auditor
Todd Kucker – Director

Management Summary

During early 2018, the UC issued new guidance related to independent contractors which increased Human Resources involvement in determining whether a worker should be classified as an employee or independent contractor. As Human Resources involvement increased, concerns were identified that past practices had resulted in misclassifying some independent contractors. As a result, Internal Audit completed an audit of independent contractors where we reviewed the many different types of work completed by independent contractors and identified areas which needed further evaluation by Human Resources.

The following table shows the areas and work which Human Resources should further evaluate to determine whether independent contractors should have been classified as employees.

Description of payments to independent contractors	Estimate of Amounts Paid during FY 2018
Parent Liaisons and Instructors in the Center for Educational Partnerships	\$52,000
Writing Instructors in Social Sciences, Humanities, and the Arts	\$46,000
Mentors for Students	\$16,000
Payments to local teachers to attend special workshops	\$10,000
Scientific Writing Services	\$3,000
Sports Officials for Recreational Sports	\$1,000
Total of identified areas of concern	\$128,000
Estimated % of amounts spent with contractors that need further review	4%

Based upon the audit testing, we concluded that processes for properly classifying individuals as independent contractors need improvement. In the report below, we recommend process improvements under the following headings:

- Employee vs. independent contractor evaluations should be completed before approving work by an independent contractor
- Human Resources' approval of independent contractors

Audit Objectives and Scope

At the request of campus leadership, Internal Audit has completed an audit of independent contractors. The purpose of the audit was to identify independent contractors who should have been classified as employees and to recommend process improvements for correctly classifying employees and independent contractors.

The audit objectives were:

- To determine which departments and programs utilize independent contractors at UC Merced;
- To review the current processes for evaluating whether an individual should be paid as an independent contractor or hired as an employee; and,

- To review the work completed by independent contractors and to identify areas which need further evaluation by Human Resources to determine whether the independent contractors should have been classified as employees.

To fulfill the objectives, Internal Audit completed the following testing:

- We discussed current procedures for determining whether an individual is an independent contractor or employee with staff in Procurement and Human Resources.
- We reviewed independent contractors who received a Form 1099 as a result of work performed during calendar year 2017. 307 individuals were paid more than \$600 for non-employee compensation during 2017 so they received 1099's from UC Merced.
- We selected a sample of independent contractors whose work was charged to consulting expense in the financial system and reviewed that the independent contractor checklists were completed as evidence that the relationship was properly evaluated.
- We reviewed "one-time payee" payments to individuals to determine whether the individuals should have been classified as employees.

Overall, the audit testing was designed to identify the many independent contractors who work for UC Merced and to evaluate whether Procurement and department purchasers correctly determine whether the individual should be paid as an independent contractor or employee. The testing included independent contractors paid during January 2017 through June 2018.

Background

UC policies and IRS guidance explain when an individual should be hired as an employee rather than being paid as an independent contractor. Employers are required to pay a portion of an employee's Social Security, Medicare, and other payroll taxes. When the individual is classified as an independent contractor, the individual is responsible for paying these amounts in their self-employment taxes. Incorrectly classifying an employee as an independent contractor can result in penalties, repayments of taxes incorrectly paid by the individuals, and back pay related to missed employee benefits. As the amounts are based upon compensation which continues to grow during the time the individual was misclassified, the potential amounts to be repaid can be significant.

Whether a worker is an independent contractor or employee depends on the facts in each situation. To determine how to properly classify a worker, three categories should be considered:

Behavioral Control – A worker is an employee when the university has the right to direct and control the work performed by the worker, even if that right is not exercised. This relates to whether the university provides training related to the work and whether the university dictates when and where the work should be performed.

Financial Control – Correctly classifying a worker depends upon the degree to which the university has the right to direct and control the financial and business aspects of the worker's job. For example, an independent contractor would generally be free to seek out other business opportunities. Also, independent contractors are often paid a flat fee for a job while employees are generally paid a guaranteed wage based upon the hour, week, or other period of time.

Relationship – The type of relationship depends upon how the worker and university perceive their interaction with one another. This requires considering details such as whether there is a written contract, whether employee-type benefits are offered, the permanency of the relationship, and whether the services are a key activity of the university.

The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work, not *what* will be done and *how* it will be done.

In the past, Procurement Services worked with departments to complete this evaluation by using an Independent Contractors checklist. Whenever an individual was being set up to be paid as an independent contractor, the checklists were completed and included in the Procurement system. During January 2018, the UC issued new guidance related to independent contractors, which reads: “In general, the determination regarding employee versus independent contractor status is made by each location according to local policy. However, in cases where it is difficult to determine a worker's correct status the Human Resources Department or the Office of the President Payroll Coordination and Tax Services Office, in coordination with the Office of General Counsel, can provide assistance in determining whether an employer-employee relationship exists.” Along with the new guidance, the Independent Contractor checklist was updated to include a check box for “Consulted with HR” in the final determination.

As Human Resources began to review whether workers should be classified as independent contractors, there were concerns regarding past practices. As a result, Internal Audit reviewed current procedures to identify areas for improvement.

Audit Results

As a result of this audit, we identified various departments and programs which need to be reviewed by Human Resources to determine whether individuals have been incorrectly classified as employees. Based upon the 2017 1099 report, \$3,233,519 of non-employee compensation was paid to individuals. After discussions with the Compensation Manager, we recommend further evaluation by Human Resources in the following areas:

Description of payments to independent contractors	Estimate of Amounts Paid during FY 2018
Parent Liaisons and Instructors in the Center for Educational Partnerships	\$52,000
Writing Instructors in Social Sciences, Humanities, and the Arts	\$46,000
Mentors for Students	\$16,000
Payments to local teachers to attend special workshops	\$10,000
Scientific Writing Services	\$3,000
Sports Officials for Recreational Sports	\$1,000
Total of identified areas of concern	\$128,000
Estimated % of amounts spent with contractors that need further review	4%

The amounts in the table are a rough estimate of how much was paid to these independent contractors during fiscal year 2017 – 2018.

Based upon our audit testing, we identified the following issues:

- Department purchasers have the ability to process orders less than \$5,000. Department purchasers are paying amounts to individuals without evaluating whether the individual should be paid as an employee or independent contractor.
- In the past, evaluation processes have not always accurately identified when an individual should be paid as an employee rather than as an independent contractor.

Our recommendations and the resulting management corrective actions are discussed below.

Observations and Recommendations

1. Employee vs. independent contractor evaluations should be completed before approving work by an independent contractor

Independent contractor checklists have been created to help purchasers evaluate whether the individuals should be paid as an employee or independent contractor. We noted that many agreements and payments to individuals are managed by department purchasers without Procurement department involvement. Amounts were paid to individuals as independent contractors without the checklist being completed.

Most department purchasers handle payments to individuals on a very infrequent basis. As training regarding orders with independent contractors is also infrequent, department purchasers were not aware of the risk and potential penalties resulting from misclassifying independent contractors. The new policy requiring Human Resources to be involved in classifying independent contractors has not been adequately communicated to campus departments. As department purchasers are tasked with the timely processing orders for their campus customers, the question of whether the individual should be classified as an employee was not considered.

The incorrect classification of independent contractors can result in the university being liable for their employment taxes. Based upon the amounts paid to independent contractors, these amounts could be significant.

We recommend that Human Resources and Procurement work together to communicate the requirements to department purchasers. Department purchasers should receive training so they are able to identify when Human Resources should be involved in evaluating whether an individual can be paid as an independent contractor.

Management Corrective Action

Human Resources and Procurement Services will work together to train department buyers regarding the requirements of the UC guidance, “Independent Contractor Guidelines for

Federal Tax Purposes”, that was sent out earlier in 2018. This training will explain the new Independent Contractor checklist and explain when Human Resources should be consulted.

This action plan will be completed by March 31, 2019.

2. Human Resources’ approval of independent contractors

During our testing, we noted instances where employees and purchasers came to the wrong conclusions after completing the independent contractor checklists. The checklists were completed to document the characteristics about the work (behavioral control, financial control, and relationship). By discussing particular checklists with Human Resources, we determined that after completing the checklists, the purchasers had incorrectly classified some individuals as independent contractors.

The correct classification of independent contractors and employees requires expertise. The recent change to the UC policy requires Human Resources involvement in order to provide this judgement. In the past, Procurement and department purchasers were responsible for determining whether an individual could be paid as an independent contractor.

We also noted that independent contractor checklists were sometimes not reviewed and approved. An employee would sometimes fill out the checklist, but there was no evidence that a business officer or supervisor in the department reviewed the accuracy of the form.

While the checklist was supposed to be a control for preventing the misclassification of independent contractors, without Human Resources involvement, it was not effective. As the new UC guidance requires, Human Resources should be involved in determining whether a worker is classified as an independent contractor or employee.

Management Corrective Action

Human Resources and Procurement Services will put together written guidance for purchasers to identify when Human Resources should be involved in the independent contractor determination. The risks and impact of misclassification will be considered in determining the level of Human Resources involvement.

The written procedures will be completed by January 31, 2019.