Department of Legislative Services
Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 1192 (Senators Manno and Middleton)
Finance

Labor and Employment - Unemployment Insurance - Independent Contractors and Severance Pay

---

This emergency bill incorporates factors that are currently specified in regulation and considered when determining independent contractor status for purposes of the State unemployment insurance (UI) law into statute. However, the bill substantively alters how these factors are used by the Secretary of Labor, Licensing, and Regulation in making the determination. For parts A and B of the "ABC test," *each of these factors must be met* – rather than considered, as under current law and regulation – in order for a determination of independent contractor status to be made. Part C of the test also has factors that each must be met, under specified circumstances. The bill also explicitly exempts an individual that receives severance pay from UI laws related to such payments if the payment is made in exchange for the individual signing a release of claims when leaving employment.

Fiscal Summary

State Effect: State expenditures increase to the extent that (1) individuals paid by the State as independent contractors are instead considered employees and subsequently file for and receive UI benefits and (2) costs for projects funded in whole or in part by the State increase because individuals currently classified as independent contractors are instead classified as employees. State expenditures for UI claim reimbursement also may increase due to the severance pay exemption. The amounts cannot be reliably estimated at this time. Revenues are not affected.

Unemployment Insurance Trust Fund Effect: The bill is a substantive change to the process through which an individual's independent contractor status is determined for purposes of the State UI law. Unemployment Insurance Trust Fund (UITF) revenues (from employer UI taxes) and expenditures (for UI benefit payments) increase to the extent that additional individuals are classified as employees rather than independent contractors. The amounts cannot be reliably estimated at this time; however, UITF revenue from existing employer taxes was about $567 million in 2016. Any substantive change potentially represents millions of dollars annually. UITF revenues and expenditures also increase due to the severance pay exemption.

Local Effect: Local government expenditures are affected in the same way as the State government. Revenues are not affected.

Small Business Effect: Meaningful. Small businesses pay additional UI taxes under the bill to the extent that (1) additional individuals are classified as employees rather than independent contractors and/or (2) the severance pay exemption applies, as discussed below.

Analysis

Bill Summary/Current Law:

Current Law: For purposes of the State UI law, employment is presumed to be covered employment if:

- regardless of whether the employment is based on the common law relation of master and servant, the employment is performed for wages or under a contract of hire that is written or oral or express or implied; and

- the employment is performed either in the State or partly in the State, or in connection with the State, subject to specified conditions.

To overcome the presumption of employment, an employer must establish that the person performing services is either an independent contractor or is specifically exempted under the law. Work that an individual performs under any contract of hire is not covered employment if the Secretary is satisfied that:

A. the individual who performs the work is free from control and direction over its performance both in fact and under the contract;
B. the individual customarily is engaged in an independent business or occupation of the same nature as that involved in the work; and
C. the work is outside of the usual course of business of the person for whom the work is performed or performed outside of any place of business of the person for whom the work is performed.

This is often referred to as the "ABC" test. Department of Labor, Licensing, and Regulation (DLLR) regulations incorporate these three conditions and specify circumstances evidencing the conditions, which "include, but are not limited to, the items listed after each condition." DLLR advises that the "circumstances evidencing the conditions" are factors to *consider* when determining whether work is covered employment; each factor is not intended or treated as a litmus test. This was also noted by the Maryland Court of Appeals in *DLLR v. Fox, 346 Md. 484, 697 A.2d 478 (1997)* which stated that "COMAR B(3)(c) lists ten factors to consider in evaluating whether the person performing the service is customarily engaged in an independent business."

The Bill: The "circumstances evidencing the conditions" (factors) in current DLLR regulations are incorporated into the statutory ABC test. As written, *each of the incorporated factors must be met* in parts A and B of the test, rather than *considered as part of an evaluation* of independent contractor status in each part of the test. Part C of the test also has factors that must be met, if the work is outside of the usual course of business of the person for whom the work is performed. Part C can also still be met under an existing condition if the work is performed outside of any place of business of the person for whom the work is performed.

Under the bill, work that an individual performs under any contract of hire is not covered employment if the Secretary is satisfied that:

A. the individual who performs the work is free from control and direction over its performance both in fact and under the contract, as evidenced by the employing unit:

- not requiring the individual to comply with detailed instructions about when, where, and how the individual is to work;
- not training the individual to perform the service in a particular manner or using a particular method determined by the employing unit;
- not establishing set hours of work for the individual performing the service;
- not establishing a schedule or routine for the individual performing the service; ***and***
- being prohibited from discharging the individual for failure to obey the employing unit's specific instructions on how the service is to be performed;

B. the individual customarily is engaged in an independent business or occupation of the same nature as that involved in the work, as evidenced by the individual:

- maintaining a business listing in the telephone directory;
- having the individual's own place of business;

  - having a financial investment in a related business and being able to incur a loss in the performance of the service;
  - having the individual's own equipment needed to perform the service;
  - determining the price of the service to be performed;
  - employing others to perform the service;
  - carrying the individual's own liability or workers' compensation insurance, or both;
  - performing the service for more than one unrelated employer at the same time;
  - setting the individual's own hours; ***and***
  - being paid by the job; and

C. the work is:

  - outside of the usual course of business of the person for whom the work is performed, as evidenced by:

    - the individual performing the work off the employing unit's premises;
    - the individual performing work that is not integrated into the employing unit's operation; ***and***
    - the service performed being unrelated to the employing unit's business; *or*

  - performed outside of any place of business of the person for whom the work is performed.

Severance Pay

Current Law: For each week that the Secretary finds an individual who otherwise is eligible for UI benefits receives or is eligible to receive dismissal payment or wages in lieu of notice (severance pay), regardless of whether the payment is required by law:

- if the payment at least equals the individual's weekly benefit amount, the individual is disqualified from receiving UI benefits; or
- if the payment is less than the individual's weekly benefit amount, the individual may receive UI benefits reduced by the amount of the payment.

Dismissal payment or wages in lieu of notice must be allocated to a number of weeks following separation from employment that equals the number of weeks of wages received. DLLR regulations are silent on whether or not these provisions apply to a severance payment that an individual receives in exchange for the individual signing a release of claims when leaving employment. (DLLR advises that it currently must determine the amount of severance pay that was for separation and the amount that was for release of claims.)

The Bill: These provisions do not apply to a dismissal payment or wages in lieu of notice that an individual receives in exchange for the individual signing a release of claims when leaving employment.

Background: UI provides temporary, partial wage replacement benefits to individuals who are unemployed through no fault of their own and who are willing to work, able to work, and actively seeking employment. Both the federal and state governments have responsibilities for UI programs. Funding for the program is provided by employers through UI taxes paid to both the federal government for administrative and other expenses and to the states for deposit in their UI trust funds. Using federal tax revenues, the UI program is administered pursuant to state law by state employees. Each state law prescribes the tax structure, qualifying requirements, benefit levels, and disqualification provisions. These laws must, however, conform to broad federal guidelines.

A Maryland employer's State tax rate is based on the employer's unemployment history and ranges within a certain percentage of the total taxable wages of the employer's employees. The taxes are deposited in UITF and can be used only to pay benefits to eligible unemployed individuals. A Maryland employer is assigned one of three different types of tax rate: the new account rate; the standard rate; or the experience (earned) rate. After an employer has paid wages to employees in two rating years prior to the computation date, the business is entitled to be assigned a tax rate reflecting the amount of UI benefits claimed by former employees.

An employer's earned rate (benefit ratio) is determined by finding the ratio between the benefits charged to the employer's account and the taxable wages reported in the three fiscal years prior to the computation date. The benefit ratio is then applied to the tax rate table in effect for the year. The table in use for a particular calendar year is determined by measuring the adequacy (on September 30 of the immediately preceding year) of UITF to pay benefits in the future. There are six tables, ranging from the lowest (Table A) to the highest (Table F).

If the balance of UITF exceeds 5.0% of total taxable wages in the State (as measured on September 30 of the current year), the lowest rate table (Table A) is used to calculate employer rates for the following calendar year. When UITF is depleted to the point the balance is less than 3.0% of the taxable wages, the highest rate table (Table F) is used to determine employer rates. State and local governments and some nonprofit organizations reimburse UITF, dollar for dollar, in lieu of paying UI taxes. **Exhibit 1** shows the six rate tables that determine the amount charged to each employer. Taxable wages are defined as the first $8,500 earned by each covered employee in a calendar year. Table A is in effect for 2017.

Exhibit 1
Unemployment Insurance Tax Rates

Table	Ratio of UITF to Taxable Wages	Minimum Rate	Maximum Rate	Taxes Per Employee Minimum	Taxes Per Employee Maximum
A	UITF exceeds 5.0%	0.3%	7.5%	$25.50	$637.50
B	UITF exceeds 4.5%, up to 5.0%	0.6%	9.0%	51.00	765.00
C	UITF exceeds 4.0%, up to 4.5%	1.0%	10.5%	85.00	892.50
D	UITF exceeds 3.5%, up to 4.0%	1.4%	11.8%	119.00	1,003.00
E	UITF exceeds 3.0%, up to 3.5%	1.8%	12.9%	153.00	1,096.50
F	UITF is 3.0% or less	2.2%	13.5%	187.00	1,147.50

UITF: Unemployment Insurance Trust Fund

Source: Department of Legislative Services

Proposed Regulations

In December 2016, DLLR proposed a regulation to update and clarify how the Secretary makes determinations of independent contractor status. According to DLLR, the proposed regulation "revises and expands upon the current factors that may be considered by the Secretary in making the three required determinations and clarifies that each determination is based on the totality of the circumstances." DLLR further indicated that the proposed regulation does not substantively change the applicable test for worker classification. A Department of Legislative Services (DLS) analysis of the proposed regulation is available on the DLS website.

Also in December 2016, DLLR proposed a regulation to reflect Chapter 383 of 2009 and also "to clarify that severance paid in exchange for a release of claims is fully deductible" from UI benefit payments. Existing DLLR regulations, in addition to not reflecting Chapter 383, are silent on this particular issue. A DLS analysis of the proposed regulation is also available on the DLS website.

Both proposed regulations were published in the February 3, 2017 issue of the *Maryland Register*. On March 10, 2017, the Joint Committee on Administrative, Executive, and Legislative Review requested that DLLR delay final adoption of the proposed regulations in order to allow the committee an opportunity to conduct more detailed studies of the proposed regulations. Notwithstanding this requested delay, DLLR may adopt the regulations following the later of 105 days after the initial publication in the *Maryland Register* – in this case, mid-May 2017 – or 30 days after notifying the committee of its intent to adopt the regulations.

State Expenditures:

Worker Classification: The State as an employer reimburses UITF dollar for dollar for UI benefits paid to individuals previously employed by the State. The bill likely results in more individuals being considered employees rather than independent contractors, including some individuals who are paid by the State. These individuals are eligible for UI benefits under the bill if they are otherwise eligible under current law. In addition, the State funds some or all of the costs of many projects (construction, information technology, *etc.*). Increasing the number of employees, rather than independent contractors, on a particular project may increase the project's overall costs.

Therefore, State expenditures increase to reimburse UITF to the extent that individuals paid by the State as independent contractors are instead considered employees and subsequently file for and receive UI benefits. State expenditures also may increase to the extent that costs for projects funded in whole or in part by the State increase because individuals currently classified as independent contractors are instead classified as employees. The amounts cannot be reliably estimated at this time.

Severance Pay: As noted above, the State as an employer reimburses UITF dollar for dollar for UI benefits paid to individuals previously employed by the State. The bill allows for additional UI benefits to be paid in certain circumstances related to severance pay. Therefore, State expenditures to reimburse UITF for UI benefits paid due to the bill may increase. The amounts cannot be reliably estimated at this time.

As a point of reference, DLLR indicates that 198 claims were filed by employees with severance pay reported by their reimbursing employers (which may include the State) of $623,200 in fiscal 2016. The severance pay reduced UI benefits paid from UITF by $261,000 (reducing benefits paid reduces employer reimbursements, *i.e.,* UITF revenues).

UITF Effect:

Worker Classification: The bill is a substantive change to the process through which an individual's independent contractor status is determined for purposes of the State UI law. The conjunctive test for independent contractor determinations significantly narrows the circumstances under which the Secretary may determine that an individual is an independent contractor. This results in more individuals being classified as employees, for whom UI taxes must be paid and UI benefits may be paid.

Therefore, UITF revenues (from employer UI taxes) and UITF expenditures (for UI benefit payments) increase to the extent that additional individuals are classified as employees rather than independent contractors. The amounts cannot be reliably estimated at this time; however, UITF revenue from existing employer taxes was about $567 million in 2016: any substantive change potentially represents millions of dollars annually.

Severance Pay: The bill allows for additional UI benefits to be paid in certain circumstances related to severance pay. Therefore UITF expenditures also increase to provide additional UI benefits and UITF revenues increase from the related UI taxes and reimbursements. The amounts cannot be reliably estimated at this time.

As a point of reference, DLLR indicates that 7,704 claims were filed by employees with severance pay reported by their employers of $25.8 million in fiscal 2016. The severance pay reduced UI benefits paid from UITF by $9.3 million (reducing benefits paid reduces benefit charges/UI taxes and employer reimbursements, *i.e.*, UITF revenues).

Local Expenditures: Local governments as employers reimburse UITF dollar for dollar for UI benefits paid to individuals they previously employed. The bill affects local government expenditures in the same way as the State government, as discussed above.

Small Business Effect: Small businesses that use independent contractors likely pay additional UI taxes due to the increased scope of covered employment under the bill. The range of potential taxes, per employee, is shown in Exhibit 1. In addition, small businesses that offer severance pay in conjunction with a waiver of liability pay additional UI taxes from increased benefit charges, which affect an employer's tax rate for three years following the benefit charges.

Additional Comments: The bill creates an inconsistency with the provisions in the Workplace Fraud Act for determining independent contractor status (that act also uses the ABC test). There may also be greater inconsistencies between UI determinations and determinations made by the Internal Revenue Service, the Comptroller, and the Workers' Compensation Commission, which follow the common law test.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Labor, Licensing, and Regulation; Comptroller's Office; Internal Revenue Service; Department of Legislative Services

Fiscal Note History: First Reader - March 24, 2017
mm/ljm

Analysis by: Stephen M. Ross

Direct Inquiries to:
(410) 946-5510
(301) 970-5510