Department of Legislative Services

Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

House Bill 70 (Delegate Glenn)
Economic Matters and Ways and Means

Construction Industry Employee Misclassification Act

This bill prohibits construction industry employers from failing to properly classify an individual as an employee with the intent to evade payment of wages, benefits, taxes, or other contributions as required by law. The bill establishes investigation and administrative hearing procedures and numerous penalties for noncompliance. The bill also establishes reporting, filing, and withholding requirements.

Filing and withholding requirements take effect June 1, 2008, applying to all tax years beginning after June 30, 2008. The remainder of the bill takes effect October 1, 2008.

Fiscal Summary

State Effect: General fund revenues could increase by $6.0 million in FY 2009 as a result of penalties assessed on noncompliant employers. Future year revenues reflect annualization and progressive compliance among employers. Potential marginal impact on income tax revenues.

Department of Labor, Licensing, and Regulation general fund expenditures could increase by $2.2 million in FY 2009 for investigative staff to administer and enforce the requirements of the bill, with other State agencies realizing additional minimal expenditures. Potential moderate increase in general fund expenditures due to the bill's penalty provisions. Future years reflect annualization.

($ in millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
GF Revenue	$6.0	$10.1	$8.6	$7.3	$6.2
GF Expenditure	2.2	2.7	2.9	3.0	3.2
GF/SF Exp.	-	-	-	-	-
Net Effect	$3.8	$7.4	$5.7	$4.3	$3.1

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Potential minimal increase in local income tax revenues. Potential moderate increase in revenues and expenditures due to the bill's penalty provisions.

Small Business Effect: Potential meaningful for small construction businesses. The bill may increase the relative competitiveness of employers that currently comply with classification requirements, while increasing expenditures among those small businesses that do not properly classify employees.

Analysis

Bill Summary: For purposes of enforcement, the bill creates a presumption of an employee-employer relationship in construction service unless a contract or service meets specified criteria. A construction industry employer or their agent is prohibited from misclassifying an employee with the intent of evading payment of wages or benefits.

The bill prohibits the establishment of a corporation or shell corporation for the purpose of evading payment of wages and benefits; a person who establishes such a corporation is guilty of a felony and is subject to a fine of up to $20,000 and/or up to five years imprisonment.

Investigations by the Commissioner of Labor and Industry

The Commissioner of Labor and Industry has to conduct investigations to determine compliance and is required to promptly investigate a compliant. Thus, an investigation into employee misclassification can be undertaken on the commissioner's own initiative or on receipt of a written complaint. A construction industry employer who is the subject of an investigation must allow access to the work site, employees and contractors, and employer records. Failure to comply may result in a stop-work order and a fine of up to $250 per day. The commissioner is required to notify specified State agencies if a violation is found.

Upon a determination by the commissioner that an employer has failed to properly classify an employee, the commissioner must issue a stop-work order within 72 hours for all business operations at all of the employer's construction sites. If the employer submits a written protest, the commissioner has to grant the employer a hearing within 48 hours of receipt of the request. Within five days of the hearing the commissioner has to file a written order upholding or reversing the stop-work order, an order the employer may appeal through the Administrative Procedure Act. The order is in effect until lifted by the commissioner, who may implement reporting requirements as a condition of rescinding the order. The bill establishes penalties for noncompliance with the commissioner's order:

- violation is a misdemeanor, subject to a fine of up to $5,000 and/or up to one year imprisonment; and
- imposition of an administrative penalty of $5,000 per day.

The commissioner is required to notify any public body in a public work contract with a noncompliant employer, with the public body required to withhold an amount sufficient to pay all applicable wages, benefits, taxes, and other required contributions. Noncompliant employers must also be reported to the Secretary of State for inclusion on a State registry. Employers on the registry are prohibited from entering into a contract for a public work project for two years. Any successor corporation is subject to the same withholding and registry provisions.

An employer may not take action against an employee for bringing action against the company; likewise, employees are prohibited from making a complaint in bad faith. Violation of these provisions is a misdemeanor, subject to a fine of up to $1,000.

Additional Administrative and Criminal Penalties

The commissioner is authorized to assess additional administrative penalties, with all sums applied to the commissioner's enforcement and administrative costs. Penalties may be assessed in the following amounts:

- up to 125% of the monetary value for violations less than $20,000;
- up to 150% of the monetary value for violations between $20,000 and $100,000; and
- up to 200% of the monetary value for violations greater than $100,000.

The commissioner has to notify the violator of the opportunity to request a hearing when serving notice of a violation and its amount. The notice may not become final until the violator has the opportunity to request a hearing. A final order may be appealed in accordance with the Administrative Procedure Act.

The commissioner is required to refer violations of the bill to the Attorney General, with criminal penalties and fines indexed according to the monetary value of the violation. The maximum penalty is for a violation valued at greater than $100,000. In this case, the violation is a felony and is subject to a fine of up to $20,000 and/or up to 30 years imprisonment. The Attorney General may bring an action in circuit court for collection of an uncontested, unpaid penalty or for production of books and records. Furthermore, individuals and employee organizations are authorized to bring a civil action against an employer for failing to properly classify the employee.

Withholding and Filing Requirements

A person engaged in construction services who pays more than $600 to another person for salaries, wages, or fees in a taxable year is required to file a quarterly return with the Comptroller documenting the amount of the payment and information identifying the recipient. Failure to file a return may result in criminal penalties. Violation is a misdemeanor subject to a fine of up to $1,000 and/or up to six months imprisonment.

The bill specifies that personal liability for income tax for construction services that are subject to withholding extends to contractors and owners of real property for which construction services are provided. An unincorporated contractor does not have any right of action against a person who withholds income tax in accordance with these requirements.

Payors who make payments for construction services according to these requirements and withhold income tax for a contractor must prepare an annual statement identifying the payor, the contractor, the amount of payments, and the amount withheld. This statement must be submitted to the contractor and the Comptroller in a required format.

These withholding and filing requirements take effect June 1, 2008, and are applicable to all taxable years beginning after June 30, 2008.

Other Requirements

The commissioner is required to annually report to the General Assembly on complaints and investigations.

Subcontractors are required to document to their contractors that workers' compensation coverage has been provided as required for all covered employees. This information must be preserved by the contractor for three years and made available to the Workers' Compensation Commission on request. A contractor that pays a subcontractor 125% more than the remuneration per construction class code must inform specified State agencies and provide the required workers' compensation documentation. Failure to comply is punishable by an administrative penalty of up to $1,000 per week. A person providing false information relating to these provisions may be subject to criminal penalties, as violation is a felony and is punishable by a fine of up to $5,000 and/or up to one year imprisonment.

Current Law: Maryland employment and procurement law establishes standards employers must follow in providing payment and adequate rates of compensation for employees. Additional insurance requirements provide wage protection for individuals who are injured or laid off in the course of their employment. Other federal and State laws additionally provide family and medical leave, collective bargaining protections, and occupational safety standards that apply exclusively to employees.

Prevailing Wage

The federal Davis-Bacon Act provides the foundation for state prevailing wage laws requiring workers performing a specific job to be paid an hourly wage consistent with the industry standard in a geographic area. The primary purpose of the laws is to stabilize wages by preventing employers from paying less than the rate commonly paid to workers performing comparable work in the region. The laws are also intended to prevent contractors from importing workers from lower-wage areas to undercut local bidders for government contracts.

Maryland Prevailing Wage Law extends to any public works contract in excess of $0.5 million with construction costs that are more than 50% State financed. Wage determinations issued for each construction project specify the wage and benefit rate for each classification of worker for the given type of construction. Each determination is made specific to the jurisdiction in which the project is located and is effective for a period of one year.

Wage Payment and Collection

Maryland Wage Payment and Collection Law regulates the payment of wages by State employers. The law requires employers to • pay workers the wage promised; • establish regular paydays; • pay wages when due; • pay employees in a specified manner; • pay employees at least once every two weeks, with exceptions; • furnish employees with a statement of gross earnings; • advise employees of their rate of pay and designated payday; and • pay an employee all wages due on termination of employment.

Insurance Requirements

All employers in Maryland are required to provide workers' compensation coverage for their employees. An employer, or their insurer, is required to compensate covered employees upon a determination that an accidental personal injury suffered by an employee was the result of his or her employment.

Employers are further required to meet federal and State unemployment insurance requirements for their employees. All private business employers and nonprofit organizations employing one or more persons are subject to Maryland Unemployment Insurance Law, with employer contributions generally based on taxable wages for covered employment.

Background: A May 2007 report by the U.S. Government Accountability Office found that in 2005 there were 10.3 million independent contractors working nationwide, with 22% of that total employed in construction. Other affected industries include cleaning and janitorial services, food service, landscaping, and agriculture. Independent contractors in these industries often work on a contingent basis to provide extra coverage to an employer on a temporary or part-time basis. Independent contractors do not generally have access to employer-based health insurance coverage and pension programs and are not covered by workers' compensation and unemployment insurance. Other protections, such as employee safety requirements, minimum wage and overtime compensation, and anti-discrimination protections, are generally unavailable to these contractors.

An employer may intentionally misclassify an employee to avoid paying the wages and benefits generally due to its regular, full-time employees. This practice reduces the employer's costs by reducing the amount of compensation available to the employee and circumventing federal and state tax and withholding requirements. The Internal Revenue Service last estimated that 15% of employers had improperly classified one or more of their employees, resulting in a loss of $1.6 billion in Social Security, unemployment, and income tax revenue in 1984. GAO estimated that the loss in inflation-adjusted 2006 dollars is $2.7 billion. The IRS has developed a memorandum of understanding to prevent questionable employment tax practices and improve information-sharing among states and the federal government; as of November 2007, 29 states, not including Maryland, had signed the agreement.

There is no single, recognized standard for determining whether a worker should be properly considered as an employee or an independent contractor. Courts have generally used one of two tests to determine whether an employee is properly classified. An economic realities test attempts to determine whether the worker financially depends on the company or whether the worker is self-employed. A common law test attempts to determine the degree of control the contractor has over the end work product. Other considerations may include which party owns the tools or equipment used in performing the job, the worker's skill level, and the duration of the contract.

State Revenues: Under the bill's penalty provisions, DLLR's Division of Labor and Industry may generate $6.0 million in revenue in fiscal 2009. Once fully operational, the misclassification unit could generate an estimated $10.1 million in fiscal 2010, with incremental reductions each year based on improved compliance.

DLLR advises that there are 2,466 construction sites active in the State. IRS has estimated that 15% of all construction employers have misclassified one or more employees. Applying this percentage to the State's construction sites, violations would be expected at approximately 370 sites statewide, with DLLR estimating an average of six violations per site based on the number of trades operating on a typical construction project. Given the experience of the Prevailing Wage Unit, the average violation under this bill would generate $5,362 in penalty revenue.

On an annual basis, the bill could generate $11.9 million; however, first-year start-up delays would likely reduce that amount by at least half, producing an estimated $6.0 million. With progressive rates of compliance, penalty revenue could decrease by a conservative estimate of 15% per year; the department advises that annual revenue reductions could be as much as 40% per year once fully implemented. The bill specifies that certain administrative penalties collected must be applied to the Division of Labor and Industry's costs in enforcing and administering the bill. Absent the creation of a new special fund, it is assumed that this revenue would accrue to the general fund.

In addition to the penalty revenue, the Comptroller may realize additional income tax revenue as a result of the bill; however, the new requirements would likely affect the timing of tax payments more than the amount. The Comptroller's Office advises that much of the revenue from withholding would have otherwise been collected through estimated and final tax payments from workers classified as independent contractors. If additional workers are classified as employees, more tax payments will be generated through employer withholding rather than estimated taxes. Increases in total tax revenue are expected to be marginal.

State Expenditures: The Division of Labor and Industry estimates that it will require 40 investigative staff to comply with the requirements of the bill, with 25 investigators assigned to the field and 15 assigned to the office to handle complaints. These investigators will be required to monitor the estimated 2,466 construction sites in Maryland and meet the bill's other notification and hearing procedures. The staffing ratio indicated for this bill is consistent with other of the division's investigative units, with five investigators assigned to the Prevailing Wage Unit to monitor 190 public sites.

Given these staffing levels, general fund expenditures by the Division of Labor and Industry could increase by an estimated $2.2 million in fiscal 2009, which accounts for the bill's October 1, 2008 effective date for active enforcement activities. This estimate reflects the cost of hiring 40 fraud investigators, 5 administrative personnel, 2 assistant Attorneys General, and 1 program manager. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	48
Salaries and Fringe Benefits	$1,813,691
Mileage and Other Travel Expenses	134,410
Computers and Office Equipment	155,450
Other Operating Expenses	69,705
Total FY 2009 State Expenditures	**$2,173,256**

Future year expenditures reflect • full salaries with 4.4% annual increases and 3% employee turnover; and • 2% annual increases in ongoing operating expenses.

Other State agencies may also experience increased expenditures as a result of this bill. The Comptroller's Office advises that the bill's filing requirements may require additional contractual staff, particularly for processing of required annual reports. Other affected agencies may include the Office of Administrative Hearings to adjudicate contested administrative penalties, the Secretary of State to develop the required registry of noncompliant employers, and the Workers' Compensation Commission to handle workload resulting from the increase in covered employees. With the exception of the Comptroller's Office, these agencies did not project that the increase in activity would require additional resources.

Prosecution and Incarceration Expenditures

The bill requires the commissioner to refer all violations to the Attorney General for appropriate action, who then may bring an action in circuit court for collection of an uncontested, unpaid administrative penalty or the production of books and records requested by the commissioner. This provision could have a potentially significant impact on the Attorney General's workload.

The bill establishes imprisonment terms of up to 30 years for those guilty of a felony, potentially increasing general fund expenditures due to more people being committed to Division of Correction facilities and increased payments to counties for reimbursement of inmate costs. The number of people convicted of this proposed crime is unknown.

Persons serving a sentence longer than 18 months are incarcerated in DOC facilities. Currently, the average total cost per inmate, including overhead, is estimated at $2,600 per month. This bill alone, however, should not create the need for additional beds, personnel, or facilities. Excluding overhead, the average cost of housing a new DOC inmate, including medical care and variable costs, is $526 per month. Excluding medical care, the average variable cost is $148 per month.

Persons serving a sentence of one year or less in a jurisdiction other than Baltimore City are sentenced to local detention facilities. For persons sentenced to a term of between 12 and 18 months, the sentencing judge has the discretion to order that the sentence be served at a local facility or DOC. The State reimburses counties for part of their incarceration costs, on a per diem basis, after a person has served 90 days. State per diem reimbursements for fiscal 2009 are estimated to range from $19 to $71 per inmate depending upon the jurisdiction. Persons sentenced to such a term in Baltimore City are generally incarcerated in DOC facilities. The Baltimore City Detention Center, a State-operated facility, is used primarily for pretrial detentions.

Local Revenues: Revenues could increase as a result of the bill's monetary penalty provisions from cases heard in the circuit courts. Local tax revenue could also increase marginally with increased compliance with classification requirements.

Local Expenditures: Expenditures could increase as a result of the bill's incarceration penalties. Counties pay the full cost of incarceration for people in their facilities for the first 90 days of the sentence, plus part of the per diem cost after 90 days. Per diem operating costs of local detention facilities are expected to range from $40 to $129 per inmate in fiscal 2009.

Additional Information

Prior Introductions: A similar bill was introduced as HB 12 during the 2007 special session but was not referred to a committee.

Cross File: None.

Information Source(s): Workers' Compensation Commission; Department of General Services; Injured Workers' Insurance Fund; Comptroller's Office; Maryland Insurance Administration; Department of Labor, Licensing, and Regulation; Office of the Attorney General; Department of Legislative Services

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