

Department of Legislative Services
 Maryland General Assembly
 2009 Session

FISCAL AND POLICY NOTE

House Bill 1070 (Delegate Davis)
 Economic Matters

Labor and Employment - Misclassification of Employees as Independent Contractors

This bill establishes penalties for knowingly and willfully misclassifying an employee as an independent contractor and authorizes the Commissioner of Labor and Industry to investigate suspected misclassification violations.

Fiscal Summary

State Effect: General fund expenditures increase by \$256,800 in FY 2010 by the Department of Labor, Licensing, and Regulation (DLLR) and special fund expenditures increase by \$17,600 in the Workers’ Compensation Commission (WCC) for enforcement. Out-year costs reflect annualization, inflation, and diminished need for enforcement due to increased employer compliance. Potential significant general fund revenue increase in FY 2011 due to employer compliance with income tax withholding rules and from penalty provisions; these diminish over time due to increased employer compliance.

(in dollars)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
GF Revenue	-	-	-	-	-
SF Revenue	-	-	-	-	\$0
GF Expenditure	\$256,800	\$433,900	\$452,500	\$361,000	\$377,100
SF Expenditure	\$17,600	\$41,600	\$43,500	\$45,500	\$47,600
Net Effect	(\$274,300)	(\$475,400)	(\$496,000)	(\$406,500)	(\$424,700)

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

Unemployment Insurance Trust Fund: Potential significant increase in revenues for the Unemployment Insurance Trust Fund beginning in FY 2011.

Injured Workers’ Insurance Fund: Potential significant increase in revenues beginning in FY 2011.

Local Effect: Potential significant increase in local income tax revenues. Potential minimal increase in circuit court expenditures to hold additional hearings generated by the bill. The number of additional circuit court hearings and the rate at which misclassification is addressed in court under the bill cannot be reliably determined at this time.

Small Business Effect: Potential meaningful. 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. Small businesses may experience minimal expenditure increases due to the bill's recordkeeping requirements.

Analysis

Bill Summary: A person may not knowingly and willfully designate an employee as an independent contractor in order to avoid paying any portion of income taxes, unemployment insurance, workers' compensation, and/or conforming to the State's fair labor standards such as the wage and hour law, wage payment, and living wage requirements. Employers may be fined up to \$3,000 for each employee found to be misclassified. Penalty revenue accrues to the general fund.

The bill specifies that, with some exceptions, an employer may enter into a contract with a sole proprietor, subcontractor, or tiered subcontractor that presumes proper classification as long as certain terms are provided for in the written contract. The sole proprietor, subcontractor, or tiered subcontractor must agree to fulfill the responsibilities associated with that classification, such as paying the appropriate income or withholding taxes, obtaining proper insurance, and complying with State wage and hour laws. The presumption of proper classification does not apply if the employer has been found to have misclassified an employee within one year or under other specified conditions.

Employers must keep, for a period of three years, explicit records of all employees and independent contractors hired to perform services for the employer. The commissioner may inspect and copy the records for the purposes of investigation of improper classification.

If the commissioner finds a knowing and willful violation, a court may impose a penalty of up to \$3,000. If, while investigating a misclassification complaint, the commissioner finds evidence of violations of workers' compensation law, the commissioner may seek civil penalties for those violations. The commissioner may notify the appropriate agencies if he or she suspects that an employer has not paid unemployment insurance, workers' compensation, or accurate tax returns in order to ensure compliance with State

law. These agencies may follow their established enforcement procedures to recover lost revenues but must file a complaint in the appropriate court to seek penalties for the misclassification of employees.

Current Law: An employer who is found to have misclassified an employee must comply with unemployment insurance and workers' compensation requirements. The State has no established penalties for misclassification.

All employers in Maryland are required to provide workers' compensation coverage for their employees. An employer, or its 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.

Maryland employment and procurement law establishes standards that an employer must follow in providing payment and adequate rates of compensation for an employee. Additional insurance requirements provide wage protection for an individual who is injured or laid off. Other federal and State laws additionally provide family and medical leave, collective bargaining protections, and occupational safety standards that apply exclusively to employees.

An employer is further required to meet federal and State unemployment insurance requirements for 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.

In order to determine the proper classification of an individual, DLLR uses a measure termed the "ABC" test. An independent contractor must meet each of the three standards of this measure. The test's first standard relates to direction and control of a worker. An employer should not be responsible for training an independent contractor, setting his or her work hours, or providing direct orders on how work is performed. The test's second standard considers whether the work is outside the usual course of business for the employer, meaning that service performed by an independent contractor should be integrated into the employer's operation and is unrelated to the employer's business. The final standard relates to whether or not the worker is independently established. An independent contractor should have liability and workers' compensation insurance, a place of business, and a stake in the success or failure of the enterprise. WCC uses a different test, based on case law, to determine whether a worker is a covered employee. The criteria for determining the existence of a relationship include whether the employer has the power to hire the worker, terminate the worker, and control the worker's conduct. This common law test also considers how wages are paid and whether the work is part of the regular business of the employer.

Background: When a company hires an employee, it is responsible for paying half of that employee's Social Security and Medicare taxes, as well as premiums for workers' compensation and unemployment insurance coverage. Employers also typically withhold federal, state, and local income taxes. An employee is responsible for half of his or her Social Security and Medicare taxes, as well as any state and federal income tax in excess of the amounts withheld by the employer.

By contrast, an independent contractor pays all of his or her Social Security and Medicare taxes and has no income taxes withheld but is still responsible for paying them in full. Independent contractors are not covered by workers' compensation or unemployment insurance, nor do they receive overtime compensation or benefits such as health insurance. They are treated by the law as temporary, freelance workers and are comparable to self-employed individuals.

A May 2007 report by the U.S. Government Accountability Office found that in 2005 there were 10.3 million independent contractors working nationwide. 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. That report confirmed that 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.

Misclassification in Maryland

Recent audits of Maryland employers generate widely divergent estimates of the rate at which employers misclassify employees. As reported in a recent national study of misclassification in the construction industry, random audits of Maryland construction companies by the U.S. Department of Labor found that 5% had misclassified their employees as independent contractors. This is substantially below the national average, which is estimated to be between 15% and 20%.

Over the last three years, DLLR's Division of Unemployment Insurance has conducted random and targeted audits of employers registered with the division to determine whether employees are correctly classified. Results of these audits displayed in **Exhibit 1** indicate that the rate of misclassification found through a combination of targeted and random auditing in Maryland may be as high as 20% to 25%.

Exhibit 1
Audits Conducted by the Division of Unemployment Insurance

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Contributing Employers	137,037	139,103	140,334
Number Audited	2,875	2,988	3,293
Violations (all types)	1,179	979	1,269
Misclassifications (employers)	800	627	849
Workers Affected	6,477	4,090	7,048

Source: Department of Labor, Licensing, and Regulation

State Expenditures: The Department of Legislative Services (DLS) assumes that the bill's immediate effect on the number of misclassification complaints filed with DLLR is minimal given its October effective date and the seasonal nature of the industries, such as construction and landscaping, that have a disproportionately high number of misclassified workers. However, caseloads are expected to increase during the ensuing spring and summer and then gradually decline as employer compliance increases. Construction and landscaping are largely seasonal activities, and both industries have experienced significant employment losses in the current recession. Therefore, DLLR does not require additional staff until March 2010, when the weather improves and activity in the construction and landscaping sectors increase.

Following an initial surge in complaints investigated during spring and summer 2010, employer compliance likely increases. Moreover, DLLR reports that its Workplace Fraud Working Group has been developing strategies to provide outreach and education to employers, as well as coordinated enforcement. Together, these factors suggest that new complaints referred to DLLR begin a steady decline in fiscal 2011, and staffing levels decline in tandem.

Therefore, general fund expenditures by DLLR increase by an estimated \$256,764 in fiscal 2010, which accounts for the fiscal effect being delayed until March 1, 2010. This estimate reflects the cost of hiring two permanent fraud investigators, one contractual fraud investigator, one office clerk, an office secretary, one contractual data programmer, and one assistant Attorney General. Administrative staff assists in tracking and scheduling inspections, database development, hearing and court appearances, and document production. This estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses as shown below.

Regular Positions	5.5
Contractual Positions	2
Salaries and Fringe Benefits	\$126,994
Database Development	75,000
Start-up Costs	36,110
Other Operating Expenses	<u>36,216</u>
Total FY 2010 State Expenditures	\$274,320

Likewise, WCC advises that it requires a half-time assistant Attorney General to handle additional cases for the agency in circuit courts; this position is special funded at \$17,556 in fiscal 2010.

Future year expenditures reflect full salaries with 4.4% annual increases, employee turnover (3% for permanent staff and 6.8% for contractual staff), and 1% annual increases in ongoing operating expenses. The two contractual positions expire at the end of fiscal 2012. DLS anticipates that the data programmer is no longer needed due to the full implementation of the computer and software systems and that increased compliance among employers in the State renders a third fraud investigator unnecessary.

State Revenues: General fund revenues, and to a lesser extent special fund revenues, increase minimally due to the bill's penalty provisions. DLLR advises that, because the penalty scheme provided by the bill requires action in circuit court and establishes a high standard of proof, the agency expects a small number of penalties for misclassification. Moreover, DLS expects very few investigations of new complaints to be completed in fiscal 2010, given that they likely do not begin until the final quarter of the fiscal year.

In addition to the penalty revenue, the Comptroller may realize additional income tax revenue as a result of the bill, to the extent that enforcement requires more employers to comply with income tax withholding requirements. DLS cannot reliably estimate the extent to which enforcement efforts uncover misclassification by affected employers. Available data from DLLR and the U.S. Department of Labor indicates that between 5% and 25% of employers misclassify at least some employees and, therefore, have to withhold income taxes from their compensation. Based on available data and *for illustrative purposes only*, DLS assumes that 14% of employers misclassify employees. Based on this assumption, and on estimated wages for the construction and landscaping industries in Maryland, general fund revenues may increase by between \$5 million and \$10 million annually due to additional tax compliance in these industries.

Revenues for the Unemployment Insurance Trust Fund within DLLR's Division of Unemployment Insurance likely reflect no change in fiscal 2010 due to the limited number of enforcement investigations undertaken by the Commissioner of Labor and Industry. Enhanced enforcement by DLLR, with appropriate referral, beginning in fiscal 2011 results in more employers complying with mandated contributions to the trust fund. Revenues increase by as much as \$4 million in fiscal 2011 and 2012. Assuming continued compliance, revenues increase by as much as \$6 million and \$7 million in fiscal 2013 and 2014, respectively, due to higher levels of voluntary and enforced compliance.

Although unemployment insurance claims may increase under the bill, any such increase is not expected to be significant. Under current law, a misclassified employee who files a claim may receive unemployment insurance benefits provided that the division finds that the employer improperly classified the employee. In such cases, the employer is then responsible for unpaid unemployment insurance taxes.

Injured Workers' Insurance Fund Effect: The Injured Workers' Insurance Fund (IWIF) indicates that a reduction in misclassified workers results in an increase in premiums for insurers in the State. IWIF does not have statistics on this point but is aware of a number of cases involving misclassification, primarily in the construction industry. *For illustrative purposes only*, IWIF collects about \$60 million per year in annual premiums from the construction industry; assuming about 14% misclassification in the industry, IWIF estimates that it loses approximately \$8.5 million per year. The extent to which IWIF collects some of that foregone revenue depends on how many employers currently misclassify employees or pay employees in cash, which cannot be reliably estimated.

Although workers' compensation claims may increase under the bill, any such increase is not expected to be significant. Under current law, a misclassified employee who files a claim due to injury on the job may receive workers' compensation benefits provided that WCC finds that the employer improperly classified the employee. In such cases, the employer is then responsible for the workers' compensation benefits owed to the employee.

Local Fiscal Effect: Local tax revenue also increases, potentially significantly, with increased compliance with classification requirements. Because the bill specifies that penalties may only be imposed in court, it is expected that case loads increase minimally due to the bill. Any increase can be absorbed within existing resources.

Small Business Effect: Small businesses that are found to misclassify their employees must pay unemployment insurance, workers' compensation, and payroll taxes on behalf of misclassified employees. Expenditures by small businesses increase minimally to

comply with recordkeeping requirements. Small businesses that currently comply with all classification requirements experience may become more competitive relative to those that do not currently comply and therefore have lower labor costs.

Additional Comments: DLLR advises that the bill offers no protections for employees that report an employer for improper classification and the number of complaints from employees may be limited for this reason. According to DLLR, the number of complaints may also be limited because an employee may sign an employment agreement that serves as a rebuttable presumption of proper classification.

Additional Information

Prior Introductions: None.

Cross File: SB 912 (Senator Conway, *et al.*) - Finance.

Information Source(s): Baltimore City; Caroline, Calvert, Howard, and Montgomery counties; Office of the Attorney General; Maryland Insurance Administration; Injured Workers' Insurance Fund; Judiciary (Administrative Office of the Courts); Department of Labor, Licensing, and Regulation; National Council on Compensation Insurance; Office of Administrative Hearings; Subsequent Injury Fund; Uninsured Employers' Fund; Workers' Compensation Commission; Department of Legislative Services

Fiscal Note History: First Reader - March 2, 2009
mcp/mcr

Analysis by: Michael T. Vorgetts

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