

Department of Legislative Services
Maryland General Assembly
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FISCAL AND POLICY NOTE

Senate Bill 1005

(Senator Pugh)

Finance

**Labor and Employment - Determination of Independent Contractor Status -
Workplace Fraud Act and Unemployment Insurance**

This bill exempts specified employers from the presumption under the Workplace Fraud Act and the Unemployment Insurance (UI) program that an employer-employee relationship exists between the employer and an individual doing work for the employer if the employer presents specified documentation. It also repeals criteria for determining whether an employer knowingly violated the Workplace Fraud Act and substitutes a presumption that an individual is an independent contractor if the employer satisfies specified conditions. It further establishes a timetable for resolution of disputes under the Act and restricts the Commissioner of Labor and Industry's access to places of business for the purpose of enforcing the Act.

Fiscal Summary

State Effect: Nonbudgeted revenues for the Unemployment Insurance Trust Fund decline, potentially substantially, due to the reclassification of a large number of employees as independent contractors who therefore become exempt from payment of UI taxes. A precise estimate of the revenue decline is not feasible, but Legislative Services advises that it could total in the millions of dollars. Any loss of revenues for UI will likely be offset by reduced expenditures for these benefits due to fewer workers being covered. The Department of Labor, Licensing, and Regulation (DLLR) and the Judiciary can implement the bill's provisions with existing budgeted resources.

Local Effect: None.

Small Business Effect: Meaningful.

Analysis

Bill Summary:

Determination of Employer-Employee Relationships

For the purpose of enforcing the Workplace Fraud Act, the presumption that an employer-employee relationship exists does not apply if an employer presents:

- a written contract between the employer and an individual that describes the nature of the work and the remuneration to be paid and includes an acknowledgement by the individual of his or her responsibilities under the act;
- an signed affidavit indicating that the individual is an independent contractor who performs work for other employers; and
- a certificate of status of the individual's business that is issued by the State Department of Assessments and Taxation.

In determining whether an employer knowingly misclassified an employee as an independent contractor, the bill establishes a presumption that an individual working for remuneration is an independent contractor if the employer, prior to an investigation or filing of a complaint, (1) provided the individual with the required notice of classification as an independent contractor and the implications of the classification; and (2) sought and obtained evidence that the individual is exempt under the law or is an independent contractor who:

- withholds, reports, and remits payroll taxes on behalf of employees;
- pays UI taxes for all employees; and
- maintains workers' compensation insurance.

For the purpose of determining covered employment under the UI program, a work arrangement is not considered covered employment if the individual who performs the work has entered into a written contract that states expressly and prominently that the individual understands and knows that:

- the individual is responsible for paying estimated Social Security self-employment taxes and for paying State and federal income taxes; and
- the work is not covered employment and the individual is responsible for compliance with UI statutes.

Workplace Fraud Enforcement Activities

The commissioner may not enter a place of business or work site to review and copy records if the employer chooses to instead provide copies of the records for review. (The commissioner's right to enter a place of business or work site to observe work being performed and interview individuals is preserved.) Employers may comply with existing requirements to produce specified employment records by producing copies of the records. Employers who do not produce employment records or copies of records within 30 days of the commissioner's request are subject to a civil fine.

In the case of an investigation by the commissioner, within 45 days of receiving copies of or inspecting an employer's records, the commissioner must either issue a citation for misclassification or close the case. If the employer requests a hearing in response to the citation, the hearing must be held within 90 days of the request, unless that right is waived. Notification of a violation of the Workplace Fraud Act may only be forwarded to a public body that has a contract with the violator only after an administrative unit issues a final order or, if the final order is appealed to judicial review, a court finds a violation.

Current Law:

Workplace Fraud Act

Chapter 188 of 2009 (the Workplace Fraud Act) establishes, for the purpose of enforcement only, a presumption that work performed by an individual paid by an employer creates an employer-employee relationship, subject to specified exemptions. It prohibits construction companies and landscaping businesses from failing to properly classify an individual as an employee and establishes investigation procedures and penalties for noncompliance.

An employer in an affected industry misclassifies an employee when an employer-employee relationship exists, but the employer has not classified the individual as an employee. An employer-employee relationship exists in an affected industry unless an employer can demonstrate that a worker is an exempt person or independent contractor, as defined in the statute, and subject to clarifying regulations issued by the Commissioner of Labor and Industry.

The "ABC test" incorporated in the Workplace Fraud Act is used by DLLR to establish whether an employer-employee relationship exists for the purpose of determining whether an employee has been misclassified under the Act. The requirement to use the ABC test is not repealed by the bill. The ABC test has three components, all of which must be met to establish that an individual is an independent contractor:

- A. the individual is free from control and direction over his or her performance both in fact and under the contract (Alone);
- B. the individual customarily is engaged in an independent business or occupation (Business); and
- C. the work performed is outside the usual course of business, or outside the place of business, of the person for whom work is performed (Control).

The Workplace Fraud Act distinguishes between an employer who *improperly* misclassifies an employee and an employer who *knowingly* misclassifies an employee, and penalties are more severe for an employer who is guilty of knowingly misclassifying an employee.

The Commissioner of Labor and Industry must investigate the two specified industries as necessary to determine compliance. Investigation of a misclassification complaint may be on the commissioner's own initiative, on receipt of a written complaint, or on referral from another unit of State government. The commissioner may enter a place of business or work site to observe work being performed, interview employees and contractors, and review records as part of this investigation. The commissioner may issue a subpoena for testimony and production of records. All required records must be kept by the employer for a period of three years. An employer that fails to produce records within 15 business days after the commissioner's request is subject to a fine of up to \$500 per day. If an individual fails to comply with a subpoena, the commissioner may file a complaint in circuit court requesting an order directing compliance.

An employer issued a citation for misclassification may request a hearing within 15 days, which is referred to the Office of Administrative Hearings (OAH). If a hearing is not requested within 15 days, the citation becomes the final order. If a hearing is requested, the decision by OAH becomes the final order, which may be appealed for judicial review.

Upon issuing a citation for misclassification, the commissioner must notify any public body that contracts with the employer. Upon notification, the public body must withhold payment to the employer in sufficient amount to pay restitution to employees for wages due and to pay any taxes, benefits, or other contributions owed by the employer. Upon issuance of a favorable final order or court ruling, the public body must release the withheld funds to the employer.

Under circumstances delineated in statute, criminal penalties may also apply to employers who misclassify employees.

Unemployment Insurance

State law requires DLLR to use the ABC test in determining whether an individual is an employee or an independent contractor for the purpose of determining whether an employer should pay UI for the individual. The bill does not repeal that requirement, but instead adds an alternative test for determining covered employment under UI.

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 UI 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 UI, 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 in industries that include construction, 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 UI. Other protections, such as employee safety requirements, minimum wage and overtime compensation, and anti-discrimination protections, are generally unavailable to these contractors.

DLLR advises that misclassification leaves many Maryland workers without access to workers' compensation or UI benefits in the event that they are injured or laid off. DLLR also estimates that misclassification results in almost \$22 million in underpayment to the Unemployment Insurance Trust Fund, and potentially underpayment of State income taxes.

As of December 2011, DLLR's Task Force on Workplace Fraud had conducted 660 investigations under the Workplace Fraud Act, and issued 12 citations, which translates into a 98% compliance rate. The task force collected \$33,000 in civil fines from employers for failing to provide employment records in a timely fashion, but it has

not assessed fines for misclassification because the cited employers have either come into compliance or have their cases still pending. In addition, audits conducted by the Division of Unemployment Insurance have resulted in more than \$600,000 paid into the trust fund. DLLR advises that these funds represent employer compliance going forward; to date, DLLR has not attempted to collect retroactive payments for misclassified employees.

State Fiscal Effect: The Workplace Fraud Act authorizes the commissioner to conduct audits of employers in the landscaping and construction industries, either at his or her discretion or on the basis of complaints or referrals from other agencies. The level of enforcement activity is not expected to decrease as a result of the bill, but the outcomes of those enforcement activities may change. It is anticipated that fewer employer-employee relationships are established because of the added exemptions included in the bill. As a result, more firms likely are found to be in compliance and fewer are required to withhold State income taxes and pay workers' compensation and UI premiums and assessments than if the ABC test is retained as the exclusive standard. Any such impact is likely offset by reduced expenditures for these benefits.

Assuming that fewer firms are found to be misclassifying employees, DLLR issues fewer citations for misclassification; the additional 15 days to produce employment records likely reduces the number of civil penalties issued for failure to produce records. Since no civil penalties for misclassification have been collected to date, and only one penalty for failure to produce records has been collected, there is no meaningful reduction in general fund revenue from the foregone citations, but there is potential foregone revenue in the future.

Similarly, the Division of Unemployment Insurance within DLLR advises that the bill's alternative criteria for determining covered employment likely means that as many as 30% of individuals currently classified as employees could be reclassified as independent contractors and be exempt from payment of UI taxes. Legislative Services cannot independently verify the division's estimate but believes that the likely effect will be somewhat smaller. To the extent that significant numbers of employees are reclassified as independent contractors under the bill's definition, revenues for the UI trust fund decline, potentially by millions of dollars. The potential loss of revenue, however, may be at least partially offset by reduced expenditures for these benefits.

Small Business Effect: To the extent that small businesses employ individuals who are reclassified as independent contractors under the bill's alternative definition criteria, they may have reduced payments for workers' compensation and UI taxes. However, DLLR advises that, to the extent that their payments of State UI taxes decreases, their obligation to pay federal UI taxes increases, largely offsetting the reduction.

Individuals reclassified as independent contractors instead of employees lose the protections afforded to them by workers' compensation, UI, and occupational safety regulations because they are no longer considered employees.

Additional Information

Prior Introductions: None.

Cross File: HB 1364 (Delegate Schulz, *et al.*) - Economic Matters.

Information Source(s): Judiciary (Administrative Office of the Courts); Department of Labor, Licensing, and Regulation; Office of Administrative Hearings; Department of Legislative Services

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