

Department of Legislative Services
2012 Session

FISCAL AND POLICY NOTE

House Bill 309
Economic Matters

(Delegate W. Miller, *et al.*)

Labor and Employment - Independent Contractor - Definition

This bill specifies that an independent contractor is an individual who is not an employee for the purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act, based on the application of the 20 factors set forth in Ruling 87-41 of the Internal Revenue Service (IRS).

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 unemployment insurance (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 fiscal effect is negated, however, if the bill is determined not to affect current enforcement practices related to payment of UI taxes. Also, 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) can implement the bill's provisions with existing budgeted resources.

Local Effect: None. The change does not affect local government finances.

Small Business Effect: Meaningful.

Analysis

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.

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.

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.

The ABC test is a long-standing legal standard for determining whether an individual is an employee or an independent contractor. It is generally considered stricter than the comparable IRS standard required by the bill, which focuses primarily on the “A” portion of the ABC test. The IRS test is used only for the purpose of establishing whether an employer should withhold federal income taxes from the individual, but not for other determinations, such as whether the employer is required to purchase workers’ compensation coverage or pay UI taxes. State law requires use of the ABC test to determine if an individual is an employee for the purpose of determining eligibility for UI benefits.

The IRS standard, codified in the Code of Federal Regulations, establishes that an employer-employee relationship exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only with respect to the result to be accomplished but also regarding the details and means by which the work is performed. It is not necessary, under this standard, that the employer actually direct or control the work, but that he or she has the right to do so. If the employer can control only the result to be accomplished, but not the means and methods, then the worker is an independent contractor, not an employee.

To assist employers in determining whether an individual is an employee or independent contractor, IRS Rule 87-41 established a 20-factor test. The 20 factors are meant to be a guide for employers to determine the likelihood that an individual is an employee; it is not meant to be a formal test. Since their promulgation, the IRS has grouped the 20 factors into three categories: behavioral control, financial control, and the relationship between the parties. DLLR advises that the 20-factor test is no longer used by the IRS because it has been superseded by the three categories.

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: As noted above, the bill's definition of independent contractor contradicts the use of the ABC test for the purpose of workplace fraud and UI enforcement. The use of the ABC test in the respective statutes is not repealed by the bill, so it is unclear to what extent enforcement activities by the Division of Unemployment Insurance and the Workplace Fraud Unit within DLLR are affected. The following analysis describes the bill's potential effect if it is determined that its definition of independent contractor supersedes the use of the ABC test for both purposes. However, Legislative Services notes that it is at least equally likely that the definition does not affect enforcement activities in those two areas, negating the 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 under the IRS standard than under the ABC test. 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. 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. Since no civil penalties for misclassification have been collected to date, there is no actual 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 definition of independent contractor 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 a significant number 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 definition, 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: HB 649 of 2009 received a hearing by the House Economic Matters Committee, but no further action was taken on the bill. Its cross file, SB 1006, was referred to the Senate Finance Committee, but no further action was taken on the bill.

Cross File: None.

Information Source(s): Baltimore City; Department of Budget and Management; Department of Human Resources; Department of General Services; Howard County; Injured Workers' Insurance Fund; Comptroller's Office; Department of Labor, Licensing, and Regulation; Subsequent Injury Fund; Maryland Department of Transportation; Uninsured Employers' Fund; University System of Maryland; Workers' Compensation Commission; Department of Legislative Services

Fiscal Note History: First Reader - March 5, 2012
ncs/ljm

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