# MAINE DEPARTMENT OF LABOR

## Report on the Findings of the

## Worker Misclassification Study Group

**January 2006**

STATE OF MAINE
DEPARTMENT OF LABOR
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JOHN ELIAS BALDACCI
GOVERNOR

LAURA A. FORTMAN
COMMISSIONER

January 24, 2006

The Honorable Ethan K. Strimling, Senate Chair
The Honorable William J, Smith, Hours Chair
Members of the Joint Standing Committee on Labor
122nd Maine Legislature
100 State House Station
Augusta, ME 04333-0100

Dear Senator Strimling, Representative Smith and Members of the Joint Standing Committee on Labor:

Attached is the final Report on the Findings of the Worker Misclassification Study Group.

If you have any questions, please feel free to contact me, Vanessa Santarelli, Assistant to the Commissioner or Jane Gilbert, Deputy Commissioner.

Sincerely,

Laura A. Fortman

Laura A. Fortman
Commissioner

LAF/lm

attachment

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# Report on the Worker Misclassification Study Group

## Background:

In April 2005, the Harvard Construction Policy Research Center released a study report on the social and economic costs of employee misclassification in the construction industry in Maine. The study focused on results data pulled from employer audits conducted by the Maine Department of Labor on the construction industry in that state between 1999-2002. This data was edited and compiled by Kurtis Petersons, a Maine State Government Intern during the summer of 2004, and was provided to researchers from the Harvard Construction Policy Research Center of the University of Massachusetts and Harvard Law School who analyzed the data and issued their findings in their April report. The report findings on misclassification in the Maine construction industry closely paralleled those from an earlier study conducted on the Massachusetts' construction industry by the same researchers in December 2004.

## Summary Report Findings:

Based on the 1999-2002 unemployment insurance audit data studied, the Harvard researchers found that "at least one in seven, or 14% of Maine construction employers are estimated to have misclassified workers as independent contractors" and that "misclassification is a common occurrence rather than an isolated incident in construction companies where misclassification occurs."[1] The report went on to point out that misclassifying workers causes individuals to lose out on critical employment protections such as workers compensation, health insurance and other employee benefit programs as well as unemployment insurance protection. Worker misclassification also has an adverse impact on the Unemployment Insurance system in lost taxes (which also can keep Unemployment taxes at a higher rate for all employers than need be) and negatively impacts the worker's compensation insurance industry through lost premiums. Additionally, workers misclassified as Independent contractors are often known to under-report their personal income so state and federal governments lose out on potentially significant tax revenues as well.[2]

## Formation of Study Group:

The release of the report generated interest across government, construction labor and construction business interests. A study group was formed from interested parties in each of these groups to look more closely at the issue of worker misclassification in the Maine Construction Industry. The Governor charged the study group to look for ways in which the incidence of misclassification could be reduced. This group met a total of 4 times over the course of the summer and fall of 2005. The group focused on worker

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[1] Summary findings of the The Social and economic Costs of Employee Misclassification in the Maine Construction Industry report, issued April 25, 2005 by the Construction Policy Research Center, Labor and Worklife Program of the Harvard Law School and the Harvard School of Public Health.

[2] Summary findings of the The Social and economic Costs of Employee Misclassification in the Maine Construction Industry report, issued April 25, 2005 by the Construction Policy Research Center, Labor and Worklife Program of the Harvard Law School and the Harvard School of Public Health.

misclassification as defined in the Harvard report as occurring when "employers treat workers who would otherwise be waged or salaried employees as independent contractors (self-employed)." Neither the Harvard report nor the Study Group addressed the issue of workers being paid "under the table" (although this practice was frequently raised as a separate issue during some of the group's discussions) or the issue of undocumented workers in the workplace.

**Kick-off Meeting:**

At the kick-off meeting, there was general agreement among all of the parties that misclassification of workers in the construction industry was an issue and that it results in problems for both workers and businesses alike. Workers lose out on valuable benefits and protections and businesses find themselves on an uneven playing field when competing for project bids (the assumption being that those businesses misclassifying workers as Independent contractors have an advantage by being able to underbid those who classify workers as employees and therefore pay higher employee benefits and payroll taxes). However, there was no consensus around the underlying cause of misclassification. Although many felt that some businesses try to reduce their overhead by insisting that workers be treated as independent contractors, others pointed out that workers themselves often refuse to be hired as employees and insist on remaining independent contractors. Therefore, businesses believe that they have no choice but to treat workers in this fashion in order to get the help they need to carry out the work they are contracted to do.

There also was no agreement about possible remedies. Ideas ranged from education of both workers and employers to legislation – either to expand who is taxable under the unemployment insurance program or covered under workers' compensation, or to reduce coverage in both areas. Regardless of where the parties were on possible solutions, there was one question common to all, "why are there so many differing definitions of employee?" Based on this, the group decided to spend some of their meeting time getting a better understanding of the definitions used by the Maine Unemployment Insurance and Workers' Compensation programs, the Maine Revenue Service and the Internal Revenue Service and understanding why there are differences.

**Study Focus:**

Representatives from the Maine Unemployment Insurance program & Attorney General's office, the Maine Workers' Compensation Board, the Internal Revenue Service and the Maine Revenue Service made presentations to the Study Group on the statutes and/or guidelines used by each of these programs to determine whether or not work performed by an individual constituted employment. All government agencies consider the amount of direction and control the business has on the worker when determining whether or not the worker is an employee or independent contractor. In general, if the business supplies training or equipment to the workers, or tells the workers when and how to do the job; the workers are probably employees. However, there is no single rule or test used by all government agencies to determine whether a worker is an employee or independent contractor. The reason for this is that each government program is responsible for a different aspect of employment law and the

tests or standards each uses are designed to support or carry out the intent of the law governing each of these employment directives. As such, some standards are more stringent than others particularly in those areas dealing with employment protections as opposed to revenue taxes. Informational handouts provided to the Study Group are included as attachments at the end of this report but some summary information is provided below:

A. *Internal Revenue Service & the Maine Revenue Service*: Both of these revenue-taxing entities use guidelines as opposed to a strictly defined set of criteria. Frequently referred to as the IRS "common law" tests, there is a set of 20 factors that are considered in trying to determine whether sufficient control is present to establish an employer-employee relationship. The 20 factors have been developed over the years based on examination of cases and rulings. They help to define the employer-employee relationship in three key categories: behavioral control, financial control and relationship of the parties. However, they are designed only as guidelines and there is no established limit of how many of the factors must be present in order to find an individual to be an employee versus an independent contractor. The employer would determine whether a worker is an employee or independent contractor and either pay the appropriate payroll taxes or issue a 1099 to the independent contractor to pay their own taxes. In the case of a dispute, the IRS would conduct an examination and issue a ruling as to whether the individual should be classified as an employee or independent contractor.

B. *Maine Unemployment Insurance Program:* The laws that govern this program do not contain a definition of "employee." Instead, this program looks at the nature of the relationship between the business and an individual and determines whether a 'covered employment' relationship exists for which unemployment insurance taxes are owed. If this relationship is found, the employer must pay unemployment taxes on the wages paid to the worker and the worker is covered for unemployment insurance protection purposes and may potentially be eligible to receive unemployment benefits should he or she lose their job through no fault of their own. The standards for determining whether or not such an employment relationship exists are established in statute and are commonly known as the "ABC" test. It is the broadest definition of employment of any of the tests used by the programs examined which speaks to the underlying purpose of the Unemployment Insurance program in battling economic insecurity. As stated by the Maine Legislature in 1935 when establishing the Employment Security Law,

> *"Economic insecurity due to unemployment is a serious menace to the health, morals and welfare of the people of this state. Unemployment is therefore a subject of general interest and concern which requires appropriate action by the Legislature to prevent its spread and to lighten its burden which may fall upon the unemployed worker, his family and the entire community. The achievement of social security requires protection against this greatest hazard of our economic life. This objective can be furthered by operating free public employment offices in affiliation with a nation-wide system of public employment services; by devising appropriate methods for reducing the volume of unemployment; and by the systematic accumulation of funds during the periods of employment from which benefits may be paid for periods of unemployment, thus maintaining purchasing*

*power, promoting the use of the highest skills of unemployed workers and limiting the serious social consequences of unemployment."*[3]

The intent of the ABC test, as with the Unemployment Insurance program as a whole, is to provide broader economic protection versus narrower. Therefore, the ABC test starts with the presumption that employment exists and the business must prove otherwise by passing all three prongs of the test. The ABC test is the most commonly used employment test used by state unemployment insurance programs in the country. Currently, 24 states and 2 U.S. Territories use the ABC test in its entirety to determine the employment relationship between a business and an individual.

C. *Maine Workers' Compensation Program:* The Workers Compensation Act defines an independent contractor as a person who "performs services for another under contract, but who is not under the essential control or superintendence of the other person while performing those services." To help determine whether an independent contractor relationship exists, this program uses an "8-factor" test, which corresponds closely to the three prongs of the ABC test used by the Unemployment Insurance program. The primary difference between the Unemployment Insurance program's ABC test and the 8-factor test used by Workers' Compensation is that the ABC test is conjunctive (meaning all three prongs must be met to be considered an independent contractor) whereas the Workers Compensation 8-factor test is not. In applying these factors, the Workers Compensation Board cannot give any particular factor a greater weight than any other factor. Additionally, the absence or existence of any one factor is not decisive. Further, unlike the Unemployment statutes, there is no legal presumption of employment under the Workers Compensation Act. The board considers the totality of the relationship in determining whether an employer exercises essential control or superintendence of the person. The application of these eight factors requires a fact-intensive analysis to make an employment determination.

**Subsequent Meeting Discussion:**

Group discussion focused around these definitions and the varying reasons misclassification may come about. The opinion of the group was that it wasn't always an intentional attempt to reduce the overhead cost of the business or to keep from providing employee benefits or protection. It can also arise from confusion about the different definitions, or lack of knowledge that there *are* differences; not only by the business but often by the legal or accounting professionals that assist businesses with these aspects of business operation. The group also acknowledged that because of the impact of misclassification on the competitive bid process for projects, that some employers may feel pressured into classifying workers as independent contractors in order to compete on a level playing field with those that purposely do this to undercut the bidding process. The idea of increased educational efforts around the differing definitions and applications held merit with the group but only if these efforts extended to both businesses and workers/independent contractors. The group also felt that informational materials provided by the varying agencies needed to be clearer and written in a more understandable fashion.

[3] 26M.R.S.A. Section 1042

Another area discussed at length by the group was enforcement of existing laws. The group felt more attention should be given to strictly and consistently enforcing these various employment laws across all businesses to not only ensure that workers get the benefit coverage and protections that they should be getting but to level the competitive playing field for all business so that one does not have an unfair financial advantage over the other. The government agencies represented also explained that there is more enforcement going on than what the labor and business interests were aware of as strict confidentiality laws for the most part prevent publicly publishing or releasing the results of enforcement audits or actions.

Much discussion took place around the idea of how to ensure that those individuals who wanted to maintain their separation as independent contractors 'paid their own way' with regard to taxes and workers compensation coverage and didn't leave the liability for these items with the business. Although there was general agreement that the independent contractor should be held accountable for these types of responsibilities, there was no agreement on how this accountability could be brought about. One of the biggest barriers seen in this area was a lack of any comprehensive listing or database of all "Independent" contractors in the state, which would be needed to both assess individual liability and enforce individual accountability for compliance.

Additional discussion points of this group included:

1. That many benefits in this country accrue from the employer-employee relationship and that individual workers do not understand what it is they give up by being independent contractors versus employees. Additionally, there may be incentives for certain workers to push for independent contractor status to avoid family or societal responsibilities.

2. Businesses who misclassify workers may not realize they also give up rights such as immunity from civil lawsuit afforded by the Workers' Compensation system under Maine law. Businesses expose themselves to civil liability should a misclassified (according to the Workers' Compensation Act) independent contractor get hurt. This would be true regardless of any contract specifying otherwise. Workers' Compensation premium costs were the highest avoided cost of those costs identified in the Harvard study.

3. That the respective federal (IRS) and state (MRS) tax revenue agencies are more focused on receiving either a 1099 or a W-4 (any tax revenues) than whether workers are classified as employees or as independent contractors due to the nature of the tax laws they administer. This contrasts with the Workers' Compensation Board and the Unemployment Compensation systems where coverage itself is dependent on the relationship's existence.

4. That there is no one feature of the system in place that guarantees that a worker can be considered an independent contractor for all purposes due to the differing purposes and goals of the various employment laws being administered. Furthermore, the combination of features that would do this (such as incorporation

and paying their own taxes and premiums for all these systems) greatly increases the burden on the independent contractor to the point that compliance is less likely.

**Study Group Findings:**

Although there was no consensus from the group around specific recommendations for reducing or eliminating the incidence of worker misclassification in the Construction Industry, there were a number of ideas generated that may warrant further study and analysis. These included the following:

- That government agencies consider the feasibility of a single definition of "employee"-- if one definition is not feasible, work to provide clarification around the different definitions and requirements and ensure that each agency only applies their own definition (as opposed to making employment decisions based on another agency's laws or definitions).

- Use 1099s (MRS) to identify independent contractors. Examine the feasibility of using Maine Revenue Services to continue research and evaluation of data from the form 1099 to determine the extent and appropriateness of the use of independent contractors (of all industries, not just construction). [**Note:** the Harvard Study also recommended further analysis using an approach that matches 1099 information returns filed by businesses on behalf of their independent contractors with individual income tax returns for the workers concerned. This approach would enable analysts to identify those individuals that derive all or most their income from a single business – a strong indicator of misclassification – and thus provide the basis to more accurately estimate the percent of workers misclassified.[4]]

- Education – needed for *both* business and independent contractors. Initiate and implement a public information effort including workplace postings (similar to Minimum Wage and Workers' Compensation) advising of rules and conditions under which independent contractors can be utilized.

- Enforcement – strong enforcement of existing laws. Vigorous enforcement of proper classification of employees.

- Examine whether there are ways to allow the independent contractor to function as such legally and hold businesses that hire them harmless in terms of liability. Independent contractors assume their own liability (i.e., for work injuries, unemployment, etc.) – cannot go back at the businesses they performed work for. Additionally, independent contractor shouldn't be allowed to collect Unemployment Insurance or Workers' Compensation benefits if they aren't paying into these systems themselves. Shift responsibility to independent contractors – they need to pay their own way. As part of such a program's implementation, consider allowing

[4] Summary findings of the The Social and economic Costs of Employee Misclassification in the Maine Construction Industry report, issued April 25, 2005 by the Construction Policy Research Center, Labor and Worklife Program of the Harvard Law School and the Harvard School of Public Health.

amnesty for independent contractors to deal with any taxes owed and to encourage program participation.

- Need to make sure that businesses are not precluded from hiring independent contractors legitimately.

- Workers' Compensation Insurers want binding workers compensation liability pre-determinations.

- Possibly require independent contractors to register as a business with some agency (i.e., Secretary of State for example).

Attachments:

1. Worker Misclassification Study Group Members

2. Harvard study report: "The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry" released April 25, 2005.

3. IRS handouts on independent contractors or employee business relationships.

    - "Independent Contractor or Employee" – brochure & fact sheet
    - "Revenue Ruling", 87FED Section 6503
    - "SS-8 Determination of Worker Status" Form & Instructions

4. ABC test handouts including article, "Applying the 'ABC' Test to determine liability for unemployment Compensation" by Elizabeth Wyman, Assistant Attorney General, State of Maine.

    - "Determining Liability for Unemployment Compensation: The ABC Test"
    - "Independent Contractors in Maine" Brochure
    - "Applying the 'ABC Test" to Determine Liability for Unemployment Compensation," article by Elizabeth Wyman, Assistant Attorney General, State of Maine

5. Workers Compensation handout on the Workers' Compensation Act – Determination of Independent Contractor Status.

# Attachment I

## Study Group Member & Participant List

## Worker Misclassification Study Group Member & Attendee List

**Members**

1. Lloyd Black, Maine Department of Labor, Unemployment Compensation
2. Laura Boyett, Maine Department of Labor, Unemployment Compensation
3. Alan R. Burton, Cianbro Corporation
4. John Butts, Associated Constructors of Maine, Inc.
5. Joan Cook, Maine Department of Labor, Unemployment Compensation
6. Elaine Corrow, Dept. Administration & Financial Svs, Maine Revenue Services
7. Mary Delano, Bernstein, Shur, Sawyer & Nelson
8. Christine Gauthier, U.S. Department of Treasury, Internal Revenue Service
9. Jane Gilbert (Group Leader), Maine Department of Labor
10. Rod Gillespie, Operators Local 4
11. Peter Gore, Maine Chamber of Commerce
12. Ed Gorham, Maine AFL-CIO
13. John R. Hanson, Building Trades Council
14. Bruce Hilfrank
15. Rick Holden, Maine Staffing Association
16. Gregory Jamison, MEMIC
17. Mike Joseph, Joseph's Flooring
18. Bruce King, Carpenters Local 1996.
19. Peter Lacy, Maine Department of Labor, Labor Standards
20. John Leavitt, Carpenters Local 1996
21. Leslie Manning, Maine Department of Labor, Labor Standards
22. Sandy Mathieu, Home Builders Association of Maine
23. Ned McCann, Maine AFL-CIO
24. James McGregor, Maine Merchants Association
25. Jan McNitt, Maine Workers Compensation Board
26. Kathleen Newman, Associated Builders & Contractors, Inc. of Maine
27. Doug Newman, Newman Concrete Services, Inc.
28. William Peabody, Maine Department of Labor, Labor Standards
29. Roger Pomerleau, Maine Merchants Association 496
30. Craig Reynolds, MEMIC
31. Ashley B. Richards, Jr., Richards & Company/HBRA
32. John Rioux, Maine Department of Labor, Labor Standards
33. John Rohde, Maine Workers Compensation Board
34. Alan Stearns, Office of the Governor
35. Beth Sturtevant, CCB Inc
36. Doug Trask, Ironworkers Local
37. Chris Tucker, Laborers Local 1377
38. Daniel Walker, Bernstein, Shur, Sawyer & Nelson
39. Elizabeth Wyman, Office of the Attorney General

# Attachment II

**Harvard study report: "The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry" released April 25, 2005.**

# The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry

Françoise Carré, Ph.D. and Randall Wilson
Center for Social Policy
McCormack Graduate School of Policy Studies
University of Massachusetts Boston

A report of the

## Construction Policy Research Center

## Labor and Worklife Program, Harvard Law School
## and
## Harvard School of Public Health

Elaine Bernard, Ph.D. and Robert Herrick, Sc.D. Principal Investigators

April 25, 2005

This project was funded by the Center to Protect Workers' Rights in Silver Spring, MD.
through a cooperative agreement from the National Institute for Occupational Safety and Health.

# I. Summary Findings

With this study, a cross disciplinary team of the Center for Construction Policy Research has taken a first and significant step in documenting employee misclassification in the Maine construction industry. This report documents the dimensions of misclassification and its implications for tax collection and worker compensation insurance.

Misclassification occurs when employers treat workers who would otherwise be waged or salaried employees as independent contractors (self employed). Or as one report commissioned by the U.S. Department of Labor put it, misclassification occurs "when workers (who should be) getting W-2 forms for income tax filing instead receive 1099-Miscellaneous Income forms."[1]

Forces promoting employee misclassification include the desire to avoid the costs of payroll taxes and of mandated benefits. Chief among these factors is the desire to avoid payment of worker compensation insurance premiums.

Employee misclassification creates severe challenges for workers, employers, and insurers as well as for policy enforcement. Misclassified workers lose access to Unemployment Compensation and to appropriate levels of worker compensation insurance. Also, they are liable for the full Social Security tax. They lose access to employer-based benefits as well. For employers, the practice of misclassification creates an uneven playing field. Employers who classify workers appropriately have higher costs and can get underbid by employers who engage in misclassification. The collection of Unemployment Compensation tax, and to some degree that of the income tax, are adversely affected by misclassification. Worker Compensation insurers experience a loss of premiums.

Using several years of de-identified data on Unemployment Compensation tax audits made available, tabulated, and prepared by the Maine Department of Labor (DoL) Bureau of Labor Standards, we have developed estimates of the dimensions of misclassification in the state and particularly in the construction industry.

Because this study relies on Unemployment Compensation tax audits to develop estimates of the dimensions and impacts of misclassification, it addresses primarily the forms of misclassification that can be documented. It does not fully capture the scope of underground economy activities in construction.

## Employee Misclassification in Maine

- During the years 1999-2002, *at least one in seven, or 14% annually, of ME construction employers are estimated to have misclassified workers* as independent contactors. This estimate translates into a minimum of 748 construction employers statewide.[2] Across all industries[3], 11% of employers annually from 1999 to 2002 were found to under-report worker wages and Unemployment Compensation tax liability to the state and thus to have misclassified workers. This represents about 4,800 employers statewide.[4]

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[1] Lalith de Silva et al. 2000. *Independent contractors: prevalence and implications for Unemployment Insurance programs.* Planmatics, Inc., Prepared for US Department of Labor Employment and Training Administration. Planmatics, 2000. (Hereafter, Planmatics 2000.)

[2] The yearly number of Maine construction establishments averaged over the period 1999-2002 was 5,274 in construction and 42,856 across all industries.

[3] The "all industries" category includes Construction as well.

[4] Planmatics, 2000. This estimate is based on audits of employers that, while not selected by fully statistically random methods, are considered random, or non-targeted, audits in common auditing practices

- *When construction employers misclassify, they do so extensively.* A key measure of misclassification is the degree or severity of its impact *within* employers who misclassify. This measure indicates that *misclassification is a common occurrence rather than an isolated incident in construction companies where misclassification occurs.* According to our estimate, over 4 in 10 workers (45%) are misclassified annually in construction employers found to be misclassifying in the period 1999-2002.

- When we consider the workforce of all employers (those that misclassify and those that do not), *at least one in nine (11.0%) construction workers annually in ME is estimated to be misclassified as an independent contractor during the period 1999-2002.*

- We estimate that the actual number of construction workers affected by misclassification across the state to be at least 3,213 annually during the period 1999-2002.[5]

- Maine construction employers are about as likely as their counterparts in Massachusetts to misclassify workers as independent contractors. In both cases, about one in seven (14%) of employers in this industry do so.

- Construction workers in Maine, however, are misclassified at higher rates than those in Massachusetts. For those working for employers who misclassify, they are somewhat more likely than Massachusetts workers to be misclassified (45% versus 40% of Massachusetts workers employed by misclassifying employers). The misclassification rate for workers in all construction employers is also higher: one in nine (11%) for Maine, compared to one in twenty (5%) for Massachusetts workers.

- While misclassified individuals lose out on Unemployment Compensation, the UC system is adversely affected as well. We estimate that approximately $314,319 annually in Unemployment Compensation taxes are not levied on the payroll of misclassified construction workers statewide.[6]

- At income tax time, workers misclassified as independent contractors are known to under-report their personal income; therefore, the state experiences a loss of income tax revenue. Based on an estimate that 30% of the income of misclassified workers is not reported, we estimate roughly that $2.6 million annually are lost due to misclassification in construction. Based on an estimate that 50% of misclassified worker income goes unreported, roughly $4.3 million a year in income tax loss occurs due to misclassification in construction.

- The worker's compensation insurance industry loses on premium collection, a significant issue if, as is reported in previous studies[7], misclassified workers are surreptitiously added onto companies' worker compensation policies *after* they are injured. For these workers, benefits are paid out even though premiums were not collected. We estimate that up to $6.5 million of worker compensation premiums are not paid annually for misclassified construction workers.[8]

- On the federal level, misclassified workers' FICA taxes go uncollected. We estimate that the misclassification of construction workers results in a loss of nearly $10.3 million annually.

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[5] The yearly number of workers over the period 1999-2002 was 29,209 in construction and 573,322 across all industries.

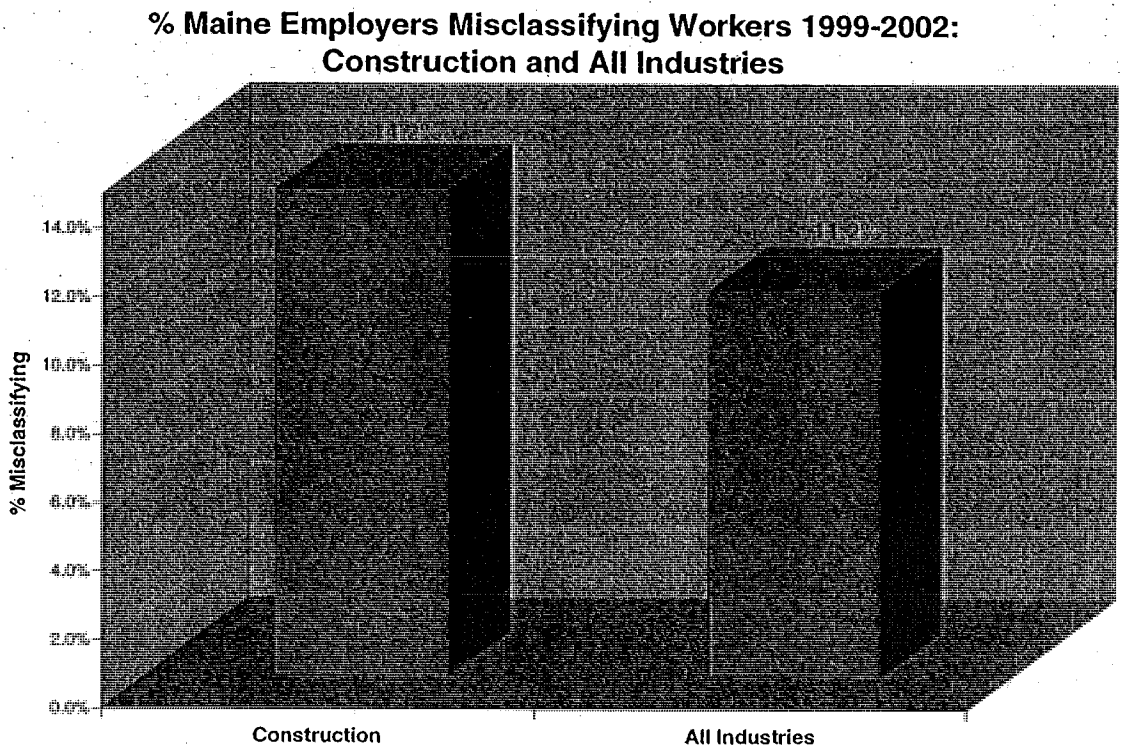
[6] This figure represents estimated *annual* losses to Unemployment Compensation tax revenues for construction. While it is based on audit data pooled from *multiple years* (1999-2002), it is a statewide estimate for *a single year* in the years 1999-2002, based on construction employment averaged over the four-year period. Note that all subsequent estimates in this report for tax losses (to Unemployment Compensation, state income tax, and worker compensation) are computed similarly, drawing on the entire period of audits to create average loss estimates for a single year.

[7] Planmatics, 2000.

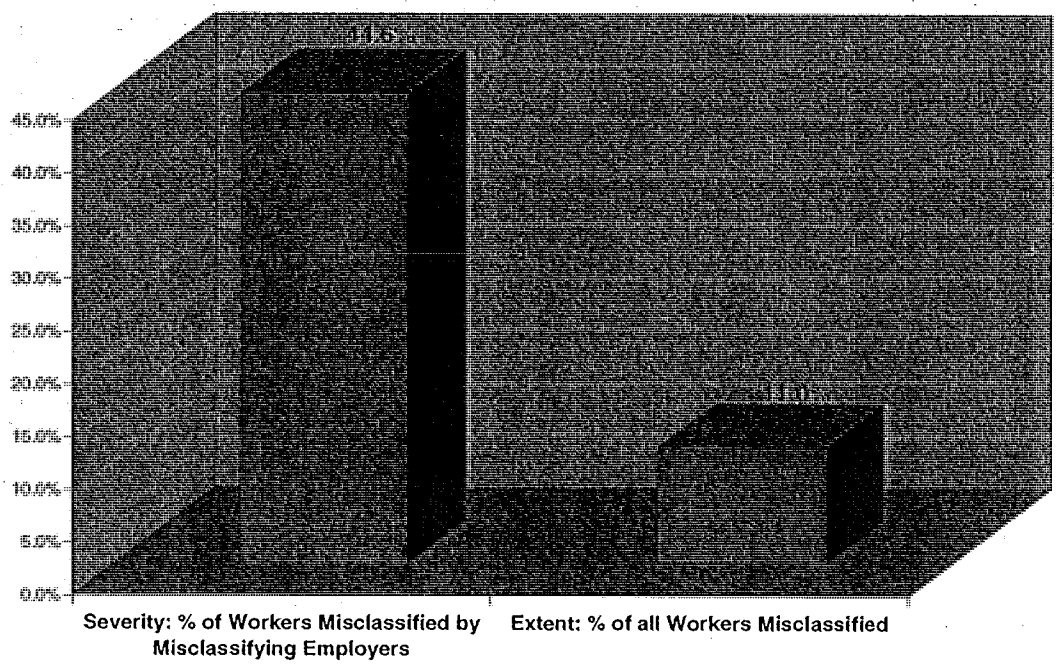
[8] This assumes that worker compensation insurance premiums comprise an average of $20 per $100 of payroll. Using a more conservative estimate, at $12 per $100 of payroll, annual losses are close to $2.3 million.

- We believe that worker misclassification is a compelling problem requiring attention. It has significant consequences for workers, employers, insurers, and for tax revenues. We strongly recommend that a study employing both business and individual income tax returns be conducted by the Maine Revenue Services. It would provide an even more accurate measure of the tax revenue implications of misclassification. Workers, businesses, revenue collection agencies, and policy analysts all stand to benefit from better documentation of the impacts of misclassification.

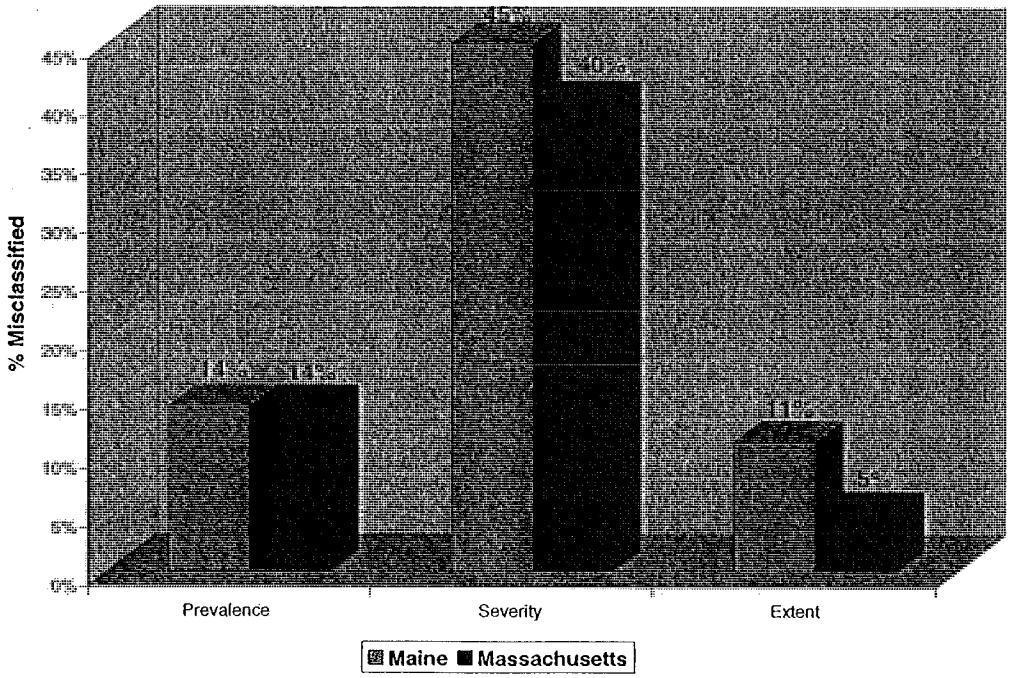
## Facts at a Glance



## Severity and Extent of Construction Worker Misclassification: Maine 1999-2002




## Construction Misclassification in Maine vs Massachusetts: Prevalence, Severity, and Extent



## Acknowledgements

This project received funding from the National Institute for Occupational Safety and Health through a cooperative agreement with the Center to Protect Workers' Rights in Silver Spring, MD.

The authors wish to thank the Maine Department of Labor. We are particularly grateful to William Peabody, Director, Bureau of Labor Standards, and John Rioux, Director of the Technical Services Division, Bureau of Labor Standards, who provided access to de-identified audit data, prepared data files, and answered our numerous queries about variable definitions. Kurtis Petersons, Intern at the Bureau of Labor Standards, compiled the audit data from the reports, supplemented it with manual records, and made extensive computations of the magnitude and impacts of misclassification for the state. In so doing, he made a crucial contribution to this project.[9]

In addition, we would like to thank the staff of the Tax Division, Bureau of Unemployment Compensation, who performed the audits, collected the data, and allowed access to it; particular thanks to Claire Hersom, who supplied and explained audit reports, and answered detailed questions that arose. Lloyd Black also assisted with clarification of audit terms and methods.

The authors also thank the members of this project for contributing to the implementation of the research and the interpretation of the results: Elaine Bernard, Ph.D. and Robert Herrick, Sc.D., Principal Investigators, as well as Mark Erlich of the United Brotherhood of Carpenters Local 40 and Prof. David Weil, Economics, Boston University and Harvard Kennedy School of Government. We also thank Lorette Baptiste and Dr. John Trumpbour at the Harvard Labor and Worklife Program.

# II. The Problem

*Misclassification occurs when employers treat workers who would otherwise be waged or salaried employees as independent contractors.* Or, as one report commissioned by the U.S. Department of Labor put it, "when workers (who should be) getting W-2 forms for income tax filing instead receive 1099- Miscellaneous Income forms."[10] In practice, these workers must take out their own taxes for Social Security and Medicare, rather than having the employer withhold them. But determining who is an employee, and who is a contractor, is sometimes far from simple. The distinction is complicated by deliberate deceptions on the part of employers (and collusion by workers, at times), who seek to avoid paying taxes and meeting other legal obligations to employees and to government. But even when there is no intent to deceive, ambiguities in employment law and relationships can result in misclassification, or make it easier to occur.

*How is misclassification accomplished?* Misclassification usually begins at the point when workers are hired. Practices vary widely. In one common pattern, employers put prospective hires to work as self-employed contractors and, for tax purposes, issue them a "1099" Miscellaneous income form. (Workers are sometimes referred to on construction sites as "1099s" or "subs," as well as independent contractors.) The paperwork does not stop there. Sometimes, before workers can begin employment, employers require them to purchase their own workers' compensation and liability insurance coverage. They are expected to sign certificates of worker's compensation insurance and of liability insurance as well as various other waivers absolving the employer of obligations. (However, because this workers' compensation insurance only covers the holders' employees, it has no value for the worker and only protects the employer in case of tax and/or insurance audits.) Another pattern, at the other end of the spectrum of practices, entails entirely informal arrangements with cash payment and no 1099 tax reporting. This second pattern leaves

[9] Petersons, Kurtis. 2004. *Prevalence of Misclassification in the Construction Industry: Executive Summary.* Maine Department of Labor. Bureau of Labor Standards. Unpublished Report, August.
[10] Planmatics, 2000.

no documentation. The practice is part of what is termed the "underground economy" and is often paired with the hiring of unprotected, undocumented workers.

*Forces promoting employee misclassification include the desire to avoid the costs of payroll taxes, and of mandated benefits.* One factor stands out, however. A recent U.S. Department of Labor-sponsored report found that the "number one reason" for misclassifying workers lies in avoiding payment of workers' compensation insurance premiums and thus escaping workplace injury and disability-related disputes.[11] Driven by increased medical costs, worker compensation costs rose significantly over the past 20 years.[12] And in industries such as construction worker compensation costs are particularly high.

*Misclassification creates severe challenges for workers, employers and insurers as well as for policy enforcement.* For workers who are misclassified, it creates immediate and long term problems. These include the lack of access to unemployment compensation, and to appropriate levels of worker compensation insurance.[13] They entail liability for the full Social Security tax (rather than half for employees). They also include the loss of access to health insurance, and other employer-based social protection benefits. If injury strikes, it can be catastrophic for the worker.

Misclassification creates challenges for compliant employers because it creates an uneven "playing field." Employers who respect the law and classify employees appropriately have a higher wage bill and can get underbid by contractors that do not comply and have lower costs.

Misclassification presents a two-fold challenge for policy implementation. The *enforcement* of labor standards, such as those governing health and safety, or of wage and hours regulations is made more difficult in contexts where there are misclassified independent contractors. *Tax collection* is affected as well. This includes collection of Unemployment Compensation tax. It also includes state income tax because independent contractors are known to underreport their income.

The worker compensation insurance industry is also adversely affected by misclassification. Employers with misclassified workers have been known to surreptitiously add uncovered independent contractors, or those with insufficient coverage, back onto a company's worker compensation policy *after* they are injured. Therefore, benefits are paid out to workers for whom an insurance premium has not been paid according to a U.S. DOL commissioned study.[14]

Misclassification presents broader societal costs that are harder to document. For example, workers without health insurance might resort to publicly subsidized emergency medical care. The costs of "uncompensated care pools" make their way into the costs of health and worker compensation insurance. Also, workers who sustain injuries, and have inadequate worker compensation coverage, make use of public assistance when they are unable to work.

A problem of this importance for individual workers, businesses, and government requires thorough documentation. This study of the Center for Construction Policy Research represents a significant step in documenting employee misclassification in the Maine construction industry and in estimating the costs of misclassification in terms of tax loss and worker compensation insurance premium losses. It follows upon a similar study, completed in December 2004, of the Massachusetts construction industry. In subsequent work, the researchers plan to benchmark Maine and Massachusetts results with those of other New England states.

The Maine Department of Labor (DoL), Bureau of Unemployment Compensation, Tax Division conducts UC tax audits by drawing randomly from a sample of 38,000 active private-sector employers

[11] Planmatics, 2000.
[12] This rapid growth has tapered in recent years but the cost of Worker Compensation insurance remains high.
[13] Misclassified workers must establish that they are indeed employees in order to receive unemployment or worker compensation insurance.
[14] Planmatics, 2000, p. 76.

in the state. The list thus generated is sorted by regions in the state associated with field staff and inspectors, who then conduct audits based on the list. According to the Bureau, the resulting list is random for a particular region, though there may be regions that are over-represented in the audit sample relative to their share of employers and employment.

Using several years of de-identified data on Unemployment Compensation tax audits made available by the Maine Department of Labor, we have developed estimates of the dimensions of misclassification in the state and particularly in the construction industry for the years 1999-2002.[15] Using methods established in previous studies, in particular one commissioned by the U.S. Department of Labor, we present projections of the costs of misclassification for Unemployment Compensation, state income tax, worker compensation insurance systems, and Social Security contribution taxes, or FICA.[16]

Unemployment Compensation (UC) tax audit records are a key source of information on employee misclassification. When an audit finds workers not covered by UC who should be (and documents under-reported wages), the cause is virtually always misclassification as independent contractor of someone who should be an employee included in the company payroll. Therefore, information from UC tax audits, indicating "new" or previously unreported workers, is a useful proxy for employee misclassification.[17]

Because this study relies exclusively on UC tax audits to develop estimates of the dimensions and impacts of misclassification, it addresses primarily the forms of misclassification that can be documented. It cannot fully capture underground economy activities in construction and other sectors. Thus all estimates are, of necessity, low or conservative in nature.

# III. Dimensions of Misclassification in Maine

## When employers engage in misclassification

During the years 1999-2002, at least one in seven, or 14%, of Maine construction employers are estimated to have misclassified workers as independent contactors. This estimate translates into a minimum of 748 construction employers statewide. Construction employers appear to engage in misclassification more frequently than the average of employers across all industries. Across all industries[18] as a whole, 11% of employers were found to under-report worker wages and UC tax liability to the state and thus to have misclassified workers. This represents about 4,792 employers statewide. This conservative estimate is based on audits of employers that, while not selected by fully statistically random methods, are considered non-targeted or random audits in common auditing practices.[19]

**Prevalence of Misclassification: Percentage and Number of Maine Employers Found to Misclassify Workers as Independent Contractors - Maine 1999-2002**

| | % Misclassifying | Number Misclassifying |
|---|---|---|
| All Industries | 11% | 4,792 |
| Construction | 14% | 748 |

[15] This study analyzes data on private sector employers exclusively.

[16] Planmatics, 2000.

[17] In audit data, "new workers" that is, previously uncovered workers who are to be added to the employer payroll for UC tax purposes, are proxies for misclassified workers.

[18] This "all industries" category includes Construction as well.

[19] Planmatics, 2000.

## Workers affected by misclassification

To understand how workers are affected by misclassification, we use two measures. The first measure is the percent of workers misclassified *within employers found to have misclassified workers.* This first measure is the degree of impact, or *severity of impact,* of misclassification when it occurs. The second is the percent of workers misclassified *among all workers in construction or in the state as a whole* (including employers who misclassify and those who do not). This second measure is the *extent* of misclassification.

**1) Severity of impact of misclassification:**

The measure of severity of impact indicates that in construction companies where misclassification occurs, it is a common occurrence rather than an isolated incident. According to the estimate, more than 4 in 10 workers (45%) are misclassified in these employers.

**2) Extent of misclassification**

*Over the 1999-2002 period, at least one in nine (11.0%) construction workers in ME is estimated to be misclassified as an independent contractor annually.* Based on this proportion, we estimate that the actual number of construction workers affected across Maine is at least **3,213.**

**Severity and Extent of ME Workers Misclassified as Independent Contractors**

| | Percent Misclassified |
|---|---|
| Severity: % of Workers Misclassified by Misclassifying Employers | 44.6% |
| Extent: % of all Workers Misclassified | 11.0% |

# IV. Implications of Employee Misclassification in Maine

We estimate the implications of employee misclassification for Unemployment Compensation tax revenues as well as state income tax revenues. We also estimate the amount of workers' compensation insurance premiums lost due to misclassification. These cost estimates rely upon our estimates of prevalence and extent of misclassification from random audits. They are therefore conservative estimates. In fact, our approach is more conservative than that used in the DOL commissioned study, which used a rate of prevalence derived from mixes of random and targeted audits.[20] (Further details on calculation methods are in the Appendix.)

Data used here from Maine employer audits are closer to a truly random sample than those available in many states. The Maine Department of Labor (DoL), Bureau of Unemployment Compensation, Tax Division conducts UC tax audits by drawing randomly from a sample of 38,000 active private-sector employers in the state. The list thus generated is sorted by regions in the state associated with field staff and inspectors, who then conduct audits based on the list. According to the Bureau, the resulting list is random for a particular region, though there may be regions that are over-represented in the audit sample relative to their share of employers and employment.

[20] Planmatics, 2000.

## The implications of employee misclassification for Unemployment Compensation tax

Workers who should be misclassified as employees lose out when work ceases, and they are ineligible for Unemployment Compensation. In some cases, workers may be unaware that they are ineligible. Some employer audits are triggered when workers file for Unemployment Compensation and the claim is contested.

In addition to individuals, the Unemployment Compensation system is also affected by misclassification. The Unemployment Compensation tax is a payroll tax and, when workers are misclassified, the tax is not levied on their earnings, as it should. We estimate that $314,319 in UC tax was lost annually over the period 1999-2002 due to misclassification in construction statewide. We further estimate that the state lost an estimated $98 per construction worker misclassified per year over the period 1999-2002.[21]

To derive these estimates of the size of the UC tax loss, we replicated the method used in the 2000 US DOL-commissioned report to assess the impacts of misclassification on UC trust funds. Essentially, the method entails computing the average tax loss per worker due to misclassification for the audit sample and multiplying this amount by the estimated number of workers misclassified statewide in one year.

## The implications of employee misclassification for state income tax revenues

At income tax time, workers misclassified as independent contractors are known to under-report their personal income (they are over-represented among taxpayers found to owe taxes relative to their share of taxpayers and the problem seems to have worsened).[22] Therefore, the state experiences a loss of income tax revenue.

*Estimations of state income tax loss due to misclassification range from $2.6 million to $4.3 million, and are highly sensitive to the assumptions made in generating them. Such assumptions include the tax filing status of misclassified workers, their income levels, the deductions taken, and the proportion of their income that is under-reported.*

For this analysis, we began with a conservative estimate that 30% of the income of misclassified workers is not reported. We estimate roughly that $2.6 million of income taxes are lost due to misclassification in construction annually. We assumed that any standard or itemized deductions were taken fully on the reported share of income and therefore do not apply to the unreported income.[23] All misclassified workers were assumed to be filing as single individuals or as married persons filing separate returns.

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[21] This estimate for losses to Unemployment Compensation tax are based on *UC-taxable wages underreported by misclassifying employers*; other estimates, such as losses to worker compensation insurance premiums or to FICA tax, are based on *total misclassified wages.* These figures differ because Maine applies the UC tax to the first $12,000 of employee income only.

[22] Historically, self-employed workers (whether misclassified or not) have tended to under-report their income, according to federal sources. For example, of $79.2 billion in taxes owed the IRS in FY93, 74 % was owed by taxpayers with primarily non-wage income. Also, the IRS Inspector General reported that the number of 1099 information returns with missing or incorrect Taxpayer Information Numbers (an indicator of possible misclassification) grew by 36% from 1995-98 (US Treasury Department 2001).

[23] For this computation, we estimated the annual (self employment) earnings of misclassified construction workers to be $31,500. This estimate is a rounded average based on annual earnings of Maine construction

Using the same assumptions, but estimating that 50% of misclassified worker income goes unreported, we roughly estimate that income tax loss from construction workers amounts to $4.3 million of revenue per year.

In response to these estimates, the Maine Revenue Service (MRS) provided an alternate and lower approximation of state income tax loss, using our estimate of numbers of workers misclassified and their average earning level, but based on different assumptions regarding taxpayer households. MRS, in comparison, assumed that there were equal proportions of misclassified workers from various tax filing categories, and applied a blended rate of taxation that averaged across these categories. In the case where misclassified workers under-report 50% of their income, the MRS calculates that $2.7 million in state income tax revenue may be lost due to misclassification.[24]

These cost estimates make conservative assumptions about the share of misclassified independent contractor income that goes unreported. A U.S. General Accounting Office report cites IRS reports that self-employed workers operating formally under-report 32% of their business income[25] but that "informal suppliers" (self employed reporting cash income) do not report 81 percent of their income (GAO 1997, p. 3). Therefore, an estimate of tax loss prompted by employee misclassification could be higher, if higher shares (more than 50%) of total income go unreported.

It is also worth noting that we did not compute the loss of federal tax revenue which is also likely to be high. The IRS estimates that unreported income contributes to most of the tax gap (difference between taxes owed and taxes collected).[26]

**Estimated Annual Losses in ME State Income Tax due to Construction Worker Misclassification: 1999-2002**

| Loss Estimate by Source | 30% of income not reported | 50% of income not reported |
|---|---|---|
| GPRO | $2,580,039 | $4,266,864 |
| Maine Revenue Service | NA | $2,714,369 |

## The implications of employee misclassification for worker compensation

The workers compensation insurance industry loses on premium collection, a significant issue if, as is reported in previous studies, misclassified workers are surreptitiously added onto companies' worker compensation policies *after* they are injured. For these workers, benefits are paid out even though premiums were not collected.

Data were not available to us to compute the extent to which benefits are paid to workers for whom premiums were not paid. However, we estimate the amount of insurance premiums that would have been collected were workers not misclassified.

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workers for the years 1999-2002, derived from the BLS-ES202 database for Maine. For workers hiding 50% of their income, we estimated unpaid taxes based on a 7% tax rate on income in excess of $8,250 plus $268. Those hiding 30% of their income fell into the highest tax bracket, at 8.5% of all income over $16,500 plus $846.

[24] The MRS indicates that these calculations do not take into consideration existing compliance efforts already in place within MRS that may address underreporting/non filing issues; thus they believe that their estimate is still relatively high.

[25] A 1974 IRS report indicated that all independent contractors (misclassified or not) did not report 26% of their income, so under-reporting may be worsening over time (US Treasury Department 2001, p. 7).

[26] Out of a $62.8 billion income tax gap from individuals in 1992, 32% or $20.3 billion was due to self-employed workers (GAO 1994).

We estimate that over the period 1999-2002, up to $6.5 million annually of worker compensation premiums were not paid for misclassified construction workers. This estimate is broad. It applies an average worker compensation premium of $20 per $100 of payroll to the estimated amount of wages for misclassified workers statewide in construction. Alternatively, with an average worker compensation premium of $12 per $100 of payroll, we estimate that $3.9 million annually in premiums were not paid for misclassified construction workers; at $15 per $100 payroll, a mid-range estimate, $4.9 million in premiums were not paid annually.

A more detailed estimate of losses would apply detailed worker compensation rates for construction trades (such as finished carpentry, or drywall) appropriately weighed by the share of employment accounted for by each trade.[27]

### The implications of employee misclassification for FICA tax collection

When workers are misclassified, it also creates losses in federal revenue. One particular example is the FICA tax, or contributions to Social Security paid by both employer and employee. Using a combined tax rate of 15.3%, we estimate that misclassification of Maine construction workers results in a loss of almost $10.3 million per year over the years 1999-2002.

## VII. Strengths and limitations of estimates of misclassification

Prior research on misclassification has generated estimates *for all industries* primarily, rather than for construction per se. Only one federal study provides a 1984 estimate that 20% of construction employers engage in misclassification (GAO 1996).

In this section, we examine in greater detail estimates from other studies for all industries and compare these with the estimates we derived from our analysis of the Maine UC tax audit data. This exercise has enabled us to put lower and upper bounds to our estimate. We also compare Maine to our own findings on misclassification in Massachusetts.

### Comparing Maine 1999-2002 estimates to data from other states

The table below summarizes the results of the study commissioned by the U.S. Department of Labor for misclassification *across all industries* in nine states (Planmatics 2000), as well as a 1984 Treasury Department estimate (U.S. GAO 1996) for employers nationwide. In comparing Maine to other states, bear in mind that the state conducts virtually all of its audits, save a small number targeted on the basis of tips or past violations, by random methods. In other states such as those studied for the U.S. Department of Labor report, audit results are based on a larger share of "targeted" audits relative to random audits. Since targeted audits are more likely to uncover employer violations, such states tend to report higher levels of documented misclassification.

The US DOL-commissioned study arrayed 9 states according to their mix of "targeted" and "random" audits. In the tables that follow, the low estimate for the 9 states sample is derived only from states with a low proportion of targeted audits in their audit mix. Maine, with essentially 100% random audits, falls within this category. Conversely, the "high" estimate is derived only from results for states with higher share of targeted audits in their mix, and the "moderate" estimate from states with 30 to 50 % of random audits in their mix.

[27] Maine compensation insurance base rates range from $10.40 per $100 payroll for interior tile work, to $22.01 for 1-2 family carpentry, and $31.40 for plastering.

**Past State and National Estimates of the Prevalence of Employer Misclassification**

| | Low Estimate | Moderate Estimate | High Estimate |
|---|---|---|---|
| All industries (9 states) 1/ | 5-10% | 13-23% | 29-42% |
| All industries (US) 2/ | | 15% | |
| All Industries ME | 11% | | |
| Construction ME | 14% | | |
| Construction MA | 14% | 24% | |
| Construction (US) 2/ | | 20% | |

1) All industries based on DOL/Planmatics state estimate ranges, ~1999
2) Based on 1984 Treasury Department estimate, cited by U.S. GAO. (1996)

For all industries, our estimates for ME generally fall close to or within the ranges found in other states and for the US as a whole. Our estimate for all Maine employers is only slightly higher (11%) than the rate found for states from the U.S. DOL study with a high share of random audits (5-10%).

The next table compares ME to the U.S. DOL study's state findings in greater detail. It also presents the degree to which each state did target audit candidates versus relying on more "random" selection methods. For the 9 states in the U.S. DOL study, we observe that, as expected, the more a state targets employers (by size/industry/location, by past record, by presence of worker claim), the higher is the observed rate of misclassification. Maine conforms closely to this pattern. For the period 1999-2002, the Maine DoL relied almost exclusively on "random" (less targeted) methods. It is thus closest to the "high random" states listed below.

## Prevalence of Misclassification in All Industries: ME vs. DOL State Estimates

| State | % employers misclassifying workers | % of audit group randomly sampled | Dominant Audit method |
|---|---|---|---|
| ME | 11% | 99-100% | High randomness |
| MD | 5% | 100% | High randomness |
| WA | 10% | 98% | High randomness |
| CO | 5% | 90% | High randomness |
| MN | 13% | 30-50% | Moderate randomness |
| NE | 10% | 30-50% | Moderate randomness |
| NJ | 9% | 30-50% | Moderate randomness |
| WI | 23% | 18% | Low randomness |
| CN | 42% | 5% | Low randomness |
| CA | 29% | 1% | Low randomness |

A further source of comparison comes from another New England state, Massachusetts. Maine construction employers are about as likely as their counterparts in the Bay State to misclassify workers as independent contractors. In both cases, about one in seven (14%) of employers in this industry do so. Workers in Maine, however, are misclassified at higher rates. For those working for employers who misclassify, they are somewhat more likely than Massachusetts workers to be

misclassified (45% versus 40% of Massachusetts workers employed by misclassifying employers). The misclassification rate for workers in all construction employers is also higher: one in nine (11%) for Maine, compared to one in twenty (5%) for Massachusetts workers.

## Construction Misclassification in Maine vs. Massachusetts: Prevalence, Severity, and Extent, 1999-2002

| | Prevalence | Severity | Extent |
|---|---|---|---|
| Maine | 14% | 45% | 11% |
| Massachusetts | 14% | 40% | 5% |

On a number of dimensions — construction wages as a share of state's average wage, distribution of construction establishments by subsectors, and distribution of employment by subsectors— the Maine construction industry does not differ significantly from that in Massachusetts. However, the two state construction industries have different unionization rates; about 10% in Maine as compared to 28% in Massachusetts (estimates). Also, the share of value of construction work is highest for the building, developing and general contracting category in Massachusetts (43% of the value of construction work). In contrast, it is highest for the specialty trade contractors in Maine (44% of the value of construction work).[28] Maine construction employers employ fewer workers, on average, than their Massachusetts counterparts, with 5.53 workers/establishment, compared with 7.38. Finally, worker compensation insurance as a share of total payroll is higher in Maine than in its southern neighbor for a number of construction trades.

# VIII. Next Steps

This study has made significant headway toward documenting the dimensions and impacts of misclassification in construction in the state. Next steps include, first, exploring in greater detail policy proposals for addressing misclassification and look at approaches that have been successful in other states. The second step will be examining more closely the misclassification of workers in distinct construction subsectors (for example, carpentry or dry walling) because accounts from the field indicate that there is wide variation across subsectors in prevalence. Third, we should compare the findings from Maine with those from other New England states. While keeping in mind variations in characteristics of the construction industry across states (e.g. firm size, distribution of activity across types of contractors), we plan to use estimates of incidence, severity, and extent derived from UC tax audit results elsewhere in New England as a further means to gauge the dimensions of misclassification in Maine. Fourth, we should study the misclassification of workers across all industries in Maine, as well as violation within specific industries other than construction. A final report for this project will provide an analysis of policy issues and present the results of Maine in the context of those for other New England states.

More importantly, this study's findings have established that worker misclassification is indeed a compelling problem requiring attention and one with significant consequences for workers, employers, insurers, and for tax revenues. A problem of this importance requires further and more precise documentation, one that would enable analysts to project revenue losses with greater confidence than is possible when relying on UC tax audit data which require making several assumptions.

[28] Sources used included: U.S. Department of Labor, Bureau of Labor Statistics, ES-202 Series (wages, distribution of employment and of establishments by subsector); U.S. Census Bureau, Current Population Survey (unionization); and U.S. Bureau of the Census, 1997 Economic Census, Construction—Geographic Area Series. (Maine, Maine). General Statistics for Establishments With Payroll By State. Table 2, page 9 (value of construction work by subsector).

A tested and more accurate method for measuring misclassification has been established in a national study by the U.S. General Accounting Office (U.S. GAO 1989) and rests on the combined use of business and individual tax information. Such a study could be replicated with state level tax information. This approach entails matching "1099 information returns" filed by businesses on behalf of their independent contractors with individual income tax returns for the workers concerned. This match enables analysts to apply criteria such as deriving all or most of one's income from a single business payer (a strong indicator of misclassification) and thus to estimate the percent of workers misclassified. The federal study (U.S. GAO 1989) that first established this method found that very stringent criteria (e.g. at least $10,000 of income all from a single business payer) point to misclassification that, in turn, is confirmed in virtually all cases (through an IRS audit). Using these criteria, or slight variations of these criteria,[29] would generate measures of the number of workers misclassified in a given tax year and the number of businesses engaged in misclassification, as well as a very reliable accounting of misclassified earnings and tax losses.

We recommend the replication of this federal study with Maine tax information. Such a replication would require the involvement of the Maine Revenue Services because it entails using individual tax record information as well as the sharing of federal business income tax return information by the Internal Revenue Service with the Maine Revenue Services. The capacity exists: as of June 2004, MRS began matching 1099-Misc forms with tax returns to enhance compliance and revenue collection.[30] This matching process could be used to count the cases of likely misclassification as was done by the U.S. GAO at the federal level.

The information generated with the present study presents a compelling case for making this investment in better documenting misclassification in the state through a systematic study of tax records. More precise measures of misclassification would inform a more specific policy debate about means to address it. Our study also makes clear that multiple parties stand to benefit from better documentation of the dimensions and implications of worker misclassification —individual workers stand to gain better social protection, tax authorities stand to recover tax revenue losses, and compliant employers would benefit from an even playing field.

Further research will also need to devise means to document underground activities and their implications. These do not leave traces in UC or tax records that we can readily examine.

[29] For example, the criterion might be amended to receiving most or 70% of one's self-employment earnings from a single business payer.

[30] The department sends independent contractors a reminder to report their income and file taxes.

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# Appendix A - Estimation Methods

*Overview of estimation method*
In each of the estimations that were made of the impacts of misclassification on employers, employees, and state revenues, we drew from a pool of employer audits performed in the years 1999-2002. Using data from multiple years improved the quality of our estimates by increasing the sample size. To generate estimates, we took the following steps:

1) Computed ratios of impact or loss from the pooled data (for instance, the percentage of audited employers misclassifying workers,1999-2002, or the percentage of total earnings that were misclassified, 1999-2002)
2) Computed *annual* averages for the state as a whole over the period 1999-2002 (for instance, the average number of construction workers, or employers, in Maine)
3) Applied ratios derived from the pooled audit data (1999-2002) to these annual averages to derive estimates of workers affected or taxes lost.

The resulting figures, explained in more detail below, are estimates of the annual tax loss or level of impact for the state in any individual year, over the period 1999-2002. *They do not represent cumulative totals for the four years, or estimates that can be reliably applied to any other year in another time period.*

*Calculating the Prevalence of Employer Misclassification (% of employers with misclassified workers)*
Employers are assumed to be misclassifying workers if their audit record reveals one or more 'new worker.' New workers are those who were not covered previously by Unemployment Compensation. We calculate the percentage of all (randomly) audited employers who are misclassifying, and apply the result to the total number of UC-covered employers in the state. We thus assume that the sample of employers selected for auditing is representative of (can stand for) all UC-contributing employers statewide.

*Calculating the Severity of Impact of Misclassification (% of workers misclassified within employers misclassifying workers as independent contractors.)*
To estimate the severity or degree of misclassification among those employers who under-report workers (who would otherwise be covered by UC), we assume that audited employers found to be misclassifying can represent all misclassifying employers in the state. We compute the percentage of workers among these audited employers who are misclassified (or "new workers,") and use it as proxy for the statewide severity (% misclassified) among all Maine employers that misclassify workers.

*Calculating the Extent of Workers Misclassified (% of all workers misclassified as independent contractors)*
We assume that total workers employed by audited employers can represent all UC-covered workers statewide. To estimate the extent of worker misclassification, we compute the percentage of workers at all audited employers who are "new workers," or previously unreported for purposes of Unemployment Compensation taxes. This percentage is applied to the total number of UC-covered workers in the state, averaged over the period 1999-2002.

*Calculating Losses in Unemployment Compensation Taxes*
Annual revenue losses from underpayment of UC taxes (owed on workers misclassified as independent contractors) were estimated using the method employed in the DOL-requested study.[31] We computed an average tax loss per worker due to misclassification of workers in the audit sample. It was derived by dividing total UC tax loss by the number of misclassified construction workers at audited firms during the period 1999-2002. Total UC tax loss was based on "underreported UC-

[31] Planmatics, 2000.

taxable wages" of workers in misclassifying firms; the totals thus refer only to the first $12,000 of worker earnings, based on Maine UC tax policy. This figure was then multiplied by the estimated number of misclassified workers statewide *per year* during this period. We assumed, as before, that the workers in audited firms could stand for all construction workers statewide misclassified as independent contractors (and that the distribution of wages was similar).

*Calculating Losses in the State Income Tax*

To estimate losses in state income tax revenue, we computed two estimates, one assuming that misclassified workers did not report 30% of their income, and the other assuming 50% of income was unreported. To derive tax liability on these amounts, we assumed an average yearly earnings level for construction workers of $31,500. This was based on averaging the annual earnings reported by the US BLS for each of the years 1999-2002 and rounding off. For workers concealing 30% of their income, we used a marginal tax rate of 8.5% for income in excess of $16,500 plus $846, while for those not reporting 50% of income, the highest marginal rate (7.0% for income over $8,250, plus $268) was used. We then computed the differences between taxes on fully reported income and taxes on 30% and 50% hidden income, and multiplied it by the estimated number of misclassified workers statewide (3,213) for each case.

| For Single Persons and Married Persons Filing Separate Returns, 2000-2001 | |
|---|---|
| If taxable income is : | Tax owed is: |
| $8,250 but less than $16,500 | $268 + 7.0% of amount over $8,250 |
| $16,500 or more | $846 + 8.5% of amount over 16,500 |

These estimates were predicated on several assumptions:

1) the average annual wage for construction workers during the period 1999-2002 was $31,500
2) we can derive a usable estimate of tax losses by multiplying the average tax loss per misclassified worker by the estimated number of misclassified workers statewide
3) the average misclassified construction worker can be treated, for tax purposes, as a single head of household or married person filing separate tax returns
4) any standard or itemized deductions were taken fully on the reported share of income and therefore do not apply to the unreported income.

Method for Estimating State Tax with 30% of Income unreported

| | |
|---|---|
| Average income (if fully reported) | $31,500 |
| Tax rate | 8.5% |
| Tax due: 8.5% * ($31,500 - $16,500) | $2,121 |
| % Income reported | 70% |
| Taxable reported income (70% * $31,500) | $22,050 |
| Tax rate | $846 + 8.5% of amount over 16,500 |
| Tax due: 8.5% * ($22,050 – 16500) + $846 | $1,318 |
| Tax due (fully reported) - Tax due (under-reported) = tax loss | $803 |
| Number of construction workers misclassified statewide | 3,213 |
| Tax loss (individual loss * # of workers misclassified) | **$2,580,039** |

Method for Estimating State Tax with 50% of Income unreported

| | |
|---|---|
| Average income (if fully reported) | $31,500 |
| Tax rate | 8.5% |
| Tax due: 8.5% * ($31,500 - $16,500) | $2,121 |
| % Income reported | 50% |
| Taxable reported income (50% * $31,500) | $15,750 |
| Tax rate | $268 + 7.0% of amount over $8,250 |
| Tax due: 7% * ($15,750 - $8,250) + $268 | $793 |
| | |
| Tax due (fully reported) - Tax due (under-reported) = tax loss | $1,328 |
| Number of construction workers misclassified statewide | 3213 |
| Tax loss (individual loss * # of workers misclassified) | **$4,266,864** |

*Calculating Revenue Losses on Worker Compensation Insurance Premiums*

We assumed that all average WC premiums for workers, including construction workers, can be estimated by assuming $20 per $100 of payroll for workers compensation. We computed unreported wages from misclassifying employers as a percentage of total payroll from randomly audited firms, and assumed that this could represent the percentage of wages unreported from total construction wages paid by misclassifying employers statewide. Applying this to the actual total wages of UC-contributing employers statewide yielded an estimate of unreported wages for construction employers. Taking 20% of these figures produced estimates of WC revenue losses. We also computed lower estimates of premium losses by setting the WC rate at $12 and $15 per $100 per payroll.

*Calculating Losses in the FICA Tax*

To compute losses in federal payroll taxes for Social Security (FICA), we first calculated the percentage of taxable wages paid by audited employers that went to misclassified workers. This was done by dividing total taxable misclassified wages by total post-audit taxable wages (on all employers). The resulting ratio (7.25%) was then applied to the total wages paid to construction workers statewide, averaged over 1999-2002. This yielded an estimate of total misclassified wages statewide paid annually for the four year period. We then multiplied that estimate by 0.153 (the total contribution by both employers and workers to Social Security, or 15.3%) to determine losses to FICA.

# Appendix B - The Role of Audit Methods

The report commissioned by the US Department of Labor used Unemployment Compensation (UC) tax audit results from 9 states to obtain an estimate of misclassification (Planmatics 2000). Unemployment Compensation Tax audits seek to establish whether all workers supposed to be covered by Unemployment Compensation are in fact covered. Most often, when workers are not covered, it is because they were classified as independent contractors. When an audit finds workers not covered by UC who should be, they are reclassified as a "new worker" on the payroll subject to taxation. Therefore UC tax audits are a useful source of information about misclassification, one that has been relied upon by previous studies such as the DOL commissioned report.

UC tax audits are the best source of information on misclassification behavior available to researchers to date, and have been used by the US Department of Labor to gauge the prevalence and extent of misclassification. Using them to estimate misclassification, however, is not a straightforward matter. UC tax audit practices aim at redressing tax loss. The sampling of employers for audit purposes is not meant to be statistically random; it is meant to assist in UC tax collection. Some of the audit methods used are targeted; they aim to audit employers with a high likelihood of misclassification based on past UC tax record. Therefore these methods result in a relatively high observed rate of misclassification. Conversely, other audit methods are not targeted; they are conventionally called random audits. All state UC tax revenue departments practice a mix of methods. Therefore, audits are not a statistically perfect source of information; they allow for estimation rather than for an actual measure of the dimensions of misclassification.[32]

The Maine Department of Labor (DoL), Bureau of Unemployment Compensation, Tax Division conducts UC tax audits by drawing randomly from a sample of 38,000 active private-sector employers in the state. The list thus generated is sorted by regions in the state associated with field staff and inspectors, who then conduct audits based on the list. According to the Bureau, the resulting list is random for a particular region, though there may be regions that are over-represented in the audit sample relative to their share of employers and employment.

The DoL performed 296 random audits of construction employers over the period studied (1999-2002).[33] These were drawn from a larger pool of 2,118 audits conducted across all industries in that time period. They are referred to here as "random", or "not targeted." The remainder of DoL construction audits were nine targeted or "conversion" audits based on contested unemployment claims, a determination that a worker is in fact an employee, or other reasons to suspect hidden and/or misclassified wages. Their purpose of conversion audits is to locate cases of likely misclassification and other instances of noncompliant reporting for purposes of UC tax liability.

For our estimates of impacts, we have used results from random or non-targeted audits only. This approach is more conservative than that taken in the US DOL commissioned study.[34] That study relied on results from both random and targeted audits (to the exclusion of highly targeted audits) to generate the estimates used to project tax revenue losses.

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[32] An actual measure would require a large scale random survey of workers and employers throughout the state.

[33] The majority of audits were completed during the years 2000-2002; a small fraction (16, or about 5%) were completed in 1999. These figures exclude a small number of audits deemed unusable by DoL staff.

[34] Planmatics, 2000.

This project was funded by the Center to Protect Workers' Rights in Silver Spring, MD., through a cooperative agreement with the National Institute for Occupational Safety and Health.

Center to Protect Worker Rights
CPWR's main focus is to develop practical ways to protect the safety and health of construction workers and their families. It is the research, development, and training arm of the AFL-CIO's Building and Construction Trades Department. CPWR works with more than 30 organizations nationwide, including the National Resource Center for OSHA Training.

Construction Policy Research Center
The Construction Policy Research Center is a joint activity of the Harvard School of Public Health and the Labor and Worklife Program at Harvard Law School. The Center serves as the focus for quantitative and qualitative research in the full range of issues affecting the construction workforce. It is a link that fosters collaborative arrangements that cross organizational boundaries. The Center promotes the purposes of academic programs, interdisciplinary research projects, and outreach. The Labor and Worklife Program (LWP) is Harvard University's forum for research and teaching on the world of work and its implications for society. Located at the Harvard Law School, the LWP brings together scholars and policy experts from a variety of disciplines to analyze critical labor issues in the law, economy, and society.

Center for Social Policy
The Center for Social Policy engages in high-quality applied research, technical assistance, program evaluation, and outreach activities aimed at addressing social and economic inequalities in Massachusetts, New England and across the country. It is part of the John W. McCormack Graduate School of Policy Studies, University of Massachusetts Boston. CSP accomplishes its mission through active engagement with policymakers, service providers, and those communities most directly affected by local, state, and federal social welfare policies.

# Attachment III

**IRS handouts on Independent Contractors or employee business relationships.**

- **"Independent Contractor or Employee" – brochure & fact sheet**
- **"Revenue Ruling", 87FED Section 6503**
- **"SS-8 Determination of Worker Status" Form & Instructions**

## IRS Tax Publications

If you are not sure whether you are an employee or an independent contractor, get Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. Publication 15-A, *Employer's Supplemental Tax Guide*, provides additional information on independent contractor status.

## IRS Electronic Services

You may download and print IRS publications, forms, and other tax information materials on the Internet at www.irs.gov and you may call the IRS at 1-800-829-3676 (1-800-TAX-FORM) to order free tax publications and forms.

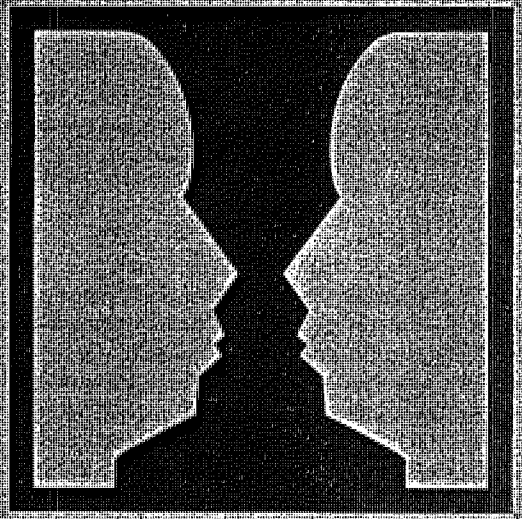
From a fax machine, dial (703) 368-9694 and you will immediately get a list of IRS tax forms faxed back to you. Follow the voice prompts to get specific forms faxed to you.

Publication 1796, *Federal Tax Products on CD-ROM*, of current and prior year tax publications and forms, can be purchased from the National Technical Information Service (NTIS). You may order Publication 1796 toll-free through the IRS at 1-877-233-6767 or via the Internet at www.irs.gov/cdorders.

Working to Put Service First
www.irs.gov

**Call 1-800-829-4933, the Business and Specialty Tax Line, if you have questions related to employment tax issues.**

# Independent Contractor

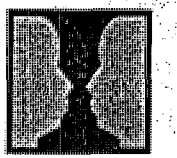


# or Employee . . .

IRS

Department of the Treasury
Internal Revenue Service

Publication [illegible]
Catalog Number [illegible]



# *Independent Contractor or Employee*

## *Which are you?*

*For federal tax purposes, this is an important distinction. Worker classification affects how you pay your federal income tax, social security and Medicare taxes, and how you file your tax return. Classification affects your eligibility for employer and social security and Medicare benefits and your tax responsibilities. If you aren't sure of your work status, you should find out now. This brochure can help you.*

The courts have considered many facts in deciding whether a worker is an **independent contractor** or an **employee**. These relevant facts fall into three main categories: *behavioral control; financial control;* and *relationship of the parties*. In each case, it is very important to consider all the facts – no single fact provides the answer. Carefully review the following definitions.

## Behavioral Control

These facts show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done – as long as the employer has the right to direct and control the work. For example:

- Instructions – if you receive extensive instructions on how work is to be done, this suggests that you are an **employee**. Instructions can cover a wide range of topics, for example:
  - how, when, or where to do the work
  - what tools or equipment to use
  - what assistants to hire to help with the work
  - where to purchase supplies and services

  If you receive less extensive instructions about what should be done, but not how it should be done, you may be an **independent contractor**. For instance, instructions about time and place may be less important than directions on how the work is performed.
- Training – if the business provides you with training about required procedures and methods, this indicates that the business wants the work done in a certain way, and this suggests that you may be an **employee**.

## Financial Control

These facts show whether there is a right to direct or control the business part of the work. For example:

- Significant Investment – if you have a significant investment in your work, you may be an **independent contractor**. While there is no precise dollar test, the investment must have substance. However, a significant investment is not necessary to be an **independent contractor**.
- Expenses – if you are not reimbursed for some or all business expenses, then you may be an **independent contractor**, especially if your unreimbursed business expenses are high.
- Opportunity for Profit or Loss – if you can realize a profit or incur a loss, this suggests that you are in business for yourself and that you may be an **independent contractor**.

## Relationship of the Parties

These are facts that illustrate how the business and the worker perceive their relationship. For example:

- Employee Benefits – if you receive benefits, such as insurance, pension, or paid leave, this is an indication that you may be an **employee**. If you do not receive benefits, however, you could be either an **employee** or an **independent contractor**.
- Written Contracts – a written contract may show what both you and the business intend. This may be very significant if it is difficult, if not impossible, to determine status based on other facts.

## When You Are an *Employee*

- Your employer must withhold income tax and your portion of social security and Medicare taxes. Also, your employer is responsible for paying social security, Medicare, and unemployment (FUTA) taxes on your wages. Your employer must give you a Form W-2, *Wage and Tax Statement*, showing the amount of taxes withheld from your pay.
- You may deduct unreimbursed employee business expenses on Schedule A of your income tax return, but only if you itemize deductions and they total more than two percent of your adjusted gross income.

## When You Are an *Independent Contractor*

- The business may be required to give you Form 1099-MISC, *Miscellaneous Income*, to report what it has paid to you.
- You are responsible for paying your own income tax and self-employment tax (Self-Employment Contributions Act – SECA). The business does not withhold taxes from your pay. You may need to make estimated tax payments during the year to cover your tax liabilities.
- You may deduct business expenses on Schedule C of your income tax return.

# INDEPENDENT CONTRACTOR OR EMPLOYEE?

SECTION 530 PROVIDES BUSINESSES WITH RELIEF FROM FEDERAL EMPLOYMENT TAX OBLIGATIONS IF CERTAIN REQUIREMENTS ARE MET.

## SECTION 530 RELIEF REQUIREMENTS

Your business has been selected for an employment tax examination to determine whether you correctly treated certain workers as independent contractors. However, you will not owe employment taxes for these workers, if you meet the **relief requirements** described below. If you do not meet these **relief requirements**, the IRS will need to determine whether the workers are independent contractors or employees and whether you owe employment taxes for those workers.

**Section 530 Relief Requirements:** To receive relief, you must meet all three of the following requirements:

### I. Reasonable Basis

First, you had a reasonable basis for not treating the workers as employees. To establish that you had a reasonable basis for not treating the workers as employees, you can show that:

- You reasonably relied on a court case about Federal taxes or a ruling issued to you by the IRS; or
- Your business was audited by the IRS at a time when you treated similar workers as independent contractors and the IRS did not reclassify those workers as employees; or
- You treated the workers as independent contractors because you knew that was how a significant segment of your industry treated similar workers; or
- You relied on some other reasonable basis. For example, you relied on the advice of a business lawyer or accountant who knew the facts about your business.

If you did not have a reasonable basis for treating the workers as independent contractors, you do not meet the **relief requirements**.

### II. Substantive Consistency

In addition, you (and any predecessor business) must have treated the workers, and any similar workers, as independent contractors. If you treated similar workers as employees, this relief provision is not available.

### III. Reporting Consistency

Finally, you must have filed Form 1099-MISC for each worker, unless the worker earned less than $600. Relief is not available for any year you did not file the required Forms 1099-MISC. If you filed the required Forms 1099-MISC for some workers, but not for others, relief is not available for the workers for whom you did not file Forms 1099-MISC.

*The IRS examiner will answer any questions you may have about your eligibility for this relief.*

Department of the Treasury
Internal Revenue Service
Publication 1976 (9-96)
Catalog Number 22927M

REV-RUL, 87FED ¶6503, **Withholding from wages: Employees: Technical service specialists.--**, Revenue Ruling 87-41, 1987-1 CB 296, (June 08, 1987)


Revenue Ruling 87-41, 1987-1 CB 296

*[Code Sec. 3401]*

**Withholding from wages: Employees: Technical service specialists.**--Penalties for failure to deposit will be waived in some cases where employers of technical service specialists fail to make timely deposits of the employer's share of social security taxes. The waiver of penalties also applies in some cases where employers fail to file Form 941. Also, a revenue ruling provides guidance in determining whether technical service specialists are employees of a technical service firm. BACK REFERENCE: 87FED ¶4939.194.

ISSUE

In the situations described below, are the individuals employees under the common law rules for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24 respectively, subtitle C, Internal Revenue Code)? These situations illustrate the application of section 530(d) of the Revenue Act of 1978, 1978-3 (Vol. 1) C.B. xi, 119 (the 1978 Act), which was added by section 1706(a) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B.--(the 1986 Act) (generally effective for services performed and remuneration paid after December 31, 1986).

FACTS

In each factual situation, an individual worker (Individual), pursuant to an arrangement between one person (Firm) and another person (Client), provides services for the client as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

*Situation* 1

The Firm is engaged in the business of providing temporary technical services to

its clients. The Firm maintains a roster of workers who are available to provide technical services to prospective clients. The Firm does not train the workers but determines the services that the workers are qualified to perform based on information submitted by the workers.

The Firm has entered into a contract with the client. The contract states that the Firm is to provide the Client with workers to perform computer programming services meeting specified qualifications for a particular project. The Individual, a computer programmer, enters into a contract with the Firm to perform services as a computer programmer for the Client's project, which is expected to last less than one year. The Individual is one of several programmers provided by the firm to the Client. The Individual has not been an employee of or performed services for the Client (or any predecessor or affiliated corporation of the Client) at any time preceding the time at which the Individual begins performing services for the Client. Also, the Individual has not been an employee of or performed services for or on behalf of the Firm at any time preceding the time at which the Individual begins performing services for the Client. The Individual's contract with the Firm states that the Individual is an independent contractor with respect to services performed on behalf of the Firm for the Client.

The Individual and the other programmers perform the services under the firm's contract with the Client. During the time the Individual is performing services for the Client, even though the Individual retains the right to perform services for other persons, substantially all of the Individual's working time is devoted to performing services for the Client. A significant portion of the services are performed on the Client's premises. The Individual reports to the Firm by accounting for time worked and describing the progress of the work. The Firm pays the Individual and regularly charges the Client for the services performed by the Individual. The Firm generally does not pay individuals who perform services for the Client unless the Firm provided such individuals to the Client.

The work of the Individual and other programmers is regularly reviewed by the Firm. The review is based primarily on reports by the Client about the performance of these workers. Under the contract between the Individual and the Firm, the Firm may terminate its relationship with the Individual if the review shows that he or she is failing to perform the services contracted for by the Client. Also, the firm will

replace the Individual with another worker if the Individual's services are unacceptable to the Client. In such a case, however, the Individual will nevertheless receive his or her hourly pay for the work completed.

Finally, under the contract between the Individual and the Firm, the Individual is prohibited from performing services directly for the Client and, under the contract between the Firm and the Client, the Client is prohibited from receiving services from the Individual for a period of three months following the termination of services by the Individual for the Client on behalf of the Firm.

*Situation 2*

The Firm is a technical services firm that supplies clients with technical personnel. The Client requires the services of a systems analyst to complete a project and contacts the Firm to obtain such an analyst. The Firm maintains a roster of analysts and refers such an analyst, the Individual, to the Client. The Individual is not restricted by the Client or the Firm from providing services to the general public while performing services for the Client and in fact does perform substantial services for other persons during the period the Individual is working for the Client. Neither the Firm nor the Client has priority on the services of the Individual. The Individual does not report, directly or indirectly, to the Firm after the beginning of the assignment to the Client concerning (1) hours worked by the Individual, (2) progress on the job, or (3) expenses incurred by the Individual in performing services for the Client. No reports (including reports of time worked or progress on the job) made by the Individual to the Client are provided by the Client to the Firm.

If the Individual ceases providing services for the Client prior to completion of the project or if the Individual's work product is otherwise unsatisfactory, the client may seek damages from the Individual. However, in such circumstances, the Client may not seek damages from the Firm, and the Firm is not required to replace the Individual. The Firm may not terminate the services of the Individual while he or she is performing services for the Client and may not otherwise affect the relationship between the Client and the Individual. Neither the Individual nor the Client is prohibited for any period after termination of the Individual's services on this job from contracting directly with the other. For referring the Individual to the Client, the Firm receives a flat fee that is fixed prior to the Individual's

commencement of services for the Client and is unrelated to the number of hours and quality of work performed by the Individual. The Individual is not paid by the Firm either directly or indirectly. No payment made by the Client to the Individual reduces the amount of the fee that the Client is otherwise required to pay the Firm. The Individual is performing services that can be accomplished without the Individual's receiving direction or control as to hours, place of work, sequence, or details of work.

*Situation 3*

The Firm, a company engaged in furnishing client firms with technical personnel, is contacted by the Client, who is in need of the services of a drafter for a particular project, which is expected to last less than one year. The Firm recruits the Individual to perform the drafting services for the Client. The Individual performs substantially all of the services for the Client at the office of the Client, using materials and equipment of the Client. The services are performed under the supervision of employees of the Client. The Individual reports to the Client on a regular basis. The Individual is paid by the Firm based on the number of hours the Individual has worked for the Client, as reported to the Firm by the Client or as reported by the Individual and confirmed by the Client. The Firm has no obligation to pay the Individual if the Firm does not receive payment for the Individual's services from the Client. For recruiting the Individual for the Client, the Firm receives a flat fee that is fixed prior to the Individual's commencement of services for the Client and is unrelated to the number of hours and quality of work performed by the Individual. However, the Firm does receive a reasonable fee for performing the payroll function. The Firm may not direct the work of the Individual and has no responsibility for the work performed by the Individual. The Firm may not terminate the services of the Individual. The Client may terminate the services of the Individual without liability to either the Individual or the Firm. The Individual is permitted to work for another firm while performing services for the Client, but does in fact work for the Client on a substantially full-time basis.

LAW AND ANALYSIS

This ruling provides guidance concerning the factors that are used to determine whether an employment relationship exists between the Individual and the Firm for

federal employment tax purposes and applies those factors to the given factual situations to determine whether the Individual is an employee of the Firm for such purposes. The ruling does not reach any conclusions concerning whether an employment relationship for federal employment tax purposes exists between the Individual and the Client in any of the factual situations.

Analysis of the preceding three fact situations requires an examination of the common law rules for determining whether the Individual is an employee with respect to either the Firm or the Client, a determination of whether the Firm or the Client qualifies for employment tax relief under section 530(a) of the 1978 Act, and a determination of whether any such relief is denied the Firm under section 530(d) of the 1978 Act (added by section 1706 of the 1986 Act).

An individual is an employee for federal employment tax purposes if the individual has the status of an employee under the usual common law rules applicable in determining the employer-employee relationship. Guides for determining that status are found in the following three substantially similar sections of the Employment Tax Regulations: sections 31.3121(d)-1(c); 31.3306(i)-1; and 31.3401(c)-1.

These sections provide that generally the relationship of employer and employee exists when the person or persons for whom the services are performed have the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so.

Conversely, these sections provide, in part, that individuals (such as physicians, lawyers, dentists, contractors, and subcontractors) who follow an independent trade, business, or profession, in which they offer their services to the public, generally are not employees.

Finally, if the relationship of employer and employee exists, the designation or

description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such a relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

As an aid to determining whether an individual is an employee under the common law rules, twenty factors or elements have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The twenty factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The twenty factors are designed only as guides for determining whether an individual is an employee; special scrutiny is required in applying the twenty factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee). The twenty factors are described below:

1. *Instructions.* A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the *right* to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66-381, 1966-2 C.B. 449.

2. *Training.* Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. See Rev. Rul. 70-630, 1970-2 C.B. 229.

3. *Integration.* Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must

necessarily be subject to a certain amount of control by the owner of the business. See *United States v. Silk,* 331 U.S. 704 (1947), 1947-2 C.B. 167.

4. *Services Rendered Personally.* If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 C.B. 410.

5. *Hiring, Supervising, and Paying Assistants.* If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593, 1955-2 C.B. 610.

6. *Continuing Relationship.* A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See *United States v. Silk.*

7. *Set Hours of Work.* The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 C.B. 337.

8. *Full Time Required.* If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 C.B. 694.

9. *Doing Work on Employer's Premises.* If the work is performed on the premises of the person or persons for whom the services are performed, that factor

suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 C.B. 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.

10. *Order or Sequence Set.* If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.

11. *Oral or Written Reports.* A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68-248, 1968-1 C.B. 431.

12. *Payment by Hour, Week, Month.* Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 C.B. 330.

13. *Payment of Business and/or Traveling Expenses.* If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able

to control expenses, generally retains the right to regulate and direct the worker's business activities. See Rev. Rul. 55-144, 1955-1 C.B. 483.

14. *Furnishing of Tools and Materials.* The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. See Rev. Rul. 71-524, 1971-2 C.B. 346.

15. *Significant Investment.* If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

16. *Realization of Profit or Loss.* A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul. 70-309. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. *Working for More Than One Firm at a Time.* If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 C.B. 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. *Making Service Available to General Public.* The fact that a worker makes

his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.

19. *Right to Discharge.* The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. Rev. Rul. 75-41, 1975-1 C.B. 323.

20. *Right to Terminate.* If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.

Rev. Rul. 75-41 considers the employment tax status of individuals performing services for a physician's professional service corporation. The corporation is in the business of providing a variety of services to professional people and firms (subscribers), including the services of secretaries, nurses, dental hygienists, and other similarly trained personnel. The individuals who are to perform the services are recruited by the corporation, paid by the corporation, assigned to jobs, and provided with employee benefits by the corporation. Individuals who enter into contracts with the corporation agree they will not contract directly with any subscriber to which they are assigned for at least three months after cessation of their contracts with the corporation. The corporation assigns the individual to the subscriber to work on the subscriber's premises with the subscriber's equipment. Subscribers have the right to require that an individual furnished by the corporation cease providing services to them, and they have the further right to have such individual replaced by the corporation within a reasonable period of time, but the subscribers have no right to affect the contract between the individual and the corporation. The corporation retains the right to discharge the individuals at any time. Rev. Rul. 75-41 concludes that the individuals are employees of the corporation for federal employment tax purposes.

Rev. Rul. 70-309 considers the employment tax status of certain individuals who perform services as oil well pumpers for a corporation under contracts that

characterize such individuals as independent contractors. Even though the pumpers perform their services away from the headquarters of the corporation and are not given day-to-day directions and instructions, the ruling concludes that the pumpers are employees of the corporation because the pumpers perform their services pursuant to an arrangement that gives the corporation the right to exercise whatever control is necessary to assure proper performance of the services; the pumpers' services are both necessary and incident to the business conducted by the corporation; and the pumpers are not engaged in an independent enterprise in which they assume the usual business risks, but rather work in the course of the corporation's trade or business. See also Rev. Rul. 70-630, 1970-2 C.B. 229, which considers the employment tax status of salesclerks furnished by an employee service company to a retail store to perform temporary services for the store.

Section 530(a) of the 1978 Act, as amended by section 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982, 1982-2 C.B. 462, 536, provides, for purposes of the employment taxes under subtitle C of the Code, that if a taxpayer did not treat an individual as an employee for any period, then the individual shall be deemed not to be an employee, unless the taxpayer had no reasonable basis for not treating the individual as an employee. For any period after December 31, 1978, this relief applies only if both of the following consistency rules are satisfied: (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee ("reporting consistency rule"), and (2) the taxpayer (and any predecessor) has not treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for periods beginning after December 31, 1977 ("substantive consistency rule").

The determination of whether any individual who is treated as an employee holds a position substantially similar to the position held by an individual whom the taxpayer would otherwise be permitted to treat as other than an employee for employment tax purposes under section 530(a) of the 1978 Act requires an examination of all the facts and circumstances, including particularly the activities and functions performed by the individuals. Differences in the positions held by the respective individuals that result from the taxpayer's treatment of one individual as an employee and the other individual as other than an employee (for example, that

the former individual is a participant in the taxpayer's qualified pension plan or health plan and the latter individual is not a participant in either) are to be disregarded in determining whether the individuals hold substantially similar positions.

Section 1706(a) of the 1986 Act added to section 530 of the 1978 Act a new subsection (d), which provides an exception with respect to the treatment of certain workers. Section 530(d) provides that section 530 shall not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. Section 530(d) of the 1978 Act does not affect the determination of whether such workers are employees under the common law rules. Rather, it merely eliminates the employment tax relief under section 530(a) of the 1978 Act that would otherwise be available to a taxpayer with respect to those workers who are determined to be employees of the taxpayer under the usual common law rules. Section 530(d) applies to remuneration paid and services rendered after December 31, 1986.

The Conference Report on the 1986 Act discusses the effect of section 530(d) as follows:

> The Senate amendment applies whether the services of [technical service workers] are provided by the firm to only one client during the year or to more than one client, and whether or not such individuals have been designated or treated by the technical services firm as independent contractors, sole proprietors, partners, or employees of a personal service corporation controlled by such individual. The effect of the provision cannot be avoided by claims that such technical service personnel are employees of personal service corporations controlled by such personnel. For example, an engineer retained by a technical services firm to provide services to a manufacturer cannot avoid the effect of this provision by organizing a corporation that he or she controls and then claiming to provide services as an employee of that corporation.
>
> . . . [T]he provision does not apply with respect to individuals who are classified, under the generally applicable common law standards, as employees of a business

that is a client of the technical services firm.

2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-834 to 835 (1986).

Under the facts of Situation 1, the legal relationship is between the Firm and the Individual, and the Firm retains the right of control to insure that the services are performed in a satisfactory fashion. The fact that the Client may also exercise some degree of control over the Individual does not indicate that the Individual is not an employee. Therefore, in Situation 1, the Individual is an employee of the Firm under the common law rules. The facts in Situation 1 involve an arrangement among the Individual, Firm, and Client, and the services provided by the Individual are technical services. Accordingly, the Firm is denied section 530 relief under section 530(d) of the 1978 Act (as added by section 1706 of the 1986 Act), and no relief is available with respect to any employment tax liability incurred in Situation 1. The analysis would not differ if the facts of Situation 1 were changed to state that the Individual provided the technical services through a personal service corporation owned by the Individual.

In Situation 2, the Firm does not retain any right to control the performance of the services by the Individual and, thus, no employment relationship exists between the Individual and the Firm.

In Situation 3, the Firm does not control the performance of the services of the Individual, and the Firm has no right to affect the relationship between the Client and the Individual. Consequently, no employment relationship exists between the Firm and the Individual.

HOLDINGS

*Situation 1.* The Individual is an employee of the Firm under the common law rules. Relief under section 530 of the 1978 Act is not available to the Firm because of the provisions of section 530(d).

*Situation 2.* The Individual is not an employee of the Firm under the common law rules.

*Situation 3.* The Individual is not an employee of the Firm under the common law rules.

Because of the application of section 530(b) of the 1978 Act, no inference should be drawn with respect to whether the Individual in Situations 2 and 3 is an employee of the Client for federal employment tax purposes.

Form **SS-8**
(Rev. June 2003)
Department of the Treasury
Internal Revenue Service

# Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding

OMB No. 1545-0004

| Name of firm (or person) for whom the worker performed services | Worker's name | |
|---|---|---|
| Firm's address (include street address, apt. or suite no., city, state, and ZIP code) | Worker's address (include street address, apt. or suite no., city, state, and ZIP code) | |
| Trade name | Telephone number (include area code) ( ) | Worker's social security number : : |
| Telephone number (include area code) ( ) / Firm's employer identification number : | Worker's employer identification number (if any) : | |

If the worker is paid by a firm other than the one listed on this form for these services, enter the name, address, and employer identification number of the payer.

## Important Information Needed To Process Your Request

We must have your permission to disclose your name and the information on this form and any attachments to other parties involved with this request. **Do we have your permission to disclose this information?** . . . . . ☐ Yes ☐ No
If you answered "No" or did not mark a box, we will not process your request and will not issue a determination.

**You must answer ALL items OR mark them "Unknown" or "Does not apply."** If you need more space, attach another sheet.

A This form is being completed by: ☐ Firm ☐ Worker; for services performed _____ (beginning date) to _____ (ending date).

B Explain your reason(s) for filing this form (e.g., you received a bill from the IRS, you believe you received a Form 1099 or Form W-2 erroneously, you are unable to get worker's compensation benefits, you were audited or are being audited by the IRS). .....

C Total number of workers who performed or are performing the same or similar services _____.

D How did the worker obtain the job? ☐ Application ☐ Bid ☐ Employment Agency ☐ Other (specify) _____.

E Attach copies of all supporting documentation (contracts, invoices, memos, Forms W-2, Forms 1099, IRS closing agreements, IRS rulings, etc.). In addition, please inform us of any current or past litigation concerning the worker's status. If no income reporting forms (Form 1099-MISC or W-2) were furnished to the worker, enter the amount of income earned for the year(s) at issue $ _____.

F Describe the firm's business. .....

G Describe the work done by the worker and provide the worker's job title. .....

H Explain why you believe the worker is an employee or an independent contractor. .....

I Did the worker perform services for the firm before getting this position? . . . . . ☐ Yes ☐ No ☐ N/A
If "Yes," what were the dates of the prior service? .....
If "Yes," explain the differences, if any, between the current and prior service. .....

J If the work is done under a written agreement between the firm and the worker, attach a copy (preferably signed by both parties). Describe the terms and conditions of the work arrangement. .....

## Part I Behavioral Control

1 What specific training and/or instruction is the worker given by the firm?

2 How does the worker receive work assignments?

3 Who determines the methods by which the assignments are performed?

4 Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution?

5 What types of reports are required from the worker? Attach examples.

6 Describe the worker's daily routine (i.e., schedule, hours, etc.).

7 At what location(s) does the worker perform services (e.g., firm's premises, own shop or office, home, customer's location, etc.)?

8 Describe any meetings the worker is required to attend and any penalties for not attending (e.g., sales meetings, monthly meetings, staff meetings, etc.).

9 Is the worker required to provide the services personally? ☐ Yes ☐ No

10 If substitutes or helpers are needed, who hires them?

11 If the worker hires the substitutes or helpers, is approval required? ☐ Yes ☐ No
If "Yes," by whom?

12 Who pays the substitutes or helpers?

13 Is the worker reimbursed if the worker pays the substitutes or helpers? ☐ Yes ☐ No
If "Yes," by whom?

## Part II Financial Control

1 List the supplies, equipment, materials, and property provided by each party:
The firm
The worker
Other party

2 Does the worker lease equipment? ☐ Yes ☐ No
If "Yes," what are the terms of the lease? (Attach a copy or explanatory statement.)

3 What expenses are incurred by the worker in the performance of services for the firm?

4 Specify which, if any, expenses are reimbursed by:
The firm
Other party

5 Type of pay the worker receives: ☐ Salary ☐ Commission ☐ Hourly Wage ☐ Piece Work
☐ Lump Sum ☐ Other (specify)
If type of pay is commission, and the firm guarantees a minimum amount of pay, specify amount $ _____.

6 Is the worker allowed a drawing account for advances? ☐ Yes ☐ No
If "Yes," how often?
Specify any restrictions.

7 Whom does the customer pay? ☐ Firm ☐ Worker
If worker, does the worker pay the total amount to the firm? ☐ Yes ☐ No If "No," explain.

8 Does the firm carry worker's compensation insurance on the worker? ☐ Yes ☐ No

9 What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary (e.g., loss or damage of equipment, material, etc.)?

## Part III Relationship of the Worker and Firm

1 List the benefits available to the worker (e.g., paid vacations, sick pay, pensions, bonuses).

2 Can the relationship be terminated by either party without incurring liability or penalty? ☐ Yes ☐ No
If "No," explain your answer.

3 Does the worker perform similar services for others? ☐ Yes ☐ No
If "Yes," is the worker required to get approval from the firm? ☐ Yes ☐ No

4 Describe any agreements prohibiting competition between the worker and the firm while the worker is performing services or during any later period. Attach any available documentation.

5 Is the worker a member of a union? ☐ Yes ☐ No

6 What type of advertising, if any, does the worker do (e.g., a business listing in a directory, business cards, etc.)? Provide copies, if applicable.

7 If the worker assembles or processes a product at home, who provides the materials and instructions or pattern?

8 What does the worker do with the finished product (e.g., return it to the firm, provide it to another party, or sell it)?

9 How does the firm represent the worker to its customers (e.g., employee, partner, representative, or contractor)?

10 If the worker no longer performs services for the firm, how did the relationship end?

## Part IV For Service Providers or Salespersons—Complete this part if the worker provided a service directly to customers or is a salesperson.

1 What are the worker's responsibilities in soliciting new customers?

2 Who provides the worker with leads to prospective customers?

3 Describe any reporting requirements pertaining to the leads.

4 What terms and conditions of sale, if any, are required by the firm?

5 Are orders submitted to and subject to approval by the firm? ☐ Yes ☐ No

6 Who determines the worker's territory?

7 Did the worker pay for the privilege of serving customers on the route or in the territory? ☐ Yes ☐ No
If "Yes," whom did the worker pay?
If "Yes," how much did the worker pay? $ _____

8 Where does the worker sell the product (e.g., in a home, retail establishment, etc.)?

9 List the product and/or services distributed by the worker (e.g., meat, vegetables, fruit, bakery products, beverages, or laundry or dry cleaning services). If more than one type of product and/or service is distributed, specify the principal one.

10 Does the worker sell life insurance full time? ☐ Yes ☐ No

11 Does the worker sell other types of insurance for the firm? ☐ Yes ☐ No
If "Yes," enter the percentage of the worker's total working time spent in selling other types of insurance. _____%

12 If the worker solicits orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments, enter the percentage of the worker's time spent in the solicitation. _____%

13 Is the merchandise purchased by the customers for resale or use in their business operations? ☐ Yes ☐ No
Describe the merchandise and state whether it is equipment installed on the customers' premises.

## Part V Signature (see page 4)

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented are true, correct, and complete.

Signature ► _____ Title ► _____ Date ► _____
(Type or print name below)

# General Instructions

*Section references are to the Internal Revenue Code unless otherwise noted.*

## Purpose

Firms and workers file Form SS-8 to request a determination of the status of a worker for purposes of Federal employment taxes and income tax withholding.

A Form SS-8 determination may be requested only in order to resolve Federal tax matters. If Form SS-8 is submitted for a tax year for which the statute of limitations on the tax return has expired, a determination letter will not be issued. The statute of limitations expires 3 years from the due date of the tax return or the date filed, whichever is later.

The IRS does not issue a determination letter for proposed transactions or on hypothetical situations. We may, however, issue an information letter when it is considered appropriate.

## Definition

**Firm.** For the purposes of this form, the term "firm" means any individual, business enterprise, organization, state, or other entity for which a worker has performed services. The firm may or may not have paid the worker directly for these services. **If the firm was not responsible for payment for services, be sure to enter the name, address, and employer identification number of the payer on the first page of Form SS-8 below the identifying information for the firm and the worker.**

## The SS-8 Determination Process

The IRS will acknowledge the receipt of your Form SS-8. Because there are usually two (or more) parties who could be affected by a determination of employment status, the IRS attempts to get information from all parties involved by sending those parties blank Forms SS-8 for completion. The case will be assigned to a technician who will review the facts, apply the law, and render a decision. The technician may ask for additional information from the requestor, from other involved parties, or from third parties that could help clarify the work relationship before rendering a decision. The IRS will generally issue a formal determination to the firm or payer (if that is a different entity), and will send a copy to the worker. A determination letter applies only to a worker (or a class of workers) requesting it, and the decision is binding on the IRS. In certain cases, a formal determination will not be issued. Instead, an information letter may be issued. Although an information letter is advisory only and is not binding on the IRS, it may be used to assist the worker to fulfill his or her Federal tax obligations.

Neither the SS-8 determination process nor the review of any records in connection with the determination constitutes an examination (audit) of any Federal tax return. If the periods under consideration have previously been examined, the SS-8 determination process will not constitute a reexamination under IRS reopening procedures. Because this is not an examination of any Federal tax return, the appeal rights available in connection with an examination do not apply to an SS-8 determination. However, if you disagree with a determination and you have additional information concerning the work relationship that you believe was not previously considered, you may request that the determining office reconsider the determination.

## Completing Form SS-8

Answer all questions as completely as possible. Attach additional sheets if you need more space. Provide information for all years the worker provided services for the firm. Determinations are based on the entire relationship between the firm and the worker.

Additional copies of this form may be obtained by calling 1-800-829-4933 or from the IRS website at **www.irs.gov.**

## Fee

There is no fee for requesting an SS-8 determination letter.

## Signature

Form SS-8 must be signed and dated by the taxpayer. A stamped signature will not be accepted.

The person who signs for a corporation must be an officer of the corporation who has personal knowledge of the facts. If the corporation is a member of an affiliated group filing a consolidated return, it must be signed by an officer of the common parent of the group.

The person signing for a trust, partnership, or limited liability company must be, respectively, a trustee, general partner, or member-manager who has personal knowledge of the facts.

## Where To File

Send the completed Form SS-8 to the address listed below for the firm's location. However, for cases involving Federal agencies, send Form SS-8 to the Internal Revenue Service, Attn: CC:CORP:T:C, Ben Franklin Station, P.O. Box 7604, Washington, DC 20044.

| Firm's location: | Send to: |
|---|---|
| Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Illinois, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, Wyoming, American Samoa, Guam, Puerto Rico, U.S. Virgin Islands | Internal Revenue Service<br>SS-8 Determinations<br>P.O. Box 630<br>Stop 631<br>Holtsville, NY 11742-0630 |
| Alabama, Connecticut, Delaware, District of Columbia, Florida, Georgia, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Virginia, West Virginia, all other locations not listed | Internal Revenue Service<br>SS-8 Determinations<br>40 Lakemont Road<br>Newport, VT 05855-1555 |

## Instructions for Workers

If you are requesting a determination for more than one firm, complete a separate Form SS-8 for each firm.

CAUTION *Form SS-8 is not a claim for refund of social security and Medicare taxes or Federal income tax withholding.*

If the IRS determines that you are an employee, you are responsible for filing an amended return for any corrections related to this decision. A determination that a worker is an employee does not necessarily reduce any current or prior tax liability. For more information, call 1-800-829-1040.

**Time for filing a claim for refund.** Generally, you must file your claim for a credit or refund within 3 years from the date your original return was filed or within 2 years from the date the tax was paid, whichever is later.

**Filing Form SS-8 does not prevent the expiration of the time in which a claim for a refund must be filed.** If you are concerned about a refund, and the statute of limitations for filing a claim for refund for the year(s) at issue has not yet expired, you should file **Form 1040X,** Amended U.S. Individual Income Tax Return, to protect your statute of limitations. File a separate Form 1040X for each year.

On the Form 1040X you file, do not complete lines 1 through 24 on the form. Write "Protective Claim" at the top of the form, sign and date it. In addition, you should enter the following statement in Part II, Explanation of Changes to Income, Deductions, and Credits: "Filed Form SS-8 with the Internal Revenue Service Office in (Holtsville, NY; Newport, VT; or Washington, DC; as appropriate). By filing this protective claim, I reserve the right to file a claim for any refund that may be due after a determination of my employment tax status has been completed."

**Filing Form SS-8 does not alter the requirement to timely file an income tax return.** Do not delay filing your tax return in anticipation of an answer to your SS-8 request. In addition, if applicable, do not delay in responding to a request for payment while waiting for a determination of your worker status.

## Instructions for Firms

If a **worker** has requested a determination of his or her status while working for you, you will receive a request from the IRS to complete a Form SS-8. In cases of this type, the IRS usually gives each party an opportunity to present a statement of the facts because any decision will affect the employment tax status of the parties. Failure to respond to this request will not prevent the IRS from issuing a determination letter based on the information he or she has made available so that the worker may fulfill his or her Federal tax obligations. However, the information that you provide is extremely valuable in determining the status of the worker.

If **you** are requesting a determination for a particular class of worker, complete the form for **one** individual who is representative of the class of workers whose status is in question. If you want a written determination for more than one class of workers, complete a separate Form SS-8 for one worker from each class whose status is typical of that class. A written determination for any worker will apply to other workers of the same class if the facts are not materially different for these workers. Please provide a list of names and addresses of all workers potentially affected by this determination.

If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker under section 530 of the 1978 Revenue Act. However, this relief provision cannot be considered in conjunction with a Form SS-8 determination because the determination does not constitute an examination of any tax return. For more information regarding section 530 of the 1978 Revenue Act and to determine if you qualify for relief under this section, you may visit the IRS website at **www.irs.gov.**

**Privacy Act and Paperwork Reduction Act Notice.** We ask for the information on this form to carry out the Internal Revenue laws of the United States. This information will be used to determine the employment status of the worker(s) described on the form. Subtitle C, Employment Taxes, of the Internal Revenue Code imposes employment taxes on wages. Sections 3121(d), 3306(a), and 3401(c) and (d) and the related regulations define employee and employer for purposes of employment taxes imposed under Subtitle C. Section 6001 authorizes the IRS to request information needed to determine if a worker(s) or firm is subject to these taxes. Section 6109 requires you to provide your taxpayer identification number. Neither workers nor firms are required to request a status determination, but if you choose to do so, you must provide the information requested on this form. Failure to provide the requested information may prevent us from making a status determination. If any worker or the firm has requested a status determination and you are being asked to provide information for use in that determination, you are not required to provide the requested information. However, failure to provide such information will prevent the IRS from considering it in making the status determination. Providing false or fraudulent information may subject you to penalties. Routine uses of this information include providing it to the Department of Justice for use in civil and criminal litigation, to the Social Security Administration for the administration of social security programs, and to cities, states, and the District of Columbia for the administration of their tax laws. We may also disclose this information to Federal and state agencies to enforce Federal nontax criminal laws and to combat terrorism. We may provide this information to the affected worker(s) or the firm as part of the status determination process.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping,** 22 hrs.; **Learning about the law or the form,** 47 min.; and **Preparing and sending the form to the IRS,** 1 hr., 11 min. If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Products Coordinating Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send the tax form to this address. Instead, see **Where To File** on page 4.

# Attachment IV

**ABC test handouts including article, "Applying the 'ABC' Test to determine liability for unemployment Compensation" by Elizabeth Wyman, Assistant Attorney General, State of Maine.**

- **"Determining Liability for Unemployment Compensation: The ABC Test"**
- **"Independent Contractors in Maine" Brochure**
- **"Applying the 'ABC Test" to Determine Liability for Unemployment Compensation," article by Elizabeth Wyman, Assistant Attorney General, State of Maine**

# DETERMINING LIABILITY FOR UNEMPLOYMENT COMPENSATION: THE ABC TEST

*Presented by Elizabeth Wyman, Assistant Attorney General*
*to members of the working group on misclassification of employment*
*in Maine's construction industry*
*July 18, 2005*

## The ABC Test

Services performed by an individual for remuneration shall be deemed to be employment subject to this chapter unless and until it is shown to the satisfaction of the Bureau that:

1) Such individual has been and will continue to be free from control or direction over the performance of such services, both under this contract of service and in fact; and
2) Such service is either outside the usual course of business for which such service is performed, or that such service is performed outside of all the places of business of the enterprise for which such service is performed; and
3) Such individual is customarily engaged in an independently established trade, occupation, profession or business.

26 M.R.S.A. § 1043(11)(E)

**Notes:**

- Maine is one of 26 states that use the ABC test;
- Presumption of employment relationship;
- To avoid a finding of an employment relationship, an employing unit must meet each and every prong of the ABC test;
- Common law or other legal tests don't apply;
- Written contract does not govern;
- Mechanics of a "blocked claim" and field investigation

## Intent behind the ABC test:

*Economic insecurity due to unemployment is a serious menace to the health, morals and welfare of the people of this State. Unemployment is therefore a subject of general interest and concern which requires appropriate action by the Legislature to prevent its spread and to lighten its burden which may fall upon the unemployed worker, his family and the entire community. The achievement of social security requires protection against this greatest hazard of our economic life. This objective can be furthered by operating free public employment offices in affiliation with a nation-wide system of public employment services; by devising appropriate methods for reducing the volume of*

*unemployment; and by the systematic accumulation of funds during the periods of employment from which benefits may be paid for periods of unemployment, thus maintaining purchasing power, promoting the use of the highest skills of unemployed workers and limiting the serious social consequences of unemployment*

26 M.R.S.A. § 1042

**How do you prove each prong?**

A prong: Control

- It is general right to control, even if not exercised

B prong, part 1: Usual course of Business

- What service is the putative employer providing?
- Is the worker providing that service?
- Not required that it be an "integral part" of the business

B prong, part 2: Place of Business

- Can include business territory in which the employer operates
- "Significant and business related presence"

C prong: Proprietary Interest

- Does not have to be well established business, but worker must hold himself out to some community of potential customers

# Independent Contractors in Maine

## Independent Contractor or Employee: Why Does it Matter?

Being classified as an employee or independent contractor affects the taxes you pay and how you pay them. It affects eligibility for unemployment and workers' compensation, Medicare, overtime pay, and other benefits and protections. Employers must classify workers either as independent contractors or employees.

## What is an Independent Contractor?

In determining independent contractor status, all government agencies consider the amount of direction and control the business has on the worker. In general, if the business supplies training or equipment or tells the workers when and how to do the job, the workers are probably employees. Independent contractors usually use their own tools and work on their own schedule.

That said, there is no single rule or test used by all government agencies. Because they are responsible for a number of different aspects of employment law, agencies use different guidelines to decide whether a worker is an independent contractor or an employee. For example, Internal Revenue Service (IRS) and Maine Revenue Service (MRS) refer to "common law rules." Unemployment Compensation uses the "ABC" test and Workers' Compensation considers other factors. Because agencies have different ways of determining independent contractor status, a business may have to pay unemployment tax and/or carry workers' compensation coverage even if IRS or MRS determines that its workers are independent contractors for income tax purposes.

The guidelines of each agency are too detailed for one brochure. However, it is important to understand how the different laws may affect you. Employers should ask each agency if they consider workers to be employees or independent contractors before the contracted work begins.

If you work as an independent contractor, you:

- Pay your own taxes.
- May not be entitled to unemployment or workers' compensation.
- May not be protected by wage payment and recordkeeping laws, such as minimum wage and overtime.
- Direct and control your work and the work of your employees.

If your business uses independent contractors, you

- Do not withhold taxes or Medicare insurance.
- May have to carry workers' compensation insurance.
- May have to pay unemployment taxes.
- Must ensure that foreign workers are legal and documented.
- Should consult each of the governmental agencies listed in this brochure to find out if they consider your workers to be independent contractors.
- May be liable for back taxes and wages and/or penalties if you misclassify employees as independent contractors.

**The following agencies can answer questions about independent contractor issues.**

### Maine Department of Labor
P.O. Box 259
Augusta, ME 04332-0259
Tel: (207) 624-6400, Fax: (207) 624-6449
TTY: (207) 624-6003
e-mail: webmaster.bls@maine.gov
web site: www.maine.gov/labor

### Maine Workers' Compensation Board
Coverage Division
27 State House Station
Augusta, ME 04333-0027
Tel: (207) 287-7071, Fax: (207) 287-5895
TTY: (207) 287-6119
e-mail: Linda.Larrabee@maine.gov
web site: www.maine.gov/wcb

### Maine Revenue Service
Income/Estate Tax Division
24 State House Station
Augusta, ME 04333
Tel: (207) 626-8475, Fax: (207) 624-9694
TTY: (207) 287-4477
e-mail: withholding.tax@maine.gov
web site: www.maine.gov/revenue

### U.S. Department of Labor
Wage and Hour Division
100 Middle Street Plaza
Portland, ME 04101
Tel: (207) 780-3344
Fax: (207) 780-3783
e-mail: claus.james@dol.gov

P.O. Box 1356
Bangor, ME 04401
Tel: (207) 945-0330
Fax: (207) 945-0332
e-mail: collins.matthew@dol.gov
web site: www.dol.gov

### U.S. Internal Revenue Service
SS-8 Unit
SS-8 Coordinator/Site Manager
40 Lakemont Road
Newport, VT 05855
Tel: (802) 334-0252
Fax: (802) 334-5607
web site: www.irs.gov

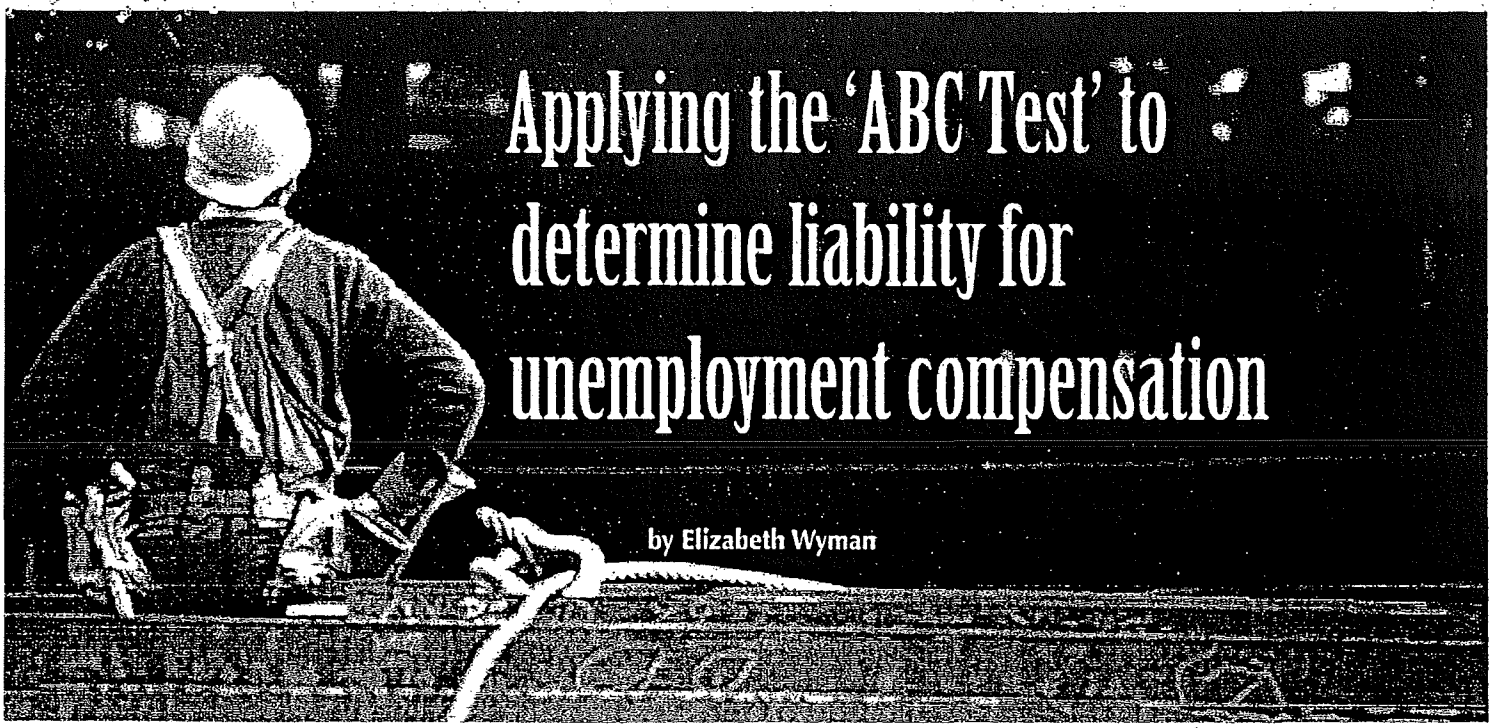
***Disclaimer: This brochure provides brief information and is not a substitute for laws or formal interpretations, which can be obtained from the agencies listed.***

Here are typical questions about independent contractor status:

1. **How can I find out how and when I have to pay taxes?**
   *Contact the Internal Revenue Service (IRS), Maine Revenue Service (MRS), and Maine Department of Labor Bureau of Unemployment Compensation (contact information listed on front page).*
2. **What kind of wage statement should employees get or businesses provide?**
   *Employees receive a W-2 wage statement. Independent contractors receive a 1099-nonwage payment statement. If you're not sure which you should get (or provide), contact the IRS.*
3. **Should businesses have written contracts with independent contractors?**
   *Written contracts can show the intent of both parties before the beginning of their working relationship. They may be useful in determining independent contractor status. The Workers' Compensation Board requires a written contract to apply for determination of independent contractor status.*
4. **Can General Contractors put people to work without putting them on the payroll?**
   *If IRS determines the workers are independent contractors, they do not have to be on the payroll for income tax purposes. However, even if IRS determines the workers are independent contractors, another agency may consider them employees. So, employers may have to buy workers' compensation insurance and pay unemployment tax. To avoid paying back taxes and penalties, businesses should contact each agency before workers start a job.*
5. **How can businesses employ temporary workers from other countries when they are unable to find sufficient U.S. workers?**
   *The Alien Labor Certification program of the Maine Department of Labor provides assistance in the hiring of temporary foreign workers.*
6. **How can employers learn if they need to purchase workers' compensation insurance?**
   *Contact the Workers' Compensation Board.*
7. **Do woodlot owners need to purchase workers' compensation insurance for workers who are harvesting trees?**
   *A woodlot owner who gets a 'Conclusive Predetermination' from the Workers' Compensation Board or contracts with a wood harvester who has an approved Certificate of Independent Status does not have to carry workers' compensation insurance for that harvester.*
8. **How do harvesters obtain proof of independent contractor status?**
   *Apply to the Workers' Compensation Board for a Certificate of Independent Status to confirm independent contractor status.*
9. **What agency investigates wage or overtime issues for employees?**
   *The Maine Department of Labor and the U.S. Department of Labor Wage and Hour Division investigate complaints.*
10. **What protection do independent contractors have if injured on the job?**
    *Contact the Workers' Compensation Board to learn about rights.*
11. **Can independent contractors get unemployment compensation?**
    *The Maine Department of Labor, Bureau of Unemployment Compensation will determine coverage.*

***If you don't know all the responsibilities of being—or contracting with—an independent contractor, find out now so you can make the right decisions and avoid legal and financial problems down the road.***

rev. 03/04



# Applying the 'ABC Test' to determine liability for unemployment compensation

by Elizabeth Wyman

When is someone an employee for the purpose of determining liability for unemployment compensation taxes? In Maine, this question is answered through application of the "ABC Test" contained in Maine's Employment Security Law.[1] Many employers in Maine are not aware that the ABC Test sets forth a much broader definition of "employee" than used in some other areas of employment law. In fact, the ABC Test often contradicts employers' assumptions that the services they are receiving are from "independent contractors" not subject to payment of unemployment taxes.

This article discusses the ABC Test, the policy underlying it, and its interpretation by the Maine Law Court.

## The language and policy of the ABC Test

Maine's Employment Security Law requires an employer to make contributions to the unemployment compensation fund based upon the amount it pays in "wages for employment."[2]

The statute broadly defines "employment" as "any service performed...for wages or under any contract of hire, written or oral, expressed or implied."[3]

The "ABC Test" is found in a subsection of the definition of "employment," and provides:

> Services performed by an individual for remuneration shall be deemed to be employment subject to this chapter unless and until it is shown to the satisfaction of the bureau that:
>
> 1. Such individual has been and will continue to be free from control or direction over the performance of such services, both under this contract of service and in fact; and
>
> 2. Such service is either outside the usual course of business for which such service is performed, or that such service is performed outside of all the places of business of the enterprise for which such service is performed; and
>
> 3. Such individual is customarily engaged in an independently established trade, occupation, profession or business.[4]

The language of the ABC Test raises two important points regarding its application. First, the statute creates a presumption of employment. Second, it is a conjunctive test. Therefore, to avoid a relationship being deemed one of employment, the putative employer has the burden of proving each prong of the ABC Test.[5] "To satisfy one or two, and not all three, leaves the relationship for purposes of the Act one of 'employment.'"[6]

The ABC Test is broad enough to mandate coverage of many workers who might, in other contexts, qualify as independent contractors. In interpreting the statute, the Law Court has stated that the ABC Test sets forth an "exemption" to the general rule of presumed employment that is meant to apply only to individuals who are truly independent contractors.[7] In establishing the Employment Security Law in 1935,[8] Maine's Legislature stated as the purpose of unemployment compensation:

> Economic insecurity due to unemployment is a serious menace to the health, morals and welfare of the people of this State. Unemployment is therefore a subject of general interest and concern which requires appropriate action by the Legislature to prevent its spread and to lighten its burden which may fall upon the unemployed worker, his family and the entire community. The achievement of social security requires protection against this greatest hazard of our economic life. This objective can be furthered by operating free public employment offices in affiliation with a nation-wide system of public employment services; by devising appropriate methods for reducing the volume of unemployment; and by the systematic accumulation of funds during the periods of employment from which benefits may be paid for periods of unemployment, thus maintaining purchasing power, promoting the use of the highest skills of unemployed workers and limiting the serious social consequences of unemployment.[9]

The ABC Test is distinct from other state and federal statutory doctrines that define the employment relationship. For example, for purposes of federal withholding tax liability, the Internal Revenue Code defines an employee to include "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."[10] The Maine Revenue Service follows the federal rule.[11]

In *Maine Auto Test Equipment v. Maine Unemployment Ins. Comm'n*,[12] the Law Court rejected the employer's argument that Section 1043 was preempted by a federal statute that defined certain sales representatives as "direct sellers" and does not treat them as employees.[13] In rejecting the argument, the Law Court cited a Supreme Court case holding that exemption of employees from a federal statute does not "operate to exempt them from state unemployment insurance taxes."[14]

Maine's workers' compensation statute includes a multipart definition of the term "employee" that differs from the ABC Test.[15] The Workers Compensation definition provides that an independent contractor is "a person who performs services for another under contract, but who is not under the essential control or superintendence of the other person while performing those services."[16] The definition goes on to provide eight additional factors that should be considered when determining whether an individual is an independent contractor.[17] This test, however, does not apply in the unemployment context.

The Law Court has held that the ABC Test expressly supersedes the application of common law "master-servant" or "control test" doctrines that have ruled in other contexts. In *Hasco Mfg. Co., v. Maine Employment Security Comm'n*,[18] the Law Court held that "[t]he common law rules relating to master and servant do not govern the meaning of the statutes."[19] Quoting a Vermont case, the Court stated: "It is plain from its terms that the three concomitant conditions bring under the definition of 'employment' many relationships outside of the common law concepts of the relationship of master and servant."[20]

The ABC Test often comes as a surprise to Maine employers. When a worker files a claim for unemployment benefits and the Benefits Division of the Bureau of Unemployment Compensation determines unemployment contributions were not paid for that employee, the result is a "blocked claim." The blocked claim triggers a field investigation in which a regionally based field advisor and examiner will go to the employer's premises to examine payroll records and other documentation, interview the employer, and make a determination as to whether employment exists pursuant to the ABC Test.[21]

An employer's contract with a worker who has agreed to be considered an "independent contractor" does not necessarily make it so for purposes of the Act. In *Maine Auto Test Equipment*, for example, the employer had each sales representative sign a contract in which the salesperson was characterized as an "independent contractor."[22] Similarly, in *Allied Resources for Correctional Health*, the employer had its health care providers sign contracts designating that they were independent contractors who were required to carry their own medical malpractice insurance.[23] In *Hasco*, the Law Court held that the employer's contract, "adroitly drawn" to suggest that there was no employment relationship between the employer and its sales representatives, was "no more than a subterfuge designed unsuccessfully to escape" the existence of an employment relationship.[24] The statute, in fact, protects

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business of selling and distributing automotive testing equipment, failed to show the requisite absence of control over its sales representatives.[41] In particular, the Court pointed to the following facts as persuasive: that the sales representatives obtained sales leads from Maine Auto; they were assigned specific geographic sales regions; they did not have authority to transact sales on credit; they could consummate sales but always subject to Maine Auto's approval; they could not compete with Maine Auto for two years after terminating their employment.[42] Again, taking these facts together, the Court concluded that the employer had failed to meet part A of the ABC Test.

In a 2002 Superior Court decision, affirmed in a memorandum decision by the Law Court, Justice Roland Cole upheld the Commission's finding that a sales representative for a giftware company was not free from that company's control. The company exercised its control by providing the sales representative with catalogs and order sheets, as well as sales leads. The company set the prices and established discounts and credit arrangements, which the sales representatives were not allowed to negotiate. The company also set the commissions without negotiation and required the sales representatives to lease the company's laptop computers and use its software. The court also found it persuasive that the company established sales goals and required the representatives to attend showroom events where they had to bring their customers. The contracts also contained non-compete clauses.[43] The court rejected the employer's argument that an Illinois court's decision that the sales reps were not employees for purposes of unemployment.[44]

## Part B: Usual Course of Business or Place of Business

PART B OF THE ABC TEST PROVIDES THE EMPLOYER WITH alternative methods of sustaining its burden. In the first alternative, the putative employer can meet Part B by showing that the services in issue are "outside of the usual course of the business for which such service is performed."[45] In *Gerber Dental Center Corp. v. Maine Unemployment Ins. Comm'n*,[46] for example, the Law Court held that the employer failed to prove that services provided by the dentists it had hired were outside Gerber's usual course of business,[47] which was the provision of dental services:

> With the exception of some minor dental tools that some individual dentists own, Gerber provides all the dental equipment and dental supplies used at its dental centers. It employs all the dental hygienists and assistants and all the support staff that handles patient appointments, billings, and collections. It publicly advertises its provision of dental services, and the individual dentists do not have their own business cards. Each dentist receives a straight percentage (30%) of the billings that Gerber collects from patients he or she works on, regardless of the fluctuations in the rent and equipment costs or other expenses incurred by Gerber in operating its dental centers. Gerber's only income comes from its billings to the patients for dental services. The nature of Gerber's operation clearly supports the commission's conclusion that Gerber's usual course of business is the provision to the public of the full range of dental services.[48]

In *McPherson Timberlands, Inc. v. Unemployment Insurance Comm'n*,[49] the employer was "in the business of managing and marketing forest products from its own land and the land of others."[50] McPherson entered into agreements with woodcutters who performed the actual harvesting of the timber.[51] The Court held that the record supported the Commission's conclusion that the work of a wood harvester was not outside the usual course of McPherson's timber management and marketing business:

> McPherson's business encompassed locating, obtaining, and selling timber at a profit. McPherson advertised its interest in buying timber from other landowners and held itself out as a harvester and marketer of the timber. McPherson was then involved with the harvesting both before and after the felling of the trees. Withee's activities were directed solely at assisting McPherson in obtaining the timber. McPherson set specifications for Withee's work and oversaw that work to ensure that specifications were met. It was McPherson, and not the landowner, who paid Withee for his work. Withee had no contact with the landowner and assumed that McPherson owned the property. Finally, McPherson sold the timber Withee harvested to various paper companies and sawmills, deriving a significant portion of its profit from those sales.[52]

The Court also specifically rejected McPherson's argument that the Commission had placed a higher burden on

the employer by describing the wood harvester's services as an "integral part of" the employer's business.[53] Reviewing two older cases, the Court clarified that the test for determining whether services were performed in the "usual course" of the employer's business is not whether those services are an "integral part of" or "merely incidental to" the employer's business, but requires the Commission to "look carefully at the individual facts of each case to determine whether the work at issue is outside the usual course of the employer's business."[54]

Alternatively, a putative employer can satisfy Part B by showing the worker's service "is performed outside of all the places of business of the enterprise for which such service is performed."[55] In *McPherson*, for example, the employer argued that the place where the timber worker harvested timber was not its home office and therefore did not qualify as "place of business."[56] The Court rejected McPherson's argument that an employer's place of business is limited to the location of its home or central office. "If the employer has a significant and business-related presence at the location in dispute, it may be found to have a place of business there."[57] In reaching this conclusion, the Court expressly approved the Vermont Supreme Court's reasoning that "the phrase 'places of business' includes not only a business's home office or headquarters but also the business territory in which the business operates."[58] The Law Court concluded that the employer's "contractual relationship with the landowner, its interest in the timber on the property, and its physical presence on the property support the Commission's conclusion that, while Withee was harvesting timber on the landowner's property, the property was within McPherson's business territory and was therefore a place of McPherson's business."[59]

In *Outdoor World Corp. v. Maine Unemployment Ins. Comm'n*,[60] the Law Court also found facts that met both alternatives in Part B. In this case, the employer owned and operated campground facilities throughout the eastern United States. It hired sales representatives in Maine to provide tours and sell campground memberships for its Moody Beach facility.[61] The Court held the Commission had correctly found that the duties of the salespeople were in the usual course of the business of Outdoor World of selling memberships to its campgrounds *and* that such duties were performed only on the premises of Outdoor World:

> The agreement between the salespeople and Outdoor World recited that Outdoor World "is in the business of developing membership campgrounds and offering the sale of such memberships to the general public." The services of the salespeople were directed exclusively to the sale of these memberships. The prospective customers made reservations to come to a campground owned by Outdoor World, where they were taken on tours by the salespeople. A customer interested in purchasing a membership was brought back to a room on the premises for the sales negotiations and signing of an agreement.[62]

Finally, in *Gerber Dental Center*, the Court held the employer's ownership or rental of the space in which the dental centers were located and where the dentists performed all their dental services defeated the employer's argument that the dentists were performing services in spaces of their own which they had merely rented from Gerber.[63]

### Part C: Proprietary Interest

To meet its burden on part C of the test, the putative employer must show that the worker has a proprietary interest in an occupation or business to the extent he or she could "operate without hindrance from any source."[64] Perhaps the most descriptive phrase interpreting Part C is found in the Court's seminal case, *Hasco*, in which it held:

> We do not have here the barber, the baker, the plumber, the doctor, the lawyer, or a man with an independent calling. To say that the individual selling Hasco products had a proprietary interest in an occupation or business to the extent that he could operate without hindrance from any source stretches the relationship between Hasco and the individual beyond recognition.[65]

In *Nyer v. Maine Unemployment Ins. Comm'n*[66], the Court upheld the Commission's finding that the employer failed to show that the carpenters, identified as "applicators" who installed siding, windows and doors, had proprietary interests in independently established businesses.[67] In *Nyer*, the Court made clear that "the requisite 'proprietary interest' need not be an established concern with various business indicia such as place of business or even a mailing address."[68] The Court emphasized, however, that:

> [A]t the very least such workers must hold themselves out to some community of potential customers as independent

tradesmen involved in a particular craft. ... Thus the workers' "business" would exist independent of the services performed by the workers on a particular job "in the sense that [the business] is the whole—of which the particular service is the part."[69]

In *Vector Marketing Corp.*, the Law Court held the employer failed to show its sales representatives and district managers were independent business people:

> Vector's first district manager in Maine, Daniel St. Cyr, did not hold himself out as an independent businessperson. Indeed, the record shows that he identified himself very closely with Vector. Further, as a district manager, St. Cyr was prohibited from selling competing products during the term of his contract and for one year thereafter. Moreover, there was no evidence that any sales representatives sold any products other than Vector's.[70]

In a more recent decision, the Law Court focused on the proprietary prong in concluding that a "free-lance" newspaper reporter was not independently established: "[B]ecause Stevens did not have prior experience as a reporter, received his only training from the Sun, did not advertise his services as a reporter, and did not perform such services for any other newspaper or magazine, the facts do not compel a result contrary to that reached by the Commission that Stevens was not customarily engaged in an independently established profession."[71]

## Statutory Exemptions

While the definition of "employment" is intended to be broad, there are a number of exemptions to the definition. The statute sets forth forty-four separate categories of labor or services that will not be included in the term "employment."[72] For example, service performed "by an individual in the employ of his son, daughter or spouse and service performed by a child under the age of eighteen in the employ of his father or mother" is not employment for purposes of the Employment Security Act.[73] Student nurses,[74] real estate brokers,[75] and hairdressers with booth licenses[76] also are entitled to an exemption from employment.

It would be wise to run through this extensive list to see if the services in issue have been legislatively excluded from the definition of employment, and therefore not subject to unemployment taxation. The list continues to grow and is the focus of frequent lobbying efforts. In the last legislative session, for example, there was a bill introduced that would create an exemption for court reporters, stenographers and videographers.[77] That bill was carried over to the next legislative session. The Law Court has held that these exemptions must be strictly construed.[78]

Although the list of exemptions is extensive, the law does not allow employment that is subject to the Federal Unemployment Tax Act (FUTA) to be exempt from state unemployment taxation (SUTA).[79] As a general rule, if it is subject to FUTA, it will be subject to SUTA.

## Conclusion

The Law Court has consistently upheld the ABC Test's presumption of employment and the difficult burden it places on employers to avoid a finding of an employment relationship. The ABC Test is intentionally broad in order to ensure economic security for Maine workers who lose their jobs. Maine employers, and their counsel, cannot avoid the imposition of unemployment compensation taxes by simply labeling their workers independent contractors or by relying on common law doctrines or other state or federal statutes. Understanding and applying the ABC Test is an important part of operating a business in Maine. ◗

[1] 26 M.R.S.A. §§ 1041-1251.

[2] 26 M.R.S.A. § 1221(1)(A). *See Lewiston Daily Sun v. Maine Unemployment Ins. Comm'n*, 1999 ME 90, ¶ 8, 733 A.2d 344, 346.

[3] 26 M.R.S.A. § 1043(11).

[4] *Id.* § 1043(11)(E).

[5] *Vector Marketing Corp. v. Maine Unemployment Ins. Comm'n*, 610 A.2d 272, 275 (Me. 1992).

[6] *Hasco Mfg. Co. v. Maine Employment Security Comm'n*, 158 Me. 413, 415 (1962).

[7] *Allied Resources for Correctional Health v. Maine Unemployment Ins. Comm'n.*, 680 A.2d 456, 457 (Me. 1996).

[8] The ABC Test was part of the original enactment of Maine's Unemployment Compensation Law, first enacted in P.L. 1935, ch. 192 § 19(g)(6). *See McPherson v. Maine Unemployment Ins. Comm'n*, 1998 ME 177, ¶ 10, n.2, 714 A.2d 818, 821.

[9] 26 M.R.S.A. § 1042.

[10] 26 U.S.C. § 3121(d).

[11] *See* 36 M.R.S.A. § 5250.

[12] 679 A.2d 79 (1996).

[13] *Id.* at 81 (citing 26 U.S.C. § 3508(a) & (b)).

[14] *Id.* (quoting *Standard Dredging Corp. v. Murphy*, 319 U.S. 305, 309, 63 S.Ct. 1067, 1068, 87 L.Ed. 1416 (1943)).

[15] *See* 39-A M.R.S.A. § 102(11).

[16] *Id.* § 102(13).

[17] *Id.*

[18] 158 Me. 413 (1962).

[19] *Id.* at 415.

[20] *Id.* (quoting *State v. Stevens*, 77 A.2d 844, 847 (Vt. 1951)). *See also Vector Marketing*, 610 A.2d at 274, n.3 ("Common law notions of mas-

ter,' 'servant,' and 'independent contractor' do not control the analysis under 26 M.R.S.A. § 1043(11)(E).").

[21] The rule governing field investigations provides:

Investigations of Potentially Subject Employers: Whenever a claimant reports that he or she performed services with an individual or employing unit which has not previously been determined to be an "employer" as defined in subsection 9 of Section 1043 of the Employment Security Law, and that individual or employing unit should be or might be an "employer," then a field examination shall be initiated.

Rules Governing the Administration of the Employment Security Law, Chapter 2(11)(A).

[22] *Maine Auto Test Equipment Co., Inc.*, 679 A.2d at 80.

[23] *Allied Resources for Correctional Health*, 680 A.2d at 457.

[24] *Hasco*, 158 Me. at 417.

[25] 26 M.R.S.A. § 1044(1). This section also prevents an employer from attempting to have an employee pay unemployment contributions. *Id.*

[26] The employer can request an abatement of interest and a waiver of penalties on unpaid contributions. The statute provides that if the employer can show that the delinquency arose "from reasonable questions of liability under this subchapter," it is within the Tax Division's discretion to abate part of the interest, not to exceed 75 percent of the total interest. 26 M.R.S.A. § 1225(3). If it is shown to the satisfaction of the Tax Division that "the delinquency arose through no fault of the employer, an assessment of interest may not be made." *Id.* For purpose of waiving penalties, the employer must show "reasonable cause," as set forth in 26 M.R.S.A. § 1225(8).

[27] *Id.* § 1226.

[28] *Id.* § 1043(10).

[29] *Id.* § 1043(11).

[30] 2001 ME 60, 768 A.2d 1023.

[31] *Id.* ¶ 19, 768 A.2d at 1028.

[32] *Lewiston Daily Sun*, ¶ 9, 733 A.2d at 346.

[33] *Id.* ¶ 10, 733 A.2d at 347.

[34] *Id.* In a subsequent legislative enactment, freelance writers were added to the list of exemptions to the definition of employment. 26 M.R.S.A. § 1043(11)(F)(43). *See infra* section on statutory exemptions.

[35] 26 M.R.S.A § 1043 (10).

[36] *Hasco*, 158 Me. at 418.

[37] *Allied Resources for Correctional Health*, 680 A.2d at 458.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Maine Auto Test Equipment Co., Inc.*, 679 A.2d at 81.

[42] *Id.*

[43] *Enesco Group, Inc. v. Maine Unemployment Ins. Comm'n.*, 2002 Me. Super. LEXIS 233 (2002).

[44] *Id.*

[45] 26 M.R.S.A. § 1043(11)(E)(2).

[46] 531 A.2d 1262 (Me. 1987).

[47] *Id.* at 1264.

[48] *Id.*

[49] 1998 ME 177, 714 A.2d 818.

[50] *Id.* ¶ 2, 714 A.2d at 819

[51] *Id.*

[52] *Id.* ¶¶ 14, 15, 714 A.2d at 822

[53] *Id.* ¶ 9, 714 A.2d at 821

[54] *Id.* ¶¶ 11, 12, 714 A.2d at 821-22.

[55] 26 M.R.S.A. § 1043(11)(E)(2).

[56] *McPherson*, 1998 ME 177, ¶ 16, 714 A.2d at 822-23.

[57] *Id.* ¶ 17, 714 A.2d at 823.

[58] *Id.* (citing *In re Bargain Busters, Inc.*, 287 A.2d 554, 558-59 (Vt. 1972)).

[59] *Id.* ¶ 18, 714, A.2d at 823.

[60] 542 A.2d 369 (Me. 1988).

[61] *Id.* at 370.

[62] *Id.* at 371.

[63] *Gerber Dental Center*, 531 A.2d at 1263.

[64] *Lewiston Daily Sun*, 1999 ME 90, ¶ 13, 733 A.2d at 347 (quoting *Hasco*, 158 Me. at 419).

[65] *Hasco*, 158 Me. at 419.

[66] 601 A.2d 626 (Me. 1992).

[67] *Id.* at 628.

[68] *Id.*

[69] *Id.* (quoting *Leach v. Board of Review*, 260 P.2d 744, 748 (Utah 1953)).

[70] *Vector Marketing*, 610 A.2d at 275.

[71] *Lewiston Daily Sun*, 1999 ME 90 ¶ 14. As noted above, the legislature added certain "services of an author" to the list of exemptions. *See supra* note 35 and *infra* section on statutory exemptions.

[72] 26 M.R.S.A. § 1043 (11)(F).

[73] *Id.* § 1043 (11)(F)(6).

[74] *Id.* § 1043 (11)(F)(18).

[75] *Id.* § 1043 (11)(F)(19).

[76] *Id.* § 1043 (11)(F)(29).

[77] L.D. 1618 (121st Legis. 2003).

[78] *Outdoor World*, 542 A.2d at 372 (rejecting argument that sales agents of camp memberships were exempt as real estate brokers or salespersons).

[79] The statute expressly provides that "employment" shall include "service with respect to which a tax is required to be paid under any federal law imposing a tax against which credit may be taken for contributions required to be paid into a state unemployment fund or which as a condition for full tax credit against the tax imposed by the Federal Unemployment Tax is required to be covered under this chapter." 26 M.R.S.A. § 1043(11)(G). The statute also makes clear that what is considered "wages" for purposes of the state law has to conform with FUTA's taxation of "wages." Nothing in Maine's Employment Security Law may be construed to exclude any payment or remuneration that is taxable under federal law, and likewise Maine's law may not include any wages that are not subject to federal tax. *Id.* § 1043(19)(D) & (E). □

# Attachment V

**Workers Compensation handout on the Workers' Compensation Act – Determination of Independent Contractor Status.**

# Misclassification Panel
# Monday July 18, 2005

Workers' Compensation Act – Determination of Independent Contractor Status

*The Workers' Compensation Act is contained in title 39-A of the Maine Revised Statutes Annotated.*

I. Definition under Workers' Compensation Act (WCA).

**A.** 39-A M.R.S. §102(13) defines an independent contractor as:

"'Independent contractor' means a person who performs services for another under contract, but who is not under the essential control or superintendence of the other person while performing those services. In determining whether such a relationship exists, the board shall consider the following factors:

A. Whether or not a contract exists for the person to perform a certain piece or kind of work at a fixed price;

B. Whether or not the person employs assistants with the right to supervise their activities;

C. Whether or not the person has an obligation to furnish any necessary tools, supplies and materials;

D. Whether or not the person has the right to control the progress of the work, except as to final results;

E. Whether or not the work is part of the regular business of the employer;

F. Whether or not the person's business or occupation is typically of an independent nature;

G. The amount of time for which the person is employed; and

H. The method of payment, whether by time or by job.

In applying these factors, the board may not give any particular factor a greater weight than any other factor, nor may the existence or absence of any one factor be decisive. The board shall consider the totality of the relationship in determining whether an employer exercises essential control or superintendence of the person."

**B.** The eight factor test springs from the common law definitions of master and servant, Timberlake v. Frigon & Frigon, 438 A.2d 1294, 1982 ME LEXIS 568, and can be found in workers' compensation case law as far back as

1931. See Murray's Case, 130 ME 181, 154 A. 352. The test became part of the statute in 1987.

**C.** Unlike the ABC test, which has 3 conjunctive parts, in applying the 8 factor test under the WCA the existence or absence of any one factor is not decisive. 39-A M.R.S. §102(13).

**D.** There is no legal presumption under the WCA whether a worker is or is not an employee. Title 26 (the unemployment statute) presumes employment status and the employer has the burden to prove a worker is not an employee. In determining employment status under the WCA, the worker has the legal burden to prove he/she is or is not an employee subject to the Act.

**II.** Application of the Eight Factor- Control Test

**A.** Where there is evidence an employer has a right to control the worker, the absence of the exercise of that control is given little weight in determining the existence independent contractor status under the Act. West v. C.A.M. Logging, 670 A.2d 934, 1996 ME LEXIS 31.

**B.** Factor 1 (39-A M.R.S.A. §102 (13)(A): "whether or not a contract exists for the person to perform a certain piece or kind of work at a fixed price." This factor has been interpreted by Maine courts to find that where there is no written contract and the employer retains the right to discharge employees there is a right to control by the employer. See Stone v. Thorbjornson, 656 A.2d 1211, 1995 ME LESIX 71, Bean v. Alrora Timber, Inc., 489 A.2d 1086, 1985 ME LEXIS 669, Kirk, 137 ME 73, Murray's Case, 130 ME 181. Also, Maine Law has traditionally regarded piecework as an indicator of an employment relationship. See West, 1996 ME LEXIS 31 (trucker paid by cord of wood hauled); Stone, 1995 ME LEXIS 71 (lumper paid by the pound of fish); Timberlake, 1982 ME LEXIS 568 (trucker paid by the cord of wood hauled); Kirk, 137 ME 73 (trucker paid by the yard of lime hauled); Murray's Case, 130 ME 181 (unloader paid by the ton of coal).

**C.** Factor 2 (39-A M.R.S.A. §102 (13)(B): "whether or not the person employs assistants with the right to supervise their activities." The inability to hire assistants has been interpreted to suggest control by the employer and an employment relationship. See West, 1996 ME LEXIS 31, Stone, 1995 ME LEXIS 71.

**D.** Factor 3 (39-A M.R.S.A. §102 (13)(C): "whether or not the person has an obligation to furnish any necessary tools, supplies and materials." The issue is not merely whether the individual supplied tools. West, 1996 ME LEXIS 31. In finding an employment relationship under the Act, the West court found that the uniform and hand tools supplied by the logging truck driver paled in comparative importance to the employer's owning, registering, insuring and licensing the logging truck and paying for all fuel, oil and maintenance for the truck. The Court further noted that providing the truck was sufficiently valuable to provide an incentive for control by the employer, and therefore the factor weighed heavily in favor of an employment status. West, 1996 ME LEXIS 31.

**E.** Factor 4 (39-A M.R.S.A. §102 (13)(D): "whether or not the person has the right to control the progress of the work, except as to final results." Assignment of tasks, determining rate of pay and determining when and how the work should be done suggests an employment relationship. See West, 1996 ME LEXIS 31, Bean,1985 ME LEXIS 669, Timberlake, 1982 ME LEXIS 568.

**F.** Factor 5 (39-A M.R.S.A. §102 (13)(E): "the amount of time for which the person is employed." A longer existing relationship appears to favor a finding of an employment relationship. See Murray's Case, 130 ME 181 (many years); In re Dudley, 256 A.2d 592, 1969 ME LEXIS 299 (more than 4 years); Timberlake, 1982 ME LEXIS 568 (more than 2 years); Stone, 1995 ME LEXIS 71 (5 years). The law court has stated that "[a] short period of employment has the most probative value when the worker is paid by the job. The job is then more likely to be considered the worker's job, not that of the putative employer." North East Insurance Co. v Soucy, Jr., 1997 ME LEXIS 108. However, in Soucy the court determined that the worker was an employee stating his short period of employment was not sufficient to make him an independent contractor "give the fact that he was paid by the hour and given the lack of other evidence supporting such a determination."

**G.** Factor 6 (39-A M.R.S.A. §102 (13)(F): "the method of payment, whether by time or by job." Payment by the hour suggests an employment relationship. See James A. Mitchell Case, 130 ME 516, 154 A. 184.

**H.** Factor 7 (39-A M.R.S.A. §102 (13)(G): is "whether or not the work is part of the regular business of the employer." In the workers' compensation

cases, where an individual performs a service that is an integral part of the regular business of the employer it suggests an employment relationship. See West, 1996 ME LEXIS 31, Stone, 1995 ME LEXIS 71, Timberlake, 1982 ME LEXIS 568, Kirk, 137 ME 73.

- Factor 8 (39-A M.R.S.A. §102 (13)(H): "whether or not the person's business or occupation is typically of an independent nature." The absence of evidence of the individual holding himself out as an independent contractor suggests an employment relationship. See West,1996 ME LEXIS 31 (no evidence that individual held himself as an independent contractor), Stone, 1995 ME LEXIS 71 (individually did not work for other employers and he did not hold himself out as an independent contractor). Unlike prong C of the ABC Test, analysis under Factor 8 has not looked to whether a worker has a proprietary or ownership interest in a business to determine if that worker is an independent contractor.

The workers' compensation statute does not contain a codified presumption of employment. It requires an analysis of eight factors where no one factor carries greater weight and where absence of any single factor is determinative. However, like the ABC test, it requires a fact intensive analysis.