HCR 60 STUDY OF INDEPENDENT CONTRACTORS

RESEARCH MEMORANDUM 469

Legislative Research Commission
Frankfort, Kentucky
October, 1995

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Prepared by staff of the
Interim Joint Committee on Labor and Industry

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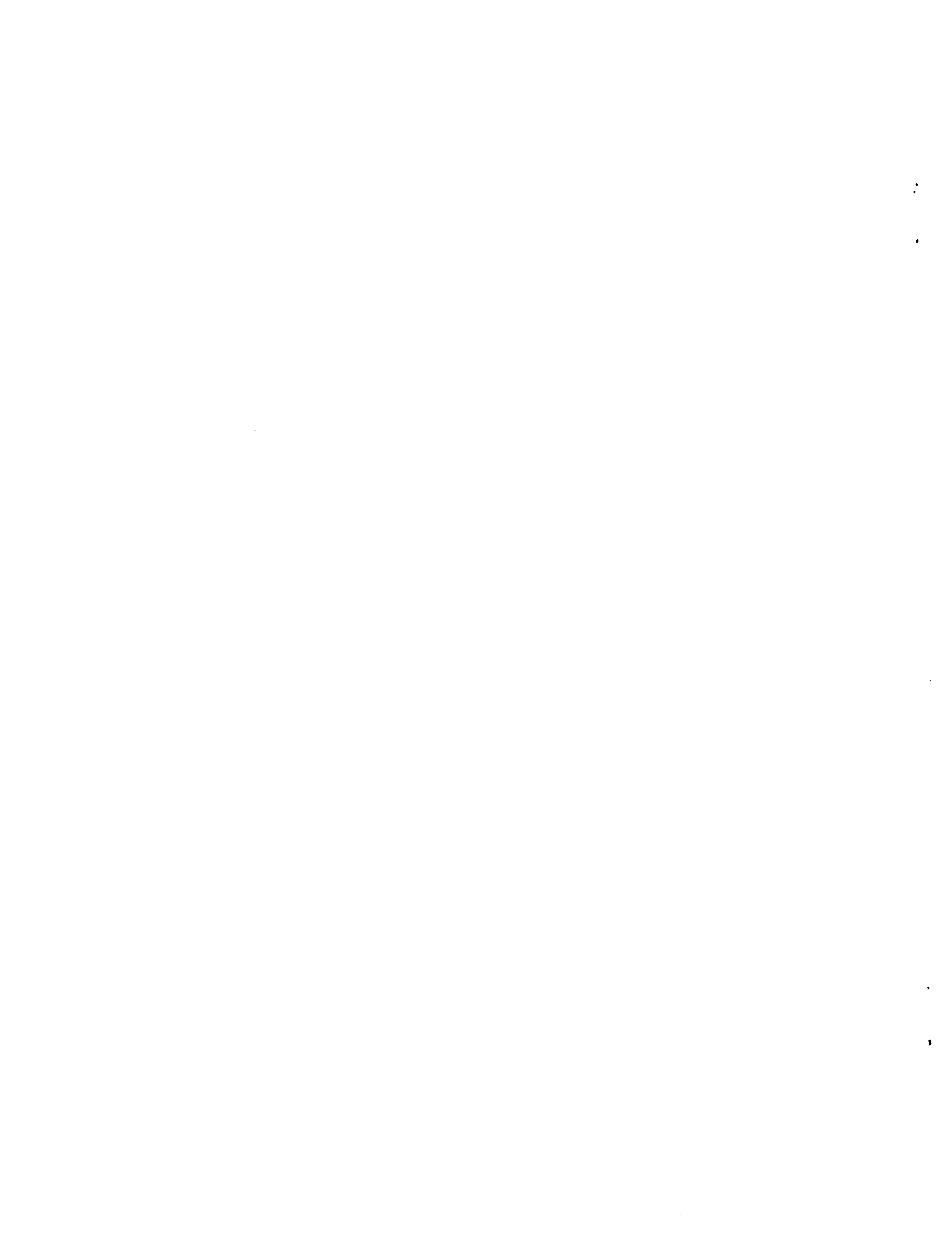

MEMORANDUM

TO: Don Cetrulo, Director
Legislative Research Commission

FROM: Senator Bob Leeper and Representative Ron Cyrus, Co-Chairmen
Interim Joint Committee on Labor and Industry

DATE: October 1, 1995

RE: HCR 60 Report on Independent Contractors

House Concurrent Resolution 60 deals with the subject of independent contractors. The problem as reported to legislators is the improper use of "independent contractor" status to evade certain state and federal requirements applicable to most employers. A person who is truly self-employed may rightfully claim he or she is an "independent contractor" and thus does not have to participate in the unemployment insurance and workers' compensation programs, since he or she does **not** have employees. The worker this report discusses is the one who calls himself or herself an independent contractor when he or she seems to be, in several significant respects, an employee.

Even though the primary impetus of this study was the concern of people in the construction industry, the reader should be aware that independent contractor issues occur in practically all occupational fields and every economic activity. In addition, independent contractor issues are inextricably linked to compliance problems in areas of workers' compensation, unemployment insurance, and taxation. Many in the building trades charge that some contractors hire individuals to perform work for them - essentially as employees - and then incorrectly claim that these people are independent contractors, which exempts them from state laws pertaining to unemployment insurance, state income tax withholding, and workers' compensation. This gives such persons a competitive advantage by reducing their cost of doing business.

There is no statutory definition for "independent contractor" in the Kentucky Revised Statutes. It may be unrealistic to believe a single definition could be devised that would accurately distinguish those who qualify from those who don't. Some agency officials believe that a presumption that an employer/employee relationship exists in all cases - unless the parties involved can prove differently - would clearly place the burden of proof on those who assert independent contractor status. However, this approach would probably require that a uniform statutory definition of independent contractor be utilized by all state agencies. It would probably also require a certification process for independent contractor status.

For purposes of unemployment insurance and workers' compensation liability, if an employer/employee relationship is found to exist between the first party and the alleged independent contractor performing work for the first party, then the "independent contractor" is considered an employee of the first party and not truly "independent". Among the tests that are applied and generally accepted in case law are the extent to which the first party controls the nature of the work and supervises its performance, and whether the contracted work is different from the activities characteristic of the first party in its normal course of business. Obviously each case is different, so some subjectivity is unavoidable in these determinations. Some hypothetical examples follow:

(1) A mine operator contracts with a truck driver to haul coal. The truck driver claims independent contractor status with no employees. However, the truck driver occasionally hires another driver to drive on weekends. The truck driver does not have workers' compensation insurance to cover the other driver, because the other driver is also considered an independent contractor. If the other driver is injured and files a WC claim, it is possible that benefits could be awarded if an Administrative Law Judge (ALJ) determines that an employer/employee relationship exists between the two truck drivers. The mine operator could be held responsible for the claim, because the driver under

contract with the mine does not have workers' compensation insurance to cover the second driver. Under the provisions of Kentucky's workers' compensation law, the insurance carrier of the mine operator would ultimately be held responsible for the claim.

If the mine operator in this example quits using the truck driver to haul coal, and the driver files for unemployment compensation, it is possible that the driver could be determined to be an employee and receive benefits. The mine operator, who has not been contributing to UI, could face severe penalties. In addition, the mine operator could face penalties from the Revenue Cabinet for not withholding and reporting taxes on the truck driver.

(2) A building contractor subcontracts the roofing of a home to a roofer. The roofer has employees, but they have all signed Form 4's (waiver of workers' compensation insurance coverage). Because of the waivers, the roofer tells the contractor that he does not have to have workers' compensation coverage on the workers. If one of the workers is injured and files a WC claim, it is possible that the roofer will be held liable, if the worker can reasonably argue that he did not know that he was signing away his rights when he signed the Form 4 and an ALJ determines that the injured worker is a covered employee. Since the roofer does not have WC insurance, the liability will be passed to the contractor, and ultimately to the contractor's insurance carrier.

Situations such as these have led to insurance carriers requiring contractors to purchase workers' compensation insurance for their subcontractors, even though the WC law does not require subcontractors who are legitimate independent contractors to be covered. There can be situations where the parties actually believe they have an independent contractor arrangement and a field audit determines that there is an employer/employee relationship. There can also be situations where the employer believes employees have legitimately signed waivers of WC coverage, and an ALJ can nonetheless find against the employer. These same examples can involve UI and the

Revenue Cabinet, and they are only a few of many problem scenarios beyond the scope of the present study.

House Concurrent Resolution 60 called for the Interim Joint Committee on Labor and Industry to conduct a study of the issue of independent contractors during the 1994-95 Interim and report its findings and recommendations to the LRC by October 1, 1995. The Committee was directed to determine the facts concerning the nature and extent of problems encountered by the various state agencies involving independent contractors and their compliance with state law, particularly in the Division for Unemployment Insurance, the Department of Workers' Claims, and the Revenue Cabinet. The report is organized as follows:

Chapter One presents an overview of the issues that make the question of independent contractor status important to the regulatory agencies involved with the employer community. Current case law tests of the employer/employee relationship are explained, as are the differences between agency interpretations that can result in an individual being declared a bona fide independent contractor by one agency and an employer (or employee) by another. The first chapter also contains agency personnel responses to interview questions concerning each agency's working definition of independent contractor, and the problems they encounter in the area of enforcement.

Chapter Two includes the responses to a survey of Kentucky's bordering states on the topic of independent contractors.

Chapter Three presents a discussion of current agency enforcement authority, including the penalties for violating existing statutes.

Chapter Four concludes the report with agency comments and the study recommendations.

CHAPTER ONE

OVERVIEW, DEFINITIONS, AND ENFORCEMENT CONCERNS

Just who is an "independent contractor"? This terminology generally refers to a self-employed individual who "contracts to do a piece of work according to his own methods and is subject to his employer's control only as to end product or final result of his work" (Black's Law Dictionary - 1990). Typically, an independent contractor does not have employees, and therefore does not participate in programs designed to protect the welfare and livelihood of employees, including unemployment insurance (UI) and workers' compensation (WC).

A person who improperly claims independent contractor status may in fact have employees who are paid in cash, receive no fringe benefits, and are left uncovered if an injury or layoff occurs. The advantages to this contractor include savings of administrative overhead associated with legal compliance, savings of insurance premium payments otherwise due to an employer's UI account and for WC, and the consequent bidding edge on legally complying competitors who **are** paying these labor costs.

Kentucky Court Rulings

Standards that define an independent contractor have evolved out of case law for WC as well as administrative guidelines used by the Internal Revenue Service in tax cases. The following synopsis of WC cases is drawn from a paper presented by Kentucky Administrative Law Judge Lloyd R. Edens, "Independent Contractors and Enforcement", at a recent LRC conference on WC (all citations are to Kentucky cases):

In a 1976 Supreme Court case, Fields v. Twin City Drive-In, the court held that the phrase, 'contract of hire' contained in KRS 342.640 did not place independent contractors within the term "employee" as used in the Workers' Compensation Act. It further held that the employer/employee relationship must exist before a person comes within the provisions of the Act. Proving that relationship is a subjective process. Two

tort cases in 1955 gave early guidance. Turner v. Lewis (282 S.W. 2d. 624, 1955) utilized the **single** factor of 'control of work' in determining the issue; while in Sam Horne Motor and Implement Company v. Gregg (279 S.W. 2d 755), the court relied upon nine factors established in the American Law Institute publication, Restatement of Agency (2nd. Edition, 1958), at section 220, 'Definition of a servant', to make a determination. Two court decisions, Locust Coal Company v. Bennett (325 S.W. 2d 322, 1959), and Cove Fork Coal Company v. Newcomb (343 S.W. 2d 838, 1961), respectively established that in WC cases, no particular factor is determinative; so that each case must be decided on its own particular facts; and that the 'control of work test' set forth in the Turner v. Lewis case is not determinative.

A 1965 decision, Ratliff v. Redmon (396 S.W. 2d 320), reaffirmed nine guidelines used in Cove Fork Coal Company. The court went on in the same case to identify the right to **control of details of the work** as the primary test. In a later decision, Chambers v. Wooten's IGA Foodliner (436 S.W. 2d 265), the court emphasized four elements, namely, **'the nature of the work...the extent of control...professional skill...and the true intentions of the parties'**. The reader may rightly conclude that subjectivity cannot be eliminated in these determinations. The other point to be noted is the implicit need to balance the evidence from multiple factors or tests of the master/servant, employer/employee relationship in order to render a fair decision that adequately recognizes the uniqueness of each case.

IRS Guidelines

Both the Revenue Cabinet and the Division for Unemployment Insurance in the Cabinet for Workforce Development utilize 20 factors, or administrative guidelines, developed by the federal Internal Revenue Service (IRS) in deciding the question of whether someone qualifies as an independent contractor. As in the preceding instance with WC, subjectivity cannot be avoided, nor can the necessity to examine the unique characteristics of each case. These 20 factors, or administrative guidelines, are used to help determine whether an employer/employee or independent contractor relationship exists, and are posed as questions* (none of which alone is determinative):

(1) Is the worker required to follow your instructions on how work gets done?

(2) Do you train the person?

(3) Are the worker's services critical to continuation of your business?

(4) Do you require the individual to personally perform the work?

(5) Do you hire assistants for the person?

(6) Do you have a continuing relationship with the individual?

(7) Do you dictate the number of working hours?

(8) Do you require the person to spend all of his or her workday on your projects?

(9) Does the person work on your premises?

(10) Do you dictate that work is done in a certain sequence?

(11) Do you require reports regarding steps taken or work accomplished?

(12) Do you pay by the hour, week, or month?

(13) Do you pay the individual's business or travel expenses?

(14) Do you supply the tools?

(15) Does the worker depend on your investment in work areas to get the job done?

(16) Does the worker incur a risk of financial loss if some services are poorly performed?

(17) Does the person work only for your business?

(18) Does the individual fail to offer services to the general public?

(19) Do you have the right to fire an individual?

(20) Can the worker quit at any time without incurring a loss?

(*questions taken from "Twenty Questions to Avoid Tax Penalties," in HR FOCUS, March, 1995.)

Other States

Florida's WC law contains a nine-factor test for determination of an independent contractor, all of which have to be met. Florida's unemployment insurance division, which currently uses the common law relationship relating to employers and employees, is attempting to incorporate the nine-factor test into its statutes.

In determining whether an individual is an employee or an independent contractor, consideration shall be given to whether:

(I) The individual maintains a separate business with his or her own work facility, truck, equipment, materials, or similar accommodations.

(II) The individual holds or has applied for a federal employer identification number, unless the independent contractor is a sole proprietor who is not required to obtain a federal employer identification number under state or federal requirements.

(III) The individual performs or agrees to perform specific services or work for specific amounts of money and controls the means of services or work.

(IV) The individual incurs the principal expenses related to the service or work he or she performs or agrees to perform.

(V) The individual is responsible for the satisfactory completion of work or services that he or she performs or agrees to perform and is or could be held liable for a failure to complete the work or services.

(VI) The individual receives compensation for work or services performed for a commission or on a per-job or competitive-bid basis and not on any other basis.

(VII) The individual may realize a profit or suffer a loss in connection with performing work or services.

(VIII) The individual has continuing or recurring business liabilities or obligations.

(IX) The success or failure of the individual's business depends on the relationship of business receipts to expenditures.

Wisconsin's Workers' Compensation Division uses the same nine-factor test as Florida to determine whether an individual is an independent contractor.

For purposes of the UI program, thirty-eight states, including all those that border Kentucky, define independent contractors according to what is commonly referred to as the "ABC" test. The basis of this is three standards that were derived from judicial interpretations. The following example, taken from the Arkansas statutes, illustrates the use of the ABC test:

Service performed by an individual for wages shall be deemed to be employment subject to this Act irrespective of whether the common-law relationship of master and servant exists, unless and until it is shown to the satisfaction of the Commissioner that:

(A) such individual has been and will continue to be free from control and direction in connection with the performance of such service, both under his contract for the performance of service and in fact; and

(B) such service is performed either outside the usual course of the business for which the service is performed or is performed outside of all the places of business of the enterprise for which the service is performed; and

(C) such individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.

The Department of Employment Security in the state of Utah utilizes an "AB" test, which is based on two factors derived from judicial interpretations:

Services performed by an individual for wages or under any contract of hire, written or oral, express or implied, are considered to be employment subject to this chapter, unless it is shown to the satisfaction of the commission that:

(a) the individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the contract of hire for services; and

(b) the individual has been and will continue to be free from control or direction over the means of performance of those services, both under the individual's contract of hire and in fact.

Wisconsin's Unemployment Compensation Division also applies the "AB test" in its determination of whether an individual is an employee or an independent contractor. There is currently an attempt to amend the statutes to require the division to consider the intent of the parties involved in determining independent contractor status. A requirement to have the division promulgate administrative regulations for the consistent application of the provisions of the statutes is also being considered.

Some states that have adopted tests other than those derived from the common law, particularly those using AB or ABC tests, have resorted to using many of the 20 common law factors in determining whether the AB or ABC factors have been met.

What should be apparent from the preceding description of the case law guidelines and tests in the WC system, as well as the IRS tests used by the Division of Unemployment Insurance and the Revenue Cabinet, is the inherent confusion involved in deciding just who is a bona fide independent contractor. The consequent ambiguity,

according to some enforcement personnel interviewed, normally favors the individual in question, rather than enforcement authorities, when these cases are either administratively appealed or decided by the courts.

Unemployment Insurance

As previously mentioned, officials of Kentucky's UI program rely upon the broader array of factors developed by the IRS to make determinations of independent contractor status, along with the body of common law decisions that give some guidance in this area. They have pointed out that even though adoption of the "ABC" test cited above would be an improvement, subjective judgment would not be entirely eliminated. The personnel interviewed definitely believe a common statutory definition would strengthen enforcement efforts.

The problem of policing independent contractors is a chronic one within UI, representing 13% to 15% of all appeals taken to the UI Commission in recent years. Staff has also reported that the number of appeals tends to rise during recessionary periods. Despite the chronic misuse of independent contractor status as evidenced by the appeal record, UI staff believe most of these disputes arise from unintentional error on the part of the businessperson involved. The division interprets the employer/employee relationship very broadly, so that even in questionable situations, it will generally decide against a claim of independent contractor status, even when another agency, often the IRS, may have decided otherwise.

A random sample of appeals (251 cases) by standard industrial classification (SIC) that involved the independent contractor issue within the last five years, showed single-family housing construction (13 cases) to be the biggest problem area, followed by legal services (10 cases) and local trucking (9 cases). Appeals occur across virtually all standard industrial classifications. Geographically, these appeals are concentrated in the most heavily populated urban areas; Louisville (60 cases), Lexington (27 cases), and

Kenton County (10 cases), with a significant number also originating out-of-state (36 cases).

UI staff indicate that they have many problems with out-of-state contractors who bid in-state work, particularly in urban border areas like Louisville, Northern Kentucky, and, to a lesser extent, the Fort Campbell area. Often, by the time a claimant makes a claim for benefits, which is UI's usual way of discovering these situations, the out-of-state contractor has completed the job and left the state. Cooperation from border states in prosecuting these individuals has been quite limited and there is no interstate compact in place to insure any reciprocity on enforcement.

Another situation that arises with some frequency occurs when a general contractor and a subcontractor agree in advance to work a job with all parties declaring themselves to be independent contractors. If a complaint is made or a claim filed for benefits, the investigator often concludes that an employer/employee relationship does in fact exist, much to the surprise and consternation of all parties. Aside from the question of guilt or innocence, the real problem for the general contractor is that, as the responsible employer, he or she must assume liability for any claims arising from the subcontractors if they don't have UI or WC coverage.

Revenue Cabinet-Income Tax

As noted, the Revenue Cabinet relies on the IRS guidelines and case law to define independent contractor. Normally, a claim of independent contractor status is not challenged unless there is clear and convincing evidence to the contrary, such as unreported wages discovered in the course of a field audit.

In the opinion of Revenue Cabinet officials, the independent contractor issue probably results in significant tax losses, although a dollar estimate would be impossible to determine. Agency representatives believe this issue is reflective of the larger problem that general tax compliance is declining across the board. Twenty years ago, the IRS estimates tax compliance at the federal level was in the high 90th.-percentile; current figures show a rather dramatic decline to around 82% today. Agency officials suggest that this translates to around 75,000 persons in Kentucky who are failing to report their income on a tax return.

The issue of independent contractor status usually arises in relation to a field audit undertaken for other reasons. Estimates indicate that close to 50% of these disputes involve an honest misunderstanding of the taxpayer's situation as an employer. A second, and perhaps primary, source of leads is tips received from disgruntled employees. A third type of non-compliance charge is that which arises when the Cabinet's registration compliance section discovers that a business has not applied for all applicable tax numbers.

The Revenue Cabinet exchanges information, to a limited extent, with other state agencies, usually in the form of interagency agreements. Agency officials indicate that differences in how "independent contractor" is defined by the agencies might indicate that increased communication among the agencies would not be especially beneficial. It was also noted that cross-sharing information about possible violators would not be of much

value if the agencies weren't budgeted enough money to hire more auditors to do the additional field investigations that would result from the cross-sharing.

Wage and Hour Provisions

Even though the terms "employer" and "employee" are both defined in KRS 337.010, Labor Cabinet officials note that there is no definition of "independent contractor" in Kentucky's wage and hour provisions. Most of the activity in the wage and hour area begins indirectly, as a wage and hour complaint by an employee, or during OSH inspections on worksites. It is on these visits that the question of the employer/employee relationship arises, typically because the businessperson under scrutiny will often assert that those working for him or her are all independent contractors. Cabinet officials estimate that approximately 80-90% of all wage and hour complaints they receive involve the independent contractor issue. The Labor Cabinet relies on court precedents and common law tests of the employer/employee relationship to determine whether an individual should be complying with wage and hour provisions of the law.

Department of Workers' Claims

Disputes concerning independent contractors in the area of WC are resolved according to case law. A complicating factor for the Department in administering the WC program is the inappropriate use of Form 4, which permits an employee to voluntarily waive WC coverage. In many situations, it has been found that the worker did not understand what he or she was signing away, or did not do so in a truly voluntary manner.

Agency officials report that there are not very many appeals taken to the Workers' Compensation Board over the issue of whether someone is an independent contractor. Most reports of violations result from field investigations. A serious problem reported recently to the Department involved insurance agents who allegedly were requesting hundreds of Form 4's (employee waivers of coverage) and encouraging their clients to file them to avoid costly premiums.

The officials contend that present fines are probably too insignificant to pose much of a deterrent to someone who wants to use independent contractor status as a

shield against WC liability. In addition to low fines, the lack of a statutory definition of independent contractor adds to its misuse.

The officials have raised the possibility of assistance from local governmental entities in helping enforce WC compliance. Statutes already exist that require an affidavit from contractors swearing compliance with UI and WC before they are issued a building permit from local government building inspectors. If the statutes were amended to require proof of compliance, such as a UI account number and a WC insurance policy, a lot of problems could possibly be prevented at the local level, especially if a uniform definition of independent contractor were in place.

State Purchasing Provisions-Finance Cabinet

Finance Cabinet officials do not consider themselves responsible for enforcing labor laws, other than prevailing wage requirements applicable to public works projects. They place the burden of compliance upon the contractor community involved with state work, and have reported that they are unaware of any problems with the general contractors who are awarded state construction work. They contend that general contractors should be making the effort to see that all subcontractors meet state requirements, since most are aware that liability for injuries or UI benefits will fall upon them if subcontractors do not have the coverage.

On any public works project, each bidder is required to sign an affidavit stating that he or she and all subcontractors are in compliance with all applicable state and federal laws relating to WC and UI. The cabinet does not verify this information, however, and is not required by statute to do so.

The Finance Cabinet's primary concern with contractors on public works projects is to see that payment and performance bond requirements have been met. The agency representatives are not averse to sharing information with other state agencies, once project bids become public information, and prior to final award of a construction contract. Generally, there is a window of about seven to ten days during which the

winning bid is examined for any disqualifying problems before the bidder is actually given the contract. Receiving information from other agencies during this "window" would give the Cabinet the opportunity to disqualify violators before a bid was let.

CHAPTER TWO

RESULTS FROM A SURVEY OF KENTUCKY'S BORDERING STATES

In preliminary discussions as this study was undertaken, legislators expressed an interest in knowing how other states, particularly those bordering Kentucky, have handled issues relating to independent contractors. Accordingly, it was agreed to undertake a survey of Kentucky's border states to gather some of that basic information.

Before considering the specific responses from each state, some general points can be made. First, a prequalification process for approval of contractors is required in six of our seven bordering states, Missouri being the exception. The prequalification process applies only to highway construction in all but Indiana, where it also applies to public works projects. Prequalification involves an examination of the applicant's financial capacity and work history. Those who satisfactorily meet various performance benchmarks (which vary by state) are then placed on an approved "prequalified list" of contractors eligible to bid state work. Performance bonds are a uniform requirement. Compliance with other state laws, such as those regarding WC and UI, is not a part of prequalification, but normally is incorporated in bid specifications or contract terms.

Second, state governments in five bordering states have no authority over the activities of local zoning boards and the building permitting process. Whether or not these local boards require compliance with UI, WC, or OSH standards is entirely up to them. In West Virginia, the state has imposed a mandate on local governments that requires them to verify that a contractor has a valid state contractor's license before a building permit may be issued.

Tennessee, West Virginia, and Virginia have contractor licensing laws. Officials in these states say licensing was instituted primarily to protect the public and to insure fair competition, a "level playing field" for legitimate contractors. All may assess fines for violations, or suspend or revoke licenses as necessary. Virginia may imprison violators.

The licensing boards derive enough income from fees to be self-supporting. None of these states mount any kind of formal public relations campaign to inform the public of the licensing law, although the director in Tennessee said she takes every opportunity to meet with contractor groups and has done numerous broadcast interviews. The licensing boards in Virginia and Tennessee notify local media of all citations issued to violators of the licensing law, which the media may then publish as a public service.

Tennessee

Tennessee has had a licensing requirement for contractors since 1931. The law has been revised twice since, in 1976 and 1994. A prequalification process is required for road projects before a bidder is eligible to submit a bid. Bidding on public works projects that are not road-related is administered through the Purchasing Division of the Department of General Services. Vendors and contractors must register with the state. Primary contractors are accountable for the satisfactory performance of any subcontractors they employ. The Purchasing Division must approve the primary contractor's use of subcontractors.

Bid and performance bonds may be required for any contract, but the invitation to bid must identify this condition. The issuance of building permits is a local, rather than state, responsibility.

The remainder of Tennessee's response gives the impression that imposition of citations (set forth in the licensing law) - involving fines of $50 to $1000 for an unlicensed operation, and civil penalties of as much as $5000 for each violation - has had a deterrent effect on the independent contractor problem. The licensing agency for contractors is supported by income derived from fees (set forth in regulation). The licensing board believes that current net enforcement and administrative costs are less than they were prior to the licensing law. The director of the licensing board believes that public awareness of the law, as well as increasing support from the contracting industry, has greatly enhanced its effectiveness. Although the board has no formal public relations

operation in place, the current director is active in this area. The public relations staff in the Department of Commerce and Insurance has produced press releases relating to contractor licensing.

West Virginia

West Virginia has had a licensing requirement for contractors since July, 1991. Wage bonding is required for any contractor who has been in business for less than five consecutive years in the state. Their contractor licensing act requires registration with several state agencies (Division of Tax & Revenue, Bureau of Employment Services, Workers' Compensation Fund, Secretary of State), as well as posting of a wage bond with the Division of Labor, if applicable. Building permits may not be issued unless a contractor can verify that he or she has a valid state contractor's license.

The Division of Labor is statutorily responsible for field inspections of contractors. Since July, 1991, when the licensing law took effect, the division has issued over 1,675 cease and desist orders to contractors without licenses. At that time, the state tax department identified 6,800 contractors; currently, the Contractor Licensing Board has over 20,000 contractors licensed.

Field enforcement and the requirement that contractors register with the pertinent state agencies in order to obtain their license have been the most effective elements in West Virginia's licensing process in reducing improper use of independent contractor status. Officials believe the licensing law is working well but note that effective communication with the public and licensees always helps to improve compliance.

It took nearly ten years to develop a licensing bill that would pass. An unlicensed contractor who receives a cease and desist order must stop all operations and is subject to a maximum fine of $2000. Repeat offenders are subject to criminal misdemeanor charges. Licensees may be disciplined by the licensing board. To date, the annual fee income ($90 per license) has been enough to make the contractor licensing operation self-sufficient.

Virginia

Virginia has had a licensing requirement for contractors since 1938. There is a prequalification process for contractors who bid on state work, administered by the Department of Transportation and the Department of General Services.

Building permits are under the authority of local governments. Proof of compliance with state laws and monitoring are up to these local jurisdictions. Local planning and zoning boards have no formal role in enforcing state laws. Local building inspectors do not routinely check for compliance with WC and UI provisions during field inspections.

Policing of the program is the responsibility of the Board for Contractors, which is located within the Department of Professional and Occupational Regulation. The board has the authority to impose fines and criminal penalties upon unlicensed individuals, and may fine, suspend, or revoke the license of anyone who violates pertinent statutes or regulations. The board conducts no formal public relations activity directed toward the general public, but listings of license revocation notices are sent out to the media on a monthly basis, and may be published or broadcast as a public service.

Ohio

According to the director of Ohio's Bureau of Employment Services, case law and the statutory definition of employment basically create the presumption that an individual who receives remuneration for performing services for an employing entity is in fact an employee, unless it can be shown to the satisfaction of the bureau that the individual has been and will continue to be *free from direction or control over the performance of such service*, both under contract and in fact (italics added). Ohio, like the other states bordering Kentucky, uses the "ABC test" described earlier to determine whether an employer/employee relationship exists for purposes of the UI program.

In the area of WC, similarly to UI, the courts have ruled that the "right of control" [Gillum v. Industrial Commission, 141 Ohio St. 373, 25 Ohio Op. 531, 48 N.E. 2d 234

(1943)] is the key deciding factor. "If the employer reserves the right to control the manner or means of doing the work, the relation created is that of master and servant, while if the manner or means of doing the work is left to one who is responsible to the employer only for the result, an independent contractor relationship is thereby created (Ibid.)". In guidelines issued by the state's Bureau of Workers' Compensation, the "right to control" is further described as the "right to direct the method and manner in which the details of the work are performed," rather than the right to reject the finished product.

Ohio does have a prequalification process applicable to state highway projects. Contractor licensing is not required in Ohio, however, on either public or private construction.

Illinois

Illinois has no licensing requirement, but it has a prequalification process in place for contractors. No problems were reported concerning independent contractor issues. Illinois has a "Bidder Responsibility Program", established in 1991, which created an objective process to review questionable contractors, and suspend, limit, or bar their ability to do state work, if necessary.

Since the inception of the Bidder Responsibility Program, there have been 41 contractor reviews, resulting in 11 suspensions and 21 limited prequalifications. The remaining nine reviews resulted in seven firms receiving standard prequalification, one firm choosing to let their prequalification expire, and one pending status. These reviews, it should be noted, occur **before** any work commences on the job in question.

Missouri

There is no licensing requirement for contractors in Missouri. Missouri does not prequalify contractors, generally, for state construction projects. Payment bonds from general contractors doing state work have been required since 1909. Performance bonds, as a matter of practice, are required on all state construction projects in excess of $5000.

Enactment of building codes and any associated permitting process is strictly a matter under the control of local jurisdictions. Practice and enforcement vary widely. The only statewide requirement is that prevailing wages be paid to all employees engaged in construction of public works.

Indiana

Indiana does not have a licensing requirement for contractors. The Public Works Division is the contracting agent and supervises most public works construction in the state. They report that on rare occasions they are told of situations in which a general contractor has employed independent crafts people as subcontractors in a manner which "appeared to be aimed at avoiding payment of benefits." They indicate that these cases are referred to the state Labor Department and note as well that such instances normally are discovered after the work has been performed.

CHAPTER THREE

EXISTING ENFORCEMENT AUTHORITY

If an agency determines that people who are claiming independent contractor status are actually engaged in an employer/employee relationship, there are certain remedies presently available. This chapter covers the major laws that pertain to compliance and the penalties, if any, for violating the statutes.

Unemployment Insurance (Workforce Development Cabinet)

Every employer must open an individual reserve account for unemployment coverage for his or her business and contribute an amount based on the number of employees and payroll. The Division of Unemployment Insurance has the statutory authority to seek a court injunction to shut down businesses that attempt to operate without such an account (KRS 341.265) or impose fines if required reports and quarterly payments are not submitted on or before required due dates. Failure to make payments can lead to lien attachment (KRS 341.310 and 341.315) or seizure of property by the Division to satisfy the debt (KRS 341.800).

KRS 341.260(2) requires contractors to either withhold UI contributions from subcontractors or require the subcontractors to have a bond to cover UI contributions. Failure to comply with this section "shall render" the contractor liable for the contribution.

Someone who claims to be an independent contractor or claims that people working for him or her are independent contractors, but is subsequently found to have employees may be found guilty of knowingly avoiding payment of UI taxes. In such an instance, the individual would be guilty of a Class D felony, if the value of the work exceeded $100.

Revenue Cabinet

The Revenue Cabinet requires employers to withhold income taxes from employees (KRS 141.310) and to file quarterly returns and pay the taxes withheld (KRS 141.330). Failure to withhold or file returns will result in the employer being personally liable for the tax. The Commonwealth has the authority to restrain the operation of an employer's business until the tax required to be withheld is paid, and the cabinet may require a corporate surety bond or cash bond, not to exceed $50,000, to be posted by an employer (KRS 141.310). In addition, the Commonwealth is authorized to attach a lien on all the property of any employer who fails to withhold or pay the tax (KRS 141.330). The penalties for violating the above are found in KRS 141.990(1), which states that violators shall be subject to the uniform civil penalties imposed in KRS 131.180 and 141.990(5), which make willful violations Class D felonies. The civil penalties may be "stacked," so they sometimes exceed 100% of the tax owed.

Employment Standards and Mediation (Labor Cabinet)

The majority of violations in the Employment Standards and Mediation Program occur in the areas of minimum wage and overtime required, under KRS Chapter 337. The penalties in KRS 337.990 are civil penalties, with a fine of not less than $100 nor more than $1000. In addition, KRS 337.055 requires employers to pay all wages due an employee upon dismissal or voluntary leaving. The penalty is a fine of not less than $100 nor more than $1000.

KRS 337.200 requires employers in the construction industry and in mining to have a performance bond for wages if they have not been in business for 5 consecutive years. The penalty for violating this statute is a fine of not less than $100 nor more than $500, with each day of violation considered a separate offense (KRS 337.994).

KRS 337.385 holds an employer liable for the full amount of wages and overtime, less any amount already paid; an additional equal amount may be charged as liquidated

damages, plus costs and attorney fees. The court may drop part or all of the damages if the employer shows he or she acted in good faith and did not realize the actions were violations of the law.

KRS 337.075 allows the commissioner to attach a lien on property of violators of wage and hour provisions of the law.

Under the prevailing wage provisions of KRS Chapter 337, KRS 337.530 requires, among other things, the contractor and all subcontractors to pay the established wage rate. If there is a violation, the commissioner of the Department of Workplace Standards shall notify the Secretary of the Finance Cabinet. The Secretary shall hold the party ineligible to bid on public works projects until the violator is determined to be in substantial compliance with the law by the commissioner (KRS 337.550). The penalty for violating KRS 337.530 is a civil penalty of not less than $100 nor more than $1000. In addition, KRS 337.990(12) states that for a flagrant or repeated violation, the offending party shall also be barred from bidding on any public works project for 2 years.

Occupational Safety and Health (Labor Cabinet)

Problems relating to independent contractor issues aren't evident in the Occupational Safety and Health (OSH) Program. The OSH program focuses on the safety and health of employees, rather than on the employer-employee relationship. OSH standards and regulations apply to all employers, employees, and places of employment throughout the Commonwealth, except for federal employees and some federal agencies that are under the authority of a safety and health agency other than OSH. Both employers and employees are required to comply with OSH standards and administrative regulations, and there are substantial penalties for violations. In addition, liens may be attached to the property of employers who violate the OSH program (KRS 338.201).

Department of Workers' Claims (Labor Cabinet)

The Dept. of Workers' Claims has jurisdiction over WC cases. KRS 342.630 requires an employer to have WC coverage on his or her employees. The penalties for violations are found in KRS 342.990(8) and 342.990(10). The former is a civil penalty, with a fine of not less than $100 nor more than $1000 for each offense. The latter is a criminal penalty, with a fine of not less than $100 nor more than $1000, or not less than 30 days nor more than 180 days in jail, or both, for each offense.

KRS 342.340 requires employers to insure their liability for compensation with an entity authorized to transact the business of WC, or show that they have the financial ability to self-insure. It also requires insurance carriers to report new and canceled coverage. New policies shall be reported within 10 days of the issuance of the policy. Canceled policies also have the 10-day notification requirement. There is no penalty to the carrier for noncompliance. This statute also requires the commissioner to notify other interested government agencies of an employer's failure to have WC coverage. Particular emphasis is put on reporting violators engaged in coal mining to the Department of Mines and Minerals.

KRS 342.402 gives the commissioner the authority to temporarily restrain or temporarily or permanently enjoin the further operation of any employer who does not have coverage.

In addition, KRS 342.770 enables the commissioner to attach a lien on the assets of employers, in favor of the Uninsured Employers' Fund, if an employer does not pay a claim.

Finance Cabinet

The Finance Cabinet requires that no state contract be awarded unless a contractor signs an affidavit stating that the contractor is in compliance with all WC and UI

provisions of the law (KRS 45A.480). Failure to comply with this law may bring a fine up to $4000, or the amount of claims from unpaid WC or UI wages, whichever is higher.

The Finance Cabinet also requires, in KRS 45A.485, contractors who are awarded state contracts under KRS Chapters 45A, 175, 176, 177, or 180 to reveal any final determination of a violation, within the previous 5-year period, of KRS Chapters 136, 139, 141, 337, 338, 341, or 342. In addition, contractors must comply with these laws for the duration of the contract. Any violation of this statute shall be grounds for cancellation of the contract and disqualification of the contractor from eligibility for future state contracts for 2 years.

Although the Finance Cabinet has the responsibility to administer KRS Chapter 45A, the Cabinet has taken the position that it is not a regulatory agency and does not have responsibility for ensuring compliance by contractors with various statutory provisions. The Finance Cabinet has no authority to attach liens on property of violators.

Department of Insurance

The Department of Insurance may also play a role in the independent contractor area. An insurance carrier may classify someone as an independent contractor or as an employee for purposes of workers' compensation coverage. If the employer disagrees with the classification, the employer may appeal to the Kentucky Appeals Board, administered by the Department of Insurance. If the employer is adversely affected, he or she may then appeal to the Commissioner of Insurance. This authority is granted in KRS 304-13.161. In determining whether or not an employer/employee relationship exists, the Commissioner uses the common law definition.

Department of Housing, Buildings and Construction

As pointed out earlier, a large percentage of independent contractor violations occur in the construction industry. The Department of Housing, Buildings and Construction has jurisdiction over the building code that regulates this industry. These statutes are found in KRS Chapter 198B. The statutes contain several key provisions:

1.) The Ky. Building Code applies to construction statewide, except mobile and manufactured homes (these are governed by HUD), farm homes and buildings, and single family dwellings, except those constructed under a trade or brand name (KRS 198B.010(4)). Probably the most frequent complaint the Department gets from homeowners is that single family dwellings are not required to be constructed under the Ky. Building Code. If these homes were included in the code, homeowners would have redress against shoddy construction under KRS 198B.130. Not complying with the code is also punishable under KRS 198B.990(1), with a fine of not less than $10, nor more than $1000. Each day the violation continues is a separate offense;

2.) All local governments are required to employ a building official or inspector to enforce the Ky. Building Code, or contract with someone to do it (KRS 198B.060(1)). There is currently no penalty for violating this provision.

3.) No person may be issued a building permit without assuring, by affidavit, that all contractors and subcontractors will be in compliance with WC and UI requirements of the law (KRS 198B.060(10)(a)). The penalty for violating this provision is a fine not to exceed $4000, or the amount of claims from unpaid WC or UI wages, whichever is higher (KRS 198B.060(10)(b)). However, there is no verification of whether the parties actually have the coverage at either the state or local level. Agency personnel note that some states require contractors to register with the state, prove required insurance coverage, and pay a large registration fee, which is held in a fund for the benefit of anyone who would be damaged by the contractor. The contractor's registration of any violator is canceled and the individual would be subject to criminal penalties.

If contractors and subcontractors had to verify compliance with labor laws, those employees who did get hurt would be protected, and the different governmental agencies would be getting the required taxes and insurance premiums.

In communities with a building inspector, the inspector issues building permits, collects affidavits, and inspects the construction. On construction projects that the state

has jurisdiction over, the state issues a letter of authorization allowing the contractor to build, but in some instances the local building inspector still issues the building permit and collects the affidavit. The inspections are done by the state in these cases, not the local inspector.

In communities without a building inspector, in many cases, building permits are issued, but affidavits aren't collected and inspections aren't done on any construction projects. Complaints from areas without a building inspector are investigated by the state. On projects that the state has jurisdiction over, the state letter of authorization is sufficient for construction to proceed, and state personnel inspect construction. The state requests affidavits, but they are not required for construction to proceed or for a certificate of occupancy to be issued.

A frequent complaint the department receives is from contractors who have projects that are under the jurisdiction of the state, but who are required by local authorities to pay for a local permit. The local governmental body is not authorized to do any inspections on these projects, but some charge a substantial additional fee for a local building permit, in which case the contractor is paying twice, because the state charges a plan review and inspection fee. In most instances, the additional fees collected by local governments are used to support their building inspection program.

KRS 198B.060(2) covers the types of construction projects over which local governments and the state have jurisdiction.

It is worth reiterating that although KRS Chapter 198B requires a signed affidavit regarding compliance with workers' compensation and unemployment insurance laws, it does not require the agency to verify that the affidavit is legitimate.

CHAPTER FOUR

AGENCY COMMENTS AND STUDY RECOMMENDATIONS

Agency Comments

Workforce Development Cabinet (Unemployment Insurance Program)

Program staff believe the definition of independent contractor should be simplified and made less subjective. They favor adoption of the "ABC test," shown as Recommendation #1 in the *Study Recommendations* section.

Revenue Cabinet

Cabinet officials believe their existing authority and penalties are sufficient. Their main concern is the lack of an objectively based and readily enforceable definition of independent contractor.

Labor Cabinet (Employment Standards and Mediation)

Training and educating employers and employees in current labor laws is needed. One method of accomplishing this would be to establish an Education and Training Program in the Labor Cabinet. The Cabinet could put on seminars throughout the state and train public and private sector personnel in basic labor laws and rights. Other state agencies would be welcome to participate.

Closer monitoring, regulation, and education of professionals who advise business clients is needed. Attorneys and CPAs occasionally give contractors incorrect information as to their employment status and the contractors get penalized. Some of those interviewed feel that the professionals who dispense false information should be liable to penalties, instead of, or in addition to, the businessperson involved. In WC cases where fraud has been proven, the penalties include possible loss of a professional license (KRS

342.335(2)). The consensus was that these professions definitely should be targeted for the training sessions.

Public service announcements informing employers that certain coverage on their employees is mandatory could help reduce violations. Making new employers aware that they need to comply with other state laws would also help. This could be done when they apply for a tax number or a UI reserve account.

The Cabinet supports a tenfold increase in the fine for violating KRS 337.200, which requires employers in construction and mining to purchase a wage performance bond. This increase would result in a fine of not less than $1000 nor more than $5000. In addition, officials support legislation requiring registrants engaged in construction work to prove compliance with KRS 337.200. The Cabinet also supports changing the mining and mineral laws to make failure to post the bond cause to revoke or deny a mining permit. The officials recommend that a contractor licensing law be enacted, and that it be tied to the creation of a new education and training section of Employment Standards and Mediation.

KRS 337.385 holds an employer liable for all unpaid wages and overtime. An additional, equal amount may be charged by the court as liquidated damages, plus costs and attorney fees. The court may drop part or all of the damages if the employer shows that he or she acted in good faith and did not realize the actions were violations of the law. Labor Cabinet officials would like to see this language changed to allow the Cabinet to assess liquidated damages, rather than a court of "competent jurisdiction".

KRS Chapter 337.075 allows the commissioner to attach a lien on property of violators of wage and hour provisions of the law. The agency recommends that the language be expanded to state that all costs of attaching the lien shall be charged to the business or employer having the lien attached, including attorney costs to process the lien.

On public works projects, the Labor Cabinet would like the Secretary of Finance to hold all moneys until the Labor Cabinet is satisfied that the provisions of KRS Chapter 337.505 to 337.550 have been met.

Labor Cabinet (Department of Workers' Claims)

KRS 342.630 requires an employer to have WC coverage on his or her employees. The penalties for violations are found in KRS 342.990(8)(c) and 342.990(10)(a). The former is a civil penalty, with a fine of not less than $100 nor more than $1000 for each offense. The latter is a criminal penalty, with a fine of not less than $100 nor more than $1000, or not less than 30 days nor more than 180 days, or both, for each offense. The agency recommends substantially increasing the fine imposed under this statute, and explicitly providing that each failure to cover an employee is a separate offense.

KRS 342.340 requires employers to insure their liability for compensation with an entity authorized to transact the business of WC, or show they have the financial ability to self-insure. It also requires insurance carriers to report new and canceled coverage. New policies shall be reported within 10 days of the issuance of the policy. Canceled policies also have the 10-day notification requirement. There is no penalty to the carrier for noncompliance. The agency would like to explore the possibility of having legislation enacted that would impose a fine large enough to discourage carriers from violating this provision of the law.

KRS 342.402 gives the commissioner the authority to temporarily restrain or temporarily or permanently enjoin the further operation of any employer who does not have coverage. Department officials recommend that the commissioner be given the authority to issue a temporary cessation order immediately, in addition to the right to seek circuit court action.

Public Protection and Regulation Cabinet (Department of Housing, Buildings and Construction)

All local governments are required to employ a building official or inspector to enforce the Kentucky Building Code, or contract with someone to do it (KRS Chapter 198B.060(1)). There is currently no penalty for violating this provision. Department officials suggest withholding state funds from communities that do not comply, as a possible deterrence to violating this statute.

The Kentucky Building Code applies to all construction other than mobile homes, farm structures, and single-family residences. Most of the officials interviewed agree that single-family residences should be subject to the code, to ensure quality construction and better-built homes and thus protect the consumer.

Study Recommendations

Based on the information compiled for this study, the following recommendations are offered by staff for consideration. It is properly left to the Kentucky General Assembly, along with top policymakers in the Executive Branch, to discuss, debate, and determine what new course, if any, will be taken by state government in dealing with independent contractors.

RECOMMENDATION #1: The Commonwealth should consider adopting statutorily the "ABC test" or some other accepted standard for state agencies to use in determining whether or not a business or individual qualifies as an independent contractor.

As previously mentioned, there is no uniform, statutory definition of independent contractor that can be used by all enforcement agencies. Each agency applies the common law definition of the employer/employee relationship, or some variation of it. Most agencies agree that a more precise term would clarify and strengthen enforcement.

RECOMMENDATION #2: The Governor should consider appointment of an interagency task force, composed of representatives from the following agencies and programs: the Labor Cabinet (OSHA, Wage and Hour, Workers' Compensation), the Department for Employment Services (Unemployment Insurance), in the Workforce Development Cabinet, and the Department of Tax Compliance, in the Revenue Cabinet.

Ex-officio members should also be appointed from the Department for Facilities Management, in the Finance and Administration Cabinet, and the Department of Housing, Buildings and Construction, in the Public Protection and Regulation Cabinet.

Their charge should be to develop, prior to the 1996 General Assembly, a plan and budget to implement a computerized interagency data network allowing cross-referencing and sharing of information pertaining to businesses and individuals who hold themselves out as independent contractors. This network would be utilized primarily to assist agency enforcement personnel in determining whether a business or individual is in compliance with all state laws relating to labor and employment, as previously described in this report, as well as to share information, particularly relating to chronic violators.

If the agencies began keeping records of independent contractor and other violations and shared that information with each other, a more efficient enforcement program could result. As it stands now, interagency communication is practically nonexistent. However, all the agencies believe a computer networking arrangement would have real benefits, such as reduced duplication of inspections, cooperative audits, and maintenance of a data bank that would function as an early warning system on problem businesses or employers. The agencies also feel that cross-sharing information with our bordering states and having interstate cooperative agreements regarding labor law violators could help in enforcement. The technical barriers and costs to such a system have not yet been explored.

RECOMMENDATION # 3: The General Assembly should consider legislation that requires all building contractors to **register** with their local building authority or the state Department of Housing, Buildings and Construction.

A registrant would be required to show proof of UI and WC coverage, as well as tax compliance (Revenue and IRS employer I.D. numbers) before he or she could obtain a building permit. It might be desirable as well to require liability insurance, in an amount based on a graduated scale pegged to business volume. Such an approach avoids setting

up a new bureaucracy, and testing applicants, which licensing involves. Another advantage of registering is to avoid restraint of fair competition, which is a risk inherent in any licensing approach. The registration process itself must not be so complicated (or tilted in favor of larger established firms) as to become a barrier to legitimate small contractors who do quality work.

The legitimate builder, upon showing satisfactory proof of compliance, would receive a dated wallet card valid for a period of one year. A nominal fee could be collected to cover any administrative expense incurred. If registration were put in place, any data entry by the previously listed enforcement agencies relating to properly registered contractors would reflect that status.

RECOMMENDATION #4: The Governor should consider instructing the enforcement staffs of the agencies involved in regulating independent contractors to give this activity a higher priority than it has had in the past. To this end, the Governor should direct each agency to include in its budget request for the 1996-98 biennium additional funding for enforcement personnel, as well as any additional funding necessary to implement the data network referred to previously. In addition, the field investigative staff and enforcement personnel of the different agencies should be directed to cooperate in their enforcement and compliance activities.

RECOMMENDATION #5: The General Assembly may want to consider whether all new construction of single family homes should be subject to the Kentucky Building Code. According to officials contacted in the Department of Housing, Buildings and Construction, single-family residences should be subject to the Code, to ensure quality construction and to protect the purchaser of the home.