State of Oregon
Employment Department

Testimony before the Senate Business and Transportation Committee
SB 136

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February 4, 2015

Introduction

The Employment Department is neutral on SB 136, although its unemployment insurance (UI) program would be impacted by this legislation. The Department would like to provide background information as you weigh the policy options.

Whether someone is considered an "employee" impacts how several sets of laws can apply, including whether payments to the worker are covered by the UI program. If payments are covered, the business pays a payroll tax on those wages and the wages can support a claim for UI benefits if the worker later becomes unemployed. Many other laws, such as worker compensation, minimum wage and overtime requirements, family leave and non-discrimination provisions also apply to "employees."

These different laws are implemented by different agencies, sometimes with different definitions. The Legislature looked at ways to create a more unified approach to determining when someone is considered an employee. This included creation of the Interagency Compliance Network which requires several state agencies, including the Employment Department, to coordinate and encourage consistency in how workers are classified.[1] It also resulted in a common definition used by several state agencies to determine whether someone is considered an employee or an independent contractor. When there are disputes about whether someone's payments are covered by the UI system, this statute, ORS 670.600, most often applies, although other standards or exceptions apply to particular situations or types of work. The distinction between an employee and an independent contractor typically depends on how much direction and control a business has over the worker and on whether the worker is customarily engaged in an independently established business.

The Employment Department has audited many businesses that operate as franchises. In deciding whether workers are employees of the franchisor, it applies existing statutory definitions including ORS 670.600. This means looking at whether the franchisee performs services for, and receives payment from, its own customers or if they instead perform services for, and get paid by, the franchisor. It also includes examining how much direction and control the franchisor exerts over the worker. This examination usually results in franchises being considered independent businesses and not employees of the franchisor. In a handful of situations, however, the business exerted so much direction and control over the workers that the workers were deemed to be employees of the franchisor. The Court of Appeals has agreed that in some circumstances, franchisees can be employees of the franchisor for purposes of unemployment insurance.[2]

What the Bill Does

[1] ORS 670.700.
[2] *Employment Dept. v. National Maintenance Contractors*, 226 Or App 473, *rev den*, 346 Or 363 (2009).

SB 136, which is similar to HB 3095 (2013), provides that if certain conditions are met, a franchisee is not an employee of the franchisor. Those conditions are:

- The franchise is subject to regulation under state (ORS 650.005 – 650.100) or federal law (16 C.F.R. part 436);
- The franchisee obtains any licenses required to operate the business; and
- The franchise is either a business entity authorized to operate in Oregon or a sole proprietor of a business in Oregon who also resides in Oregon

If those conditions are met, the franchisee is not an employee regardless of how much direction and control the franchisor has over the franchisee. While the franchise must be subject to specified state or federal laws for this exemption to apply, SB 136 does not require that the franchise be in compliance with those laws. Those laws appear to focus on the requirements of franchisors to disclose information to potential franchisees and to keep records. Current standards focus more on the ongoing relationship between the parties. As the Court of Appeals noted, "ORS chapter 650 does not, however, provide any guidance concerning the nature of the ongoing relationship between franchisor and franchisee that results after the sale of the franchise."[3]

Effect on the Public

For most existing franchises in Oregon, SB 136 will not have an impact involving UI: most franchise businesses are treated as independent businesses under current laws. There are some people, however, who would be considered employees under current law, but would not be under SB 136. For this to happen, the worker would need to be a franchisee subject to either Oregon or federal franchise laws as well as being properly licensed and authorized to operate in Oregon. The federal definition of a franchise is relatively broad and does not require a written agreement.[4] If the franchise meets these requirements, the person would not be an employee regardless of how much direction and control the franchisor has over the worker.

The businesses and workers impacted by SB 136 can be divided into two categories. The first group is those that would be impacted immediately when SB 136 becomes effective without the businesses making any changes to how the operate or are structured. These are franchisees who are considered employees under current law but would not be if SB 136 passes.

The Employment Department does not track whether businesses are franchises, but can estimate the size of this impacted group based on past enforcement activities. Over an approximately three year period, the Employment Department audited more than 4,200 businesses. As a result of those audits, the department concluded that 103 individual workers were "employees" despite being franchisees. If that is extrapolated to the entire state, it

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[3] *Employment Dept. v. National Maintenance Contractors* at 488.

[4] 16 C.F.R. § 436.1 (h) provides that "*Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

> **(1)** The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
> **(2)** The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
> **(3)** As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate."

would mean an estimated 2,668 workers, or .18% of the workforce currently covered by the UI program, would no longer be considered employees. Those workers would not be eligible for UI benefits and the amounts paid to them would not be subject to UI taxes, resulting in an estimated $2.4 million reduction in UI taxes Oregon businesses pay to the UI Trust Fund (which is used to pay UI benefits).

The second group of people impacted by SB 136 is harder to quantify. This group would be comprised of new businesses that opt to organize, or existing businesses that opt to reorganize, in a way that people who would be employees under current law would instead be franchisees. For example, someone starting a new business could make a decision to operate in a franchise model, exerting the planned amount of control over its workers, but not having to pay UI taxes. We cannot estimate how many businesses may make this decision. The more businesses that choose to do so, the bigger the decrease in tax payments to the UI Trust Fund and the more people who would lose the protection of the UI safety net; if few businesses make this decision it would have only a small impact on businesses and workers.

Impact of ORS 657.007
ORS 657.007 provides that "For purposes of this chapter, if any provision of state law conflicts with any provision of this chapter, this chapter shall control." The department believes the exclusion in SB 136 is intended to apply to the UI program. It may be possible to explicitly state in SB 136 that it overrides ORS 657.007 to avoid potential ambiguity.

Impact on Federal Unemployment Tax Credits
The U.S. Department of Labor requires state UI programs to be consistent with federal law in order for employers to get a credit against their federal unemployment tax (FUTA) obligations for the state UI taxes they pay. To avoid potential conflicts between state and federal law, SB 136 could not apply to governmental, 501(c)(3) non-profit and Tribal employers.

For franchisees that would be considered employees under current law, but not under SB 136, it would remove their earnings both from supporting a claim for UI benefits and also from being subject to state UI taxes. Because there is not a similar exemption at the federal level, if the Internal Revenue Service concludes someone is an employee, but that person is exempt under SB 136, the business would not have paid state UI taxes, so it would not receive a credit for those taxes against its FUTA obligation.

Effective Date of SB 136
SB 136 is effective on passage. This could create implementation challenges for businesses and the Employment Department. Payments to impacted workers the day before the bill is effective would be subject to UI taxes; the day the bill is effective they would not be. Unless this transition coincides with a business' pay cycle, this will likely require corrections to wage reporting by businesses and the Employment Department. This impact might be able to be mitigated if the bill were effective on the first day of a calendar quarter.

Attachment
Employment Department v. National Maintenance Contractors, 226 Or App 473, *rev den*, 346 Or 363 (2009)
Court decision discussing how in some cases franchisees can be employees for purposes of UI.

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