This report presents the results of an exploratory study of the employee leasing industry. It begins with a description of the employee leasing industry, its size and characteristics. It then presents the results of a survey of State Unemployment Insurance (UI) tax administrators on their experience with the industry and their response in terms of administrative handling of leasing companies and taxing and reporting provisions of their laws. It then attempts to determine the implications of the leasing industry on State Ul trust funds.

The Nature of the Industry

A leased employee is a worker who is essentially rented on a long-term basis from an agency that is responsible for employing the worker, paying the salary or wages and taxes, and providing benefits for that employee. An employee leasing company is an organization in the business of leasing employees to client firms. Under a typical agreement, an employer contracts with a leasing company and dismisses some or all of its employees. These workers are then hired by the leasing company and leased back to the original employer, now the client company, on a long-term basis. The leasing company pays both the employees' wages and associated payroll taxes, including Ul. It also provides the workers with other fringe benefits. This is done for a set fee (usually a percent of payroll) as stipulated in the leasing contract. The contract can be renewed any number of times.

Employee leasing had its origins in the differential pension treatment of different classes of employees, in which one group of employees (generally officers) had a more generous pension program than other employees. Historically, many small business owners have maintained pension plans as a way to defer income for themselves and other employees. Participation in these pension plans was often limited to selected key employees. As these plans were seen as both discriminating against the non-key employees of the business and as a means of deferring or avoiding income taxes, the IRS established a set of guidelines in 1942 to require employers to cover a substantial portion of their employees under the pension plans.

The most recent legislation governing differential treatment was the Tax Reform Act (TRA) of 1986, Public Law 99-514, which amended the tax shelter feature that allowed employers to offer pension plans to partners or high-paid employees with greater tax advantages. To qualify under the safe harbor provision as amended by TRA, leasing companies now are required to offer a pension plan that provides a 10-percent employer contribution to all employees of the leasing firm earning $1,000 or more annually.

Since TRA, industry growth has been fueled by increases in employee benefit costs, particularly health insurance and workers' compensation premiums, both of which represent a larger share of the nonwage labor cost than UI. Thus, while the impetus for employee leasing may lie elsewhere, the UI system is being affected as a result of these changes in labor market organization. One of the financial incentives motivating employers to use employee leasing is the growing importance of fringe benefits as a component of labor compensation.

Survey of States

The KRA Corporation (KRA) survey was designed to gain an understanding of how States are currently dealing with the employee leasing industry and to obtain a more accurate picture of the impact of employee leasing on State UI systems. In September 1994, KRA initiated a survey of State UI tax administrators that asked questions about definitions of employee leasing, applicable State laws, effects on the UI trust fund, industry size and employment, reported industry classifications, registration requirements, bonding requirements, client firm reporting requirements, failure rates of leasing companies, experience-rating procedures, and associated changes in successor rules.

The mail survey was conducted between September 1 and November 1, 1994. Follow-up telephone calls were made to obtain additional data or clarify responses. Surveys were received from all 50 States and the District of Columbia.

A common feature of many State employee leasing laws is a definition of the employee leasing arrangement or employee leasing company. Twenty-five States have such a definition in their law, with another four States defining employee leasing through regulations. Only 14 States do not have a working definition or a definition of employee leasing in any legislation, regulation, or agency policy. Two primary questions underlie most State laws and policies governing the employee leasing industry: "Who is the employer of leased employees?" and "Who is liable for unemployment contributions?" To answer these two questions, States have regulated the industry in a variety of ways.

> According to the survey responses, 27 States consider the employee leasing company the employer of leased employees, while 9 consider the client firm the employer. Of the remaining 14 respondents, 5 indicated that the employer was whoever maintained direction and control of the leased employees. Other States require that the leasing company meet criteria such as the seven-point test to be considered the employer:
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> Thirty-seven States consider partners/sole proprietors to be owners and therefore not eligible for UI benefits. In these cases, the employee leasing company is most likely serving merely as a payrolling firm for those individuals. Only six States responded that a partner/sole proprietor is considered an employee of the leasing company, whereas one considered those individuals employees of the client firm.
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> The entity considered the employer of corporate officers varies more significantly than for partners/sole proprietors. Twenty-one States consider corporate officers employees of the leasing company, and 18 consider them employees of the client firm. Two States responded that corporate officers are considered owners and are therefore not eligible for UI benefits, but two others indicated that corporate officers may be considered in dual employment.

Because of the unique nature of an employee leasing arrangement, determining liability for UI contributions and the appropriate amount of contributions can be difficult. In general, 22 States hold the employee leasing company liable for contributions, but 10 States consider the client firm to be liable if contributions are not paid by the leasing company. Nine States consider the client firm jointly and severally liable for contributions, although five States allow relief from liability if a bond is posted by the leasing company.

As a means of assessing UI tax liability, nineteen States reported that they have registration requirements for employee leasing companies. In some cases, the registration is the same as that required of all firms, whereas other States require special registration or licensing of leasing companies.

Some States require employee leasing companies to submit information in addition to a list of client firms, such as addresses and SICs of client firms. The most common information collected, in addition to client lists, is the number of employees leased to client firms. These requirements can be important to proper reporting of employment by industry in the ES 202 reporting system. Absent reporting requirements, employee leasing firms may aggregate all their leased employees in Help Supply Services (SIC 7363) rather than by the industry of their client firms.

Experience rating is a key factor in determining the amount of payroll contributions any company must pay. In the case of leasing companies, it is not always clear how the experience of a leasing company should be computed. Some States consider the experience rate of the client firm when determining the rate for the leasing company, and others maintain different experience rates for each of a leasing company's client firms. However, the overwhelming majority of States (44 of 50 responding) apply a single tax rate to the leasing company based on the overall experience of the leasing company.

Another consideration in determining both tax liability and the appropriate experience rate is the predecessor/successor relationship between a client firm and an employee leasing company. Most States indicated that employee leasing companies may not transfer the experience of client firms under their State's successorship provisions, whereas some States allow the leasing company to be the successor to the client firm. A few States commented that the leasing company is automatically considered the successor to the client firm. Generally, States indicated that employee leasing companies are treated like any other firm when considering potential predecessor/successor relationships.

With regard to the number of leased employees, 25 States provided estimates, ranging from 1 to more than 100,000 leased employees. The average number of leased employees per State is 25,342. Total leased employment in States able to provide estimates was 608,198. The States that require the submission of client lists account for 46 percent of the total (278,888 leased employees).

Twenty-nine States were able to provide estimates of the number of employee leasing companies in their State in 1993. The total estimated number of firms was 2,297. Of the 29 States providing estimates, 19 require that employee leasing companies register or maintain a license to conduct business in that State. These 19 States account for only 757 of the 2,297 firms estimated for 1993 (33 percent).

Nineteen States indicated that they record the SICs of leasing company client firms or their employment in the appropriate SIC. Although leased employment is historically thought to be found in such employment as medical office staff, legal assistants, or office support, the survey responses indicate that leased employment is found in a variety of industries. When the survey asked about the major industry of client firms, the most frequent response (30 respondents) was the service industry.

However, within the service industry, responses varied from Hotels and Motels (SIC 7011) to General Automotive Repair Shops (SIC 7538) to Public Relations Services (SIC 8743). Other common responses of industries of client firms were manufacturing, transportation, and retail trade.

Trust Fund Effects

The third purpose of this study was to estimate the effects the employee leasing industry has on State UI trust funds. These effects are measured using wage-record data from four States to identify firms engaged in employee leasing and their client firms. Using State UI tax rate data, we were then able to analyze the differences in tax rates between the identified leasing and client firms.

Selection of the four States for obtaining detailed wage and administrative data was essentially judgmental and opportunistic. Maryland was selected because we already had access to all of its wage-record data. Therefore, we could test our proposed procedures on this State before approaching other States. Maryland also has voluntary registration for leasing firms and provided an opportunity to test the extent to which we could identify these firms. Florida has extensive experience with the employee leasing industry and has passed a licensing law for employee leasing firms. Oklahoma is concerned about employee leasing, particularly the interstate aspects. Texas also expressed concern about the employee leasing industry, and the Texas Department of Licensing and Regulation maintains a licensing list of employee leasing firms.

One of the greatest difficulties in measuring the effect the employee leasing industry has had on State UI trust funds has been in identifying the employee leasing firms. In this study we address some of the difficulties of identifying employee leasing firms by developing an algorithm that uses State UI wage records to identify firms engaged in employee leasing.

Using all of the UI wage records collected from every employer, it is possible to examine an individual's employment and earnings history. It is a relatively straightforward matter to track an individual's SSN either forward or backward through time to discover from which employers that individual received wages for each year and quarter. It is the ability to track individuals from one employer to the next that makes it possible to use UI wage records to identify employee leasing firms and their client firms.

The number of leasing firms identified by the algorithm varied across the States. In Florida, 101 firms were identified as being engaged in leasing. Texas had the second largest number of identified leasing firms with 93. In Oklahoma, only 18 firms were identified by the criteria as being leasing firms. Finally, Maryland had only 15. The differences in the number of leasing firms are due to the size of the States (in the first quarter of 1994, both Texas and Florida had over 300,000 employers, while Oklahoma had 65,000); the industry mix prevalent in the States and the age of the leasing industry in the State.

As expected, most of the identified leasing firms were large. The mean employment levels for the leasing firms for the first quarter of 1994 for all four States were more than 600 employees.

Oklahoma had the smallest leasing firm mean employment, 636 employees. Also, more than three-quarters of all of the leasing firms in all three States had more than 100 employees in the first quarter of 1994; and in Florida and Texas, more than 60 percent of the identified leasing firms had more than 500 employees in the first quarter of 1994.

The number of identified client firms for each identified leasing firm also varied across the States. The mean number of client firms per identified leasing firm in Oklahoma was approximately five, the lowest of the three States for which the number of separable clients could be identified. Identified leasing firms in Texas had 13.5 clients on average, while the identified leasing firms in Florida had slightly more than 23 clients.

The algorithm identified more leasing firms in Florida than in Texas, and it identified more total client firms in Florida than in Texas. In Florida, 2,350 client firms were identified; in Texas, 1,999 client firms were identified. In Oklahoma, with its much smaller employer and identified leasing firm base, 93 firms were identified as client firms.

The most common two-digit SIC code of identified client firms in Florida was 17 (Special Trade Contractors), in Texas it was 73 (Business Services), and in Oklahoma it was 50 (Wholesale Trade Durable Goods). In all three States, the two-digit SIC codes of 80 (Health Services), 73, and 65 (Real Estate) accounted for more than 5 percent of the identified client firms' SIC codes. In addition, the two-digit SIC codes of 17 and 50 were also relatively common among all three States' 19 identified client firms.

When weighted by the number of employees involved in the leasing occurrence, the mean tax rates for the leasing firms in all three States were lower than the average tax rates for their client firms. The weighted mean tax rates of the leasing firms in both Texas and Florida were approximately 0.40 percent lower than those of their clients (19 and 26 percent reductions, respectively). In Oklahoma the leasing firms' weighted mean tax rate was 0.11 percent lower than their clients' (a 6-percent reduction).

Given that we identified only 747 changeovers in Oklahoma, the fact that the trust fund loss estimate is small ($8,700) is not surprising. At the other end of the spectrum, the estimates for the State of Texas, with 87,000 changeovers, runs to $3.2 million. Florida, with 39,800 changeovers has an estimated trust fund loss of over one million dollars. Put in perspective, using 1992 taxable wages as the base, the largest loss, in Texas, amounted to six tenths of a percent of the taxable wages. Thus, it would reduce the average tax rate by that amount. For Florida, it amounts to three tenths of one percent. In Oklahoma, given the small size of the leasing industry, the effect is infinitesimal.

Using data from Florida, we examined the potential for tax rate manipulation by the leasing firms. This involved: establishing a low rate for the firm prior to leasing occurrences; and, shifting employment if the firm has an increase in its experience rated tax rate. We found that only 27 percent of the identified leasing firms in Florida had a beginning tax rate of 2.7 percent at the time of their first leasing occurrence. We also found that 33 out of the 101 identified

[1] For this study, employment was calculated as the number of wage records for a given employer. Although this employment figure may overstate the exact number of employees on a given day, it provides a consistent method of determining employment across firms.

leasing firms experienced a substantial increase in employment in the year after their tax rate declined. Finally, most of the 10 identified leasing firms that went inactive in 1994 or 1995 experienced increases in their tax rates in prior years.

We also attempted to look at the relationship between taxes paid and benefits charged for identified leasing companies and their client firms in Florida and Oklahoma. For this analysis we used the ratio of aggregate taxes paid to benefits charged for leasing companies and their client firms. Although it would appear that the ratio of taxes to benefits was higher for the leasing companies from 1990-1994, we conclude that using the aggregate taxes and benefits is inadequate to measure leasing company effects on State UI trust funds relative to their client firms.

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