

Misclassification of wages: A problem that hurts everyone

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The misclassification of wages is a problem that impacts employers, workers, and government. Misclassified wages may mean that workers will not qualify for certain benefits, while government loses important tax revenues. The only party to gain is the employer who achieves an unfair business advantage over the competition.

What is misclassification of wages?

Misclassification most commonly occurs when an employer hires a worker and improperly classifies the worker as an “independent contractor,” rather than as an “employee.”

The difference between an independent contractor and an employee is determined in part by the concept of “right to control.” With an employee, the employer determines what needs to be done (results) and controls how it is to be done (means). The person is normally directed by the employer.

Independent contractors, on the other hand, are *not* employees but are in business for themselves. They are hired to accomplish a task or tasks as determined by the employer, but independent contractors retain the right to control how they will get the work done.

Generally, independent contractors perform a specialized service that is not central to the overall function of the business. They, usually, make themselves available to the employer community at large and do not limit themselves to performing services for a single company. Independent contractors usually supply their own tools.

The Michigan Court of Appeals decision in *McKissic v Bodine*, 42 MichApp 203 (1972) determined the Economic Reality Test for Determining Contractor v Employee Status rules are:

- What liability, if any, does the employer incur in the event of the termination of the relationship at will?
- Is the work being performed an integral part of the employer’s business which contributes to the accomplishment of a common objective?
- Is the position or job of such a nature that the worker primarily depends upon the emolument for payment of his/her living expenses?
- Does the worker furnish his/her own equipment and materials?
- Does the individual seeking employment hold him or herself out to the public as one ready and able to perform tasks of a given nature?
- Is the work or the undertaking in question customarily performed by an individual as an independent contractor?
- Control, although abandoned as an exclusive criterion upon which the relationship can be determined, is a factor to be considered along with payment of wages, maintenance of discipline and the right to engage or discharge employees.
- Weight should be given to those factors that will most favorably effectuate the objectives of the statute.

“Keeping in mind the purposes of the statute, the foregoing rules should be applied as a whole on a basis of common sense. No one can be singled out as controlling. By way of illustration, an automobile mechanic usually furnishes his/her own tools, but if hired to work in a public garage would undoubtedly be classified as an employee.”

In addition, independent contractors should receive from employers IRS form 1099-MISC, which reports payment of “non-employee compensation,” while employees receive a W-2.

Often, wages for part-time, temporary, probationary, substitute and casual labor workers are misclassified, as well. Although a worker’s job may be less than permanent, full-time, the worker is still an employee. Misclassification also occurs when workers operate in the “underground economy” and are typically paid in cash. The wages these workers receive are not reported, and the workers do not receive a 1099 form or a W-2 from their employers.

What are the consequences?

There are potential consequences when a worker’s wages are misclassified. These consequences include:

- For **workers** whose wages are misclassified, they may:
 - Be ineligible for such payments as unemployment insurance (UI) and workers’ compensation
 - Lose other labor law protections such as minimum and prevailing wage, overtime, health and safety, and family and medical leave
 - Become liable for their full Social Security taxes and have to report their own income taxes. In other cases, if the employee is paid in cash, neither the employee nor the employer is paying FICA/Social Security taxes. Consequently, the employee may receive less in Social Security benefits at retirement as the unreported wages are not credited toward the employee’s potential Social Security entitlement.
 - Lose access to employer-based benefits, such as health insurance

- For **employers** who misclassify their workers’ wages, they:
 - Avoid paying income taxes, FICA taxes, unemployment taxes and workers’ compensation premiums on workers that they do not classify as employees
 - Create an unfair competitive advantage
 - Underbid employers who do not misclassify their employees

- For **government** and **taxpayers**, worker misclassification results in:
 - Underreporting of UI taxable wages, resulting in less UI taxes being collected to pay benefits
 - Less taxes going into the UI trust fund result in higher taxes for all other employers in the state to pay for benefits
 - Uncollected income taxes and FICA taxes as some workers who receive 1099-MISCs fail to report their earnings and pay the taxes owed, and the employers are not paying their share of FICA taxes on these workers.

The Government Accountability Office reports that the underpayment of Social Security taxes, unemployment insurance and income taxes in 2006 due to worker misclassification amounted to an estimated \$2.72 billion, nationally.

UIA is taking action to correct the problem of misclassified wages in Michigan.

In April 2006, Michigan’s Unemployment Insurance Agency (UIA) began receiving from the Internal Revenue Service (IRS) statewide listings of employers who are issuing 1099-MISC statements, including the workers who received a 1099-MISC statement from the employer.

UIA field auditors are using IRS information to find misclassified wages, recoup unpaid state UI taxes, educate employers and make it fair for those employers who comply and play by the rules.

UIA uses the 1099-MISC data from the IRS in conjunction with other information to select those employers it will audit for misclassified wages.

Other states have had success in using the 1099-MISC data from IRS. These states report:

- Finding six times as many misclassified employees
- Collecting four times as much money
- Continuing payments into their state UI trust funds in future years by employers once they have properly classified their workers.

UIA is working in close coordination with its sister state of Michigan agencies – Wage & Hour Division and Workers' Compensation Agency.

The agency has also partnered with the IRS in another project – Questionable Employment Tax Practices (QETP). This state and federal partnership results in coordination of efforts in other tax areas to ensure appropriate taxes are being fairly paid by all employers.

Penalties could result

When UIA finds an employer has been misclassifying wages, it requires the liable employer to:

- Pay the required unemployment taxes
- Immediately become the liable employer, as required by the MES Act
- Be scheduled for future audits to ensure compliance

If the wage misclassification continues, it is then an intentional violation of state law, and the employer could be subjected to penalties that quadruple the amount of taxes owed on any misclassified wages.

Questions:

For more information about the misclassification of wages, contact UIA's Misclassification of Wage Unit at (313) 456-3899 or by email at dooleymauraa@michigan.gov.



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