

Fact Sheet #116 October 2019

## Employee Misclassification

The misclassification of employees is a problem that impacts employers, workers and government. When workers are misclassified, they may qualify for certain benefits, while governments lose important tax revenues. The only party to benefit through misclassification is the employer who achieves an unfair business advantage over the competition.

### What is employee misclassification?

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

The difference between an independent contractor and an employee is determined in three categories: (1) Behavioral Control; (2) Financial Control; and (3) Relationship factors. While no one category or factor is controlling, the categories are intended to provide characteristics of each individual factor. After January 1, 2013, Michigan unemployment insurance law requires the IRS 20-factor test to determine if a person performed services as an employee or as an independent contractor.

See [Fact Sheet 155, The IRS 20-Factor Test](#) for details about the Behavioral Control, Financial Control and Relationship factors.

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 is misclassified. These consequences include:

- For misclassified workers, 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 employees, 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 IRS Form 1099-MISC fail to report their earnings and pay the taxes owed, and the employers are not paying their share of FICA taxes on these workers.

UIA is taking action to correct the problem of employee misclassification in Michigan.

- Michigan's Unemployment Insurance Agency (UIA) receives from the Internal Revenue Service (IRS) 1099-MISC statements. UIA field auditors are using the IRS information to find employee misclassification, 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.
- UIA is working in close coordination with its sister State of Michigan agencies – the 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 has resulted in coordinated efforts in other tax areas to ensure that appropriate taxes are being fairly paid by all employers.

### **Penalties could result**

When UIA finds an employer has been misclassifying its employees, the Agency requires the liable employer to:

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

If the employee 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.

### **Report possible employee misclassification**

To report suspected cases of employee misclassification, call UIA Employer Customer Service at 1-855-484-2636.