



Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

BILL ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986

Senate Bill 645 (Substitute S-1 as reported)
Sponsor: Senator Mike Kowall
Committee: Commerce

Date Completed: 11-1-16

RATIONALE

Under State and Federal law, a business's obligations differ depending on whether the business hires an individual to work as an employee or as an independent contractor. For example, an employer must withhold Federal and State taxes, as well as pay unemployment insurance and workers' compensation insurance, and it may be required to provide other benefits or wages. In contrast, taxes are not withheld for an independent contractor, and he or she is provided few, if any, benefits aside from those agreed to by contract. Reportedly, the differences between the two statuses have created an incentive for firms to misclassify employees as independent contractors. This issue has been addressed by the Internal Revenue Service (IRS) in Revenue Ruling 87-41, 1987-1 C.B. 296, which provides factors the IRS uses to determine whether a person performing work for another is an employee or an independent contractor for Federal tax purposes.

Michigan has adopted the IRS's 20-factor test to determine the existence of an employer-employee relationship in the Worker's Disability Compensation Act and the Michigan Employment Security Act. Some believe that, by misclassifying employees as independent contractors, employers avoid other obligations that they are required to satisfy under State law, creating an unfair environment for businesses that properly classify their employees. Accordingly, it has been suggested that the practice be prohibited.

CONTENT

The bill would create the "Employee Classification Act" to prohibit an employer or an agent of an employer from misclassifying an employee in a report required under State law. If the misclassification resulted in a lessening or avoidance of a legal obligation to the employee, another individual, or the State, the employer or agent would be subject to the sanctions provided in the statute under which the report was required.

"Misclassify" would mean to fail to properly identify an individual as performing services in employment in an employer-employee relationship with an employer. An employer-employee relationship would be determined using the 20-factor test announced by the Internal Revenue Service in Revenue Ruling 87-41, 1987-1 C.B. 296.

BACKGROUND

For Federal employment tax purposes, the existence of an employer-employee relationship is determined based on common law rules that examine whether the person for whom services are performed has the right to direct and control the individual performing the services. The analysis focuses on whether the person for whom services are provided controls the result to be accomplished as well as the means by which it is accomplished. An employer need not actually control the manner in which the services are provided to satisfy the employee-employer test. Instead, an employer-employee relationship will be found to exist if the employer has the right to control the manner in which services are provided, regardless how the arrangement is designated.

Revenue Ruling 87-41, issued by the Internal Revenue Service in 1987, identifies 20 factors derived from previous Revenue Rulings and case law that help to differentiate whether an arrangement is an employer-employee or independent contractor relationship. None of the factors provided in Revenue Ruling 87-41 is controlling, and their importance in a given situation depends on the facts and circumstances of the relationship and occupation of the parties involved. The factors are described below:

- Instructions: An individual who must comply with another's instructions about the location, time, and manner of the work is more likely an employee.
- Training: An employer-employee relationship is indicated when the person for whom services are provided requires the services to be performed in a particular way, and requires an inexperienced worker to learn that method.
- Integration: Direction and control are usually present when the worker's services are integrated in the business operations.
- Services Rendered Personally: Interest in whether the services are provided personally usually indicates a degree of control over the method and result of the work.
- Hiring, Supervising, and Paying Assistants: This factor analyzes whether the person for whom services are provided or the worker hires, supervises, and pays assistants.
- Continuing Relationship: A continuing relationship, even if irregular, between the worker and person for whom services are provided generally indicates an employer-employee relationship.
- Set Hours of Work: The establishment of set hours of work by the person for whom services are provided indicates control, and an employer-employee relationship.
- Full Time Required: An independent contractor is generally free to work when he or she chooses; a worker required to commit full-time to the business of the person for whom services are provided is restricted from other gainful employment.
- Doing Work on Employer's Premises: If the person for whom services are provided requires the services to be performed on the premises, or otherwise controls the location where services are provided, the relationship is more likely to be one of employer-employee.
- Order or Sequence Set: If the worker is not free to follow his or her own pattern of providing the service, or the person for whom services are provided has the right to set the pattern of work, then control is demonstrated.
- Oral or Written Report: Oral or written reporting requirements demonstrate a degree of control in how the services are performed.
- Payment by Hour, Week, or Month: Payment by job or straight commission generally indicates an independent contractor relationship; payment by hour, week, or month usually demonstrates an employer-employee relationship.
- Payment of Business or Travel Expenses: When a person for whom services are provided pays for the worker's business or travel expenses and regulates the person's business activities, the worker is typically an employee.
- Furnishing of Tools and Materials: The furnishing of tools, material, or other equipment to a worker tends to show an employee-employer relationship.
- Significant Investment: A lack of investment in facilities demonstrates dependence on the person for whom services are provided, which indicates an employee-employer relationship.
- Realization of Profit and Loss: A worker who can realize a profit or risk a loss as a result of his or her services (and not simply a failure to receive payment) is generally an independent contractor.
- Working for More Than One Firm at a Time: If a worker performs more than trivial services for more than one firm, this generally indicates that the worker is an independent contractor.
- Making Services Available to General Public: If a worker makes his or her services available to the general public on a consistent basis, he or she is likely to be an independent contractor.
- Right to Discharge: If a person's or firm's right to discharge a worker generally secures his or her obedience, that relationship is likely to be one of an employee-employer.
- Right to Terminate: The right of a worker to terminate his or her relationship with the person for whom services are provided without liability generally indicates an employee-employer relationship.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

An employer is required to withhold Federal, State, and local taxes, as well as pay unemployment insurance and workers' compensation insurance premiums. Employers typically set the hours that their employees work, provide supplies or tools for the job, and engage in other actions that would lead individuals working for the employers to believe that they have control over the employees' duties and the manner in which they are performed.

Alternatively, a business that hires an independent contractor to do work is not obligated to withhold taxes for the contractor, nor must it pay unemployment or workers' compensation insurance premiums. Instead, the independent contractor is provided with a Form 1099, which sets forth the income paid to the contractor. Hiring an independent contractor has a number of advantages over hiring employees, including savings in labor costs and reduced liability, and more flexibility. These advantages create opportunity for abuse. There are certain situations in which hiring an independent contractor is practical, e.g., fulfilling one-time business needs or completing tasks outside of the firm's expertise. However, where the relationship resembles an employee-employer relationship, the use of an independent contractor relationship might simply be a way to avoid obligations imposed under Federal and State law. To prevent misclassification of employees as independent contractors for Federal tax purposes, the IRS uses a 20-factor test to analyze the relationship between the parties.

The bill would adopt the definition of an employee-employer relationship according to the IRS test, to determine whether such a relationship existed for the purposes of any report required under State law. The bill also includes language that would subject an employer to sanctions for misclassifying an employee as an independent contractor, if the misclassification reduced or avoided a person's legal obligations. This would create a mechanism to ensure that businesses were complying with State labor and tax laws related to the obligations of an employer to its employees, and establish an environment in which businesses could compete on an equal footing with respect to labor costs.

Legislative Analyst: Jeff Mann

FISCAL IMPACT

The bill would have no fiscal impact on State or local government.

Fiscal Analyst: Josh Sefton

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.