

CONTRACTOR PENALTY

House Bill 6239 as passed by the House
First Analysis (9-18-02)

Sponsor: Rep. Randy Richardville
Committee: Criminal Justice

THE APPARENT PROBLEM:

According to some members of the construction industry, there is a significant problem with construction contractors paying workers in cash. It is believed that this practice of “paying under the table” enables these contractors to circumvent state and federal laws that require employers to withhold and pay state and federal taxes (such as income, Social Security, Medicare, and unemployment taxes) on employee wages. There also appears to be a problem with employers treating employees as “independent contractors”. An employer does not have withholding requirements when contracting with an independent contractor, but does have to file a 1099 form if the compensation meets the threshold amount that triggers reporting requirements. Taxes are the responsibility of the independent contractor.

There are several problems with such practices. Obviously, if an employer pays a worker in cash and fails to either withhold taxes or to file a 1099, the worker may also be unlikely to declare the cash payments and pay the appropriate taxes; this results in a loss of tax revenue for state, local, and federal governments. Secondly, where legitimate independent contractors are aware of the laws regarding reporting requirements for self-employed persons, a person who performs labor in the capacity of an employee but who is compensated like an independent contractor may be unaware of the reporting requirements (e.g., filing quarterly estimated payments) and therefore may be unprepared to pay a large tax bill at the end of the year that may include penalties for not filing correctly. In addition, employees treated as independent contractors may lose out on Social Security and Medicare benefits, and may be denied fringe benefits such as sick pay, holiday pay, vacation days, etc., as well. Furthermore, some see the practice of paying under the table or falsely declaring an employee to be an independent contractor as creating an uneven playing field because such practices may lower a contractor’s overall expenses and also, since the worker has more take-home pay, create the illusion that the worker is

being paid more than he or she would receive from a different contractor.

Currently, both state and federal law levy monetary penalties for failure to properly withhold and pay taxes on employee wages. Federal statute, regulation, and case law establish the distinction between an employee and an independent contractor. In general, the type and amount of behavioral control that an employer has over the worker, the amount of financial control that the employer or worker has over the work, and the type of relationship between the worker and the employer determines whether a person is to be declared an employee or an independent contractor.

Apparently, however, though state and federal law require proper reporting and an employer may be subject to monetary penalties if the reporting requirements are violated, the provisions are rarely enforced and the penalties too small to act as a deterrent. Some believe, therefore, that state law should be clarified – in regard to the construction trades – that falsely declaring an employee to be an independent contractor, or coercing or assisting an employee to declare himself or herself as an independent contractor, with the intent to evade the applicable tax liability is against the law. Also, it is believed that a stiffer penalty, such as making this behavior a criminal offense and/or imposing a heavy fine, is needed so as to effectively deter an employer from such practices.

THE CONTENT OF THE BILL:

House Bill 6239 would amend the Michigan Penal Code to make it a misdemeanor offense for a contractor to knowingly coerce or assist a person earning wages to falsely declare himself or herself to be an independent contractor with intent to evade any applicable state or federal law. An offense would be punishable by imprisonment for not more than 93 days or a fine of not more than \$10,000, or both. The

bill's provision would be independent and cumulative of any other remedies or penalties provided by law.

The terms "contractor" and "wages" would mean those terms as defined in the Construction Lien Act (MCL 570.1103 and 570.1106, respectively). That act defines "contractor" as a person who, pursuant to a contract with the owner or lessee of real property, provides an improvement to real property. "Wages" means all earnings of an employee whether determined on the basis of time, task, piece, commission, or other method of calculation for labor or services except those defined as fringe benefits and withholdings.

The bill would take effect April 1, 2003.

(Note: A criminal violation for which the maximum possible penalty exceeds 92 days imprisonment triggers certain fingerprinting and retention requirements. Under Public Act 289 of 1925, such an offense requires that the state retain one set of fingerprints and send another to the FBI for inclusion in the national fingerprint database.)

MCL 750.353b

BACKGROUND INFORMATION:

Whether or not a person is an employee or an independent contractor is defined by federal statute, regulations, and by case law. Generally, under common law, the distinction is drawn according to how much control the employer has over what, when, and how a job will be done; how much control the employer has over financial considerations such as reimbursable expenses, the ability of the worker to advertise or make available his or her services to the greater market, if the worker can realize a profit or loss, and so on; and the type of relationship a worker has with the employer, e.g., whether employee-type benefits (health insurance, sick pay) are offered, the permanency of the position as opposed to a position offered for a specific period or for a specific project, the extent to which services performed by the worker are a key aspect of the regular business of the company, and if there is a written contract that describes the parties' relationship. An employee – as compared to an independent contractor – has far less autonomy in the performance of his or her services and little or no financial risk. An independent contractor may have employees working for him or her whereas an employee would not.

More information to determine whether a person would meet the common law criteria for an employee

or an independent contractor can be obtained from the Internal Revenue Service web page (<http://www.irs.treas.gov>) and from Publication 15-A, Employers Supplemental Tax Guide. If an employer files Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, the IRS will make the determination as to whether a worker is an employee or an independent contractor.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, the bill could increase local correctional costs, depending on how it affected numbers of misdemeanor convictions and sentences to probation or jail. To the extent that the bill increased collections of penal fines, it would increase penal fine revenues going to local libraries, which are the constitutionally-designated recipients of those revenues. By providing for a misdemeanor penalty of 93 days, the bill would trigger statutory requirements for fingerprinting and recordkeeping; it would, however, not present significant additional costs for the Department of State Police. (9-17-02)

ARGUMENTS:

For:

Independent contractors work in all fields, but especially so in the construction trades, where carpenters, drywall installers, roofers, plumbers, electricians, and persons who install heating and cooling systems often subcontract with general contractors for commercial and/or residential projects. At the same time, many contractors retain people in these trades as employees. But whether a person works in the capacity of an employee or as an independent contractor, it is the employer's responsibility to properly designate each worker and follow the applicable tax reporting requirements. For employees, an employer must withhold and pay the applicable state, local, and federal income taxes; Social Security taxes; and unemployment taxes, as well as follow worker's compensation requirements. For an independent contractor, the employer is required to file a 1099 form for those individuals whose compensation reaches the reporting threshold.

Reportedly, some unscrupulous contractors falsely designate as independent contractors workers who fit the criteria to be classified as employees, as a way to avoid tax and worker's compensation liability. Such a practice does more than reduce much needed tax revenue to the state, local, and federal governments. According to some industry members, designating

workers as independent contractors instead of employees enables a contractor to appear to be paying a higher wage (the take-home pay is higher since taxes have not been withheld, yet the pay may actually be less than the prevailing wage); reduces overhead by eliminating paperwork associated with withholding and paying taxes; eliminates responsibility to maintain worker's compensation insurance (the independent contractor is responsible to maintain his or her own insurance and to provide worker's compensation coverage for his or her own employees); and relieves the employer from being expected to provide fringe benefits. This gives an economic advantage over legitimate contractors.

According to committee testimony, some workers are handed a paycheck or a cash payment and told by the contractor that they are being paid as independent contractors. A worker who is improperly designated as an independent contractor may not be aware of the reporting requirements for independent contractors, who, as self-employed workers, are responsible to pay all applicable taxes, and therefore may be unprepared to pay a large tax bill. They may be unaware that many self-employed people have to file and pay estimated taxes on a quarterly basis or face penalties, and that as independent contractors they need to file a Schedule C (but, since they are really employees, they wouldn't be able to make certain deductions to reduce their tax liabilities as true independent contractors would be able to do).

Though current state and federal law allow for monetary penalties to be assessed on an employer who improperly designates his or her workers, apparently the penalties are either poorly enforced or too weak to be a sufficient deterrent. The bill would clarify, at least for the construction trades, that it is against the law to improperly designate an employee as an independent contractor for the purpose of evading tax liabilities. The bill would also make it a criminal offense, a misdemeanor, to do so. An offender could face up to 93 days in jail or be levied a fine up to \$10,000 per violation. As a 93-day misdemeanor offense, an offender would have his or her fingerprints retained by the state police and placed within the national fingerprint database maintained by the FBI. Such stiff penalties should provide the needed deterrent effect.

Against:

This clearly is a tax issue. Therefore, it seems inappropriate to apply the bill's provisions only to the construction trades. If the intent is to criminalize the intentional misdesignation of a worker's status in

order to evade taxes, then the penalty should be applied across the board.

Response:

It is true that other industries also have a problem with falsely designating employees as independent contractors. However, proponents of the bill believe that this practice is so rampant in the construction trades that the policy should be first applied to the construction industry.

Against:

The bill does not define "independent contractor". It can be very difficult, especially in the construction trades, to figure out accurately who is really an employee and who is really an independent contractor. After all, this is an industry in which a commercial builder or residential builder contracts with professionals in many trades, including roofers, drywall installers, kitchen installers, plumbers, heating and cooler contractors, electricians, etc. It seems unfair that a contractor could be subject to a criminal record, complete with his or her fingerprints being on file with the FBI, just for inaccurately identifying a worker's designation.

Response:

The bill does not define independent contractor because it is federal statute, regulations, and case law that makes the distinction between an employee and an independent contractor. The IRS publishes brochures on employers' tax responsibilities, and the IRS web site has several pages of information on how to distinguish an employee from an independent contractor, including several scenarios involving members of the building and construction industry. If an employer still is confused or unsure, he or she can submit a form to the IRS and the IRS will make the appropriate determination.

Further, to be convicted under the bill, a prosecutor would have to prove intent to evade tax liability beyond a reasonable doubt. Criminal intent is not easy to prove; therefore the bill should not inadvertently capture confused but well-meaning employers.

Against:

The bill would place the entire burden and all the penalties on the contractor. What about the worker who insists on being designated an independent contractor? There should be a parallel penalty for workers who demand to be treated as independent contractors.

Response:

A very important point is being missed here. The federal guidelines, statutes, and common law

interpretations are pretty clear as to what makes a worker an employee or an independent contractor as far as tax liabilities are concerned. In short, according to the IRS, if it walks and talks like a duck, it is a duck, even if it or anyone else insists it is a dog. Desire or intention does not determine the worker's designation – it is the amount of control an employer exerts over the job duties, the amount of financial control the business exerts over the worker and vice versa, and the type of relationship between the parties. For example, a person who is told when, where, and how to work; who is not free to do the same work for other employers; who is expected to show up every day until he or she quits or is fired is an employee. A person who is hired for a specific project or period, who works for several employers simultaneously or one after the other, who maintains his or her own office or equipment, who can realize both a profit or a loss within the scope of that employment, etc. is an independent contractor. As mentioned before, the IRS provides examples and scenarios to help people properly determine the appropriate designation, and the IRS will make the determination if asked. Furthermore, since it is the employer who does the hiring, and the employer who decides the extent of the control he or she will exercise over the worker, it is appropriate to place the burden on the employer.

Against:

The bill would make it a criminal offense to coerce an employee to declare himself or herself an independent contractor, but it doesn't define "coerce". How would one know if he or she coerced the worker without clarification as to what it means to coerce?

Response:

According to the bill's drafter, if a word is not defined in law, the courts generally look to the dictionary definition. In the case of the term "coerce", there are other laws that involve an element of coercion; for example, in contract law, a contract can be nullified if one party was subjected to undue duress or coercion. In short, "coercion" is not an unfamiliar term to lawyers and trial courts.

Against:

The bill is not clear as to which agency or agencies in the state would be responsible to enforce it. Further, if current laws are not being enforced, how would a newer, albeit stiffer law, be enforced?

POSITIONS:

The Air Conditioning Contractors of America/Michigan Chapter supports the bill. (9-17-02)

The Sheet Metal and Air Conditioner Contractors National Association/Metropolitan Detroit Chapter supports the bill. (9-17-02)

The Michigan Regional Council of Carpenters supports the bill. (9-16-02)

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.