Guidelines

Employee vs. Independent Contractor
EMPLOYEE VS. INDEPENDENT CONTRACTOR

Background

Since 1987, the Internal Revenue Ruling 87-41 used twenty common law factors for determining independent contractor versus employee status. Beginning in the year 2002, the IRS is now using a three-part, common-law test for determining employee versus independent contractor status.

IRS Penalties

It is extremely important, prior to hiring an independent contract, to apply the three-part, common-law test as described below. In recent years, the IRS has done 1099 Compliance Audits in many school districts. As a result of these IRS audits, school districts have had to reclassify independent contractors to employees and retroactively correct tax payments on behalf of both the individual and the school district. If the IRS reclassifies an independent contractor as an employee, a school district could be required to pay penalties up to 3% of all wages paid, 40% of the employee's share of social security/medicare taxes and the full share of the employer's portion of the social security/medicare taxes. The IRS can also require the school district to make these corrections retroactively for the prior three calendar years.

Once An Employee – Always an Employee

An employee in any capacity is to be treated as an employee for all services rendered. When an employee is contracted to perform special additional services, all compensation paid is subject to tax withholding and reporting, retirement, and other payroll taxes.

In 1991, the IRS implemented a matching program to select individual tax returns for review in instances where only one 1099-misc. form was filed for the taxpayer. A self-employed individual with only one 1099-misc. is a red flag and may be an indication of an employment relationship rather than a client-contractor relationship. The IRS also looks for individuals who receive both a W2 form (employee calendar earnings) and a 1099-misc. form (independent contractor calendar earnings) in the same calendar year.

THREE-PART, COMMON-LAW TEST

Behavioral Control Test

The basic question to be answered is whether the college has the right to direct and control the behavior of the worker. Questions that help determine if behavioral control exists are as follows:

1. **Instruction and Training:**
   - Does a supervisor or manager give instructions to the worker about, when, where and how the work is to be done? **If the answer is yes, the worker should be classified as an employee. An employee is subject to the supervision and control of the employer in regard to the manner in which the project, job or task is performed. (This is the most important factor). An independent contractor is hired to do a**
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particular project or job and the employer does not direct the person on how to complete the project or job.

- Is the worker required to attend training classes, and to learn and follow policies and procedures of the college? If the answer is yes, the worker should be classified as an employee. The independent contractor should already have sufficient education and training needed for the specific project and normally is not required to follow the policies and procedures of the college.

- Has the college adopted written rules, regulations or manuals that specify how the job is to be performed? If the college currently has an employee job description that describes the same type of duties that are to be performed, the person should be hired as an employee.

- Does the college instruct the worker as to what tools or equipment to use and where to purchase supplies and services? If the answer is yes, the worker should be classified as an employee.

2. Identification with the College:
   - Does the worker wear a uniform or special clothing of the college? If the answer is yes, the worker should be classified as an employee.

   - Does the worker drive a vehicle with the insignia of the college? If the answer is yes, the worker should be classified as an employee.

   - Is the worker allowed to use the forms and stationary for official correspondence of the college? If the answer is yes, the worker should be classified as an employee.

3. The Nature of the Occupation:
   - Is the person a highly-trained professional, such as an attorney, engineer or architect? (The person may or may not be an employee, depending on the other common-law tests discussed herein.) If the highly-trained professional also works for other entities, the person could be classified as an independent contractor. If the person only works for the college and no other entities, he or she should be hired as an employee. In an IRS Audit, the independent auditor's 1040 Tax Return would be evaluated to determine if the individual received income from more than one entity. If not, the IRS would deem the individual an employee, if the sole source of income was from the college.

   - Is the person's work "integrated" into the daily operations of the college? If the answer is yes, the worker should be classified as an employee. It would be considered more of an employee/employer relationship.

   - Does the college require that work be done on its premises? If the answer is yes, the worker should be classified as an employee. An independent contractor should have the flexibility to work from a home office or business location.

   - Does the person act in a staff capacity, such as coordinates, manages, directs, implements, etc.? If the answer is yes, the person should be classified as an

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An independent contractor should act more in an advisory position, such as reviews, recommends, acts as a resource, expert, speaker, etc.

- Does the college schedule vacations and holidays for the person? *If the answer is yes, the worker should be classified as an employee.* An independent contractor has control over their own schedule, as long as they meet the deadline requirements of the Independent Contractor Agreement.

4. System for Evaluating Job Performance:
   - Does the college perform periodic, formal evaluations of the person's detailed job performance? *Only employees should receive formal evaluations.*
   - Does the college have the right to discipline the person, or alter job performance, based on the evaluation? *If the answer is yes, the worker should be classified as an employee.*

Financial Control Test:

The basic question to be answered is whether the college controls the business and financial aspects of the worker's activities. Questions that help determine if financial control exists are as follows:

1. Method and Amount of Compensation:
   - Does the worker receive a level amount of pay or fixed price contract? *If the worker receives a flat monthly rate, he or she should most likely be classified as an employee.* Employees are compensated on an hourly, daily or monthly rate. Independent contractor's compensation is usually established prior to commencing the project, and is established and negotiated as a fee to be paid at the end of the contract, or on a percentage based on the completion of the project.
   - Does the worker have the opportunity to realize a profit or incur a loss on the job? *A true independent contractor can realize a profit or incur a loss.* An employee is compensated for actual hours worked.
   - Does the worker have a fixed contract price, regardless of the time and costs necessary to complete the job? *If the answer is yes, the worker is most likely an independent contractor.*

2. Offering Services to the Public:
   - Does the individual offer his or her services to other employers? *An independent contractor usually works for more than one entity.* If the individual relies solely on the college for earnings, it is considered more of an employee/employer relationship.
   - Does the person advertise? *Independent contractors would be likely to advertise, but not always; especially if they work for more than one entity and get referrals so it is not necessary to advertise.*
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- Does the person have a private logo? Most companies or individuals who work for more than one entity have a private logo.

- Does the person have an office or separate work place away from the college? An independent contractor may occasionally use a work place at the college, but not on an ongoing basis. If the worker has an assigned, designated work space, he or she should be classified as an employee. An independent contractor usually has an office or separate work place away from the college.

- Does the individual work full-time for the college, or does he or she work for other entities? Usually an independent contractor does not work full-time for the college and receives income for other entities. This is one of the major tests that the IRS uses during an audit.

3. Part-Time or Temporary Status:
   - Is the worker’s work hours controlled by the college? An independent contractor should not have assigned work hours and should have control of his or her own schedule.

4. Significant Investment in Business:
   - Does the worker incur business expenses? An independent contractor should have some business expenses that are not reimbursed by the college, such as rent and utilities, tools and equipment, advertising, insurance, postage, supplies, travel, etc.

Relationship of the Parties Test:

1. Written Agreement:
   - Is there a written contract specifying that the worker is an independent contractor? An independent contractor should have a written contract specifying the work or project to be performed.

2. Fringe Benefits:
   - Does the college provide the worker with fringe benefits limited by statute to employees, such as paid vacation, sick days, holidays, health insurance, cafeteria plan benefits, pensions plan contributions? If yes, this would indicate the worker should be classified as an employee. An independent contractor would not receive such benefits.

3. Reimbursed Expenses:
   - Does the college reimburse the worker for travel expenses or supplies? An independent contractor usually works on a profit or loss situation. The independent contractor should incur the cost for his or her own travel expenses or supplies.

4. Right to Discharge or Terminate:
   - Can the governmental agency terminate or discharge the worker at will? It is more difficult to discharge an independent contractor, unless specified in the written agreement. Also, a worker’s ability to terminate work at-will illustrates that the
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A worker merely provided labor and demonstrates an employer-employee relationship.

- Can the college sue for nonperformance of work, or withhold payment for failure to complete a contract? An independent contractor may be sued for breach of contract, such as non-performance. An employee is compensated on an hourly or monthly basis for actual hours performed; therefore, a lawsuit is unlikely.

5. Permanence of Relationship:
- Does the worker expect a long-term, indefinite relationship with the college? Courts have considered the existence of a long-term or permanent relationship between the worker and the business as relevant evidence in determining whether there is an employer-employee relationship. Although, there could be extenuating circumstances for having a long-term relationship, such as lack of alternative service providers.

- Is the worker being retained for only one job or project? This depends on the job or project and could go either way depending on what is required. This is a case where the college would need to look at other common law factors also.

6. Regular Business Activity:
- Is the work to be performed a key aspect of the regular business of the college? For example, an instructor for a class should not be hired as an independent contractor. The college’s key business is to instruct students, so an instructor should be classified as an employee. An exception to this could be if an instructor were to teach a class on a profit/loss situation. They were paid a flat rate for a class and paid for their own supplies, such as a community education class. They would not be paid at an hourly rate. This is still considered a gray area with the IRS, but could be argued, especially if the contracted instructor teaches the same course in the same profit/loss manner for other colleges.

LIABILITY ASPECT TEST

If a person employed as an independent contractor: 1) suffers an injury; 2) is the cause of an injury to others; or 3) due to negligence or action caused a financial loss, would the employer likely be held liable because a court could rule that the person was an employee (without regard to the contract and even in spite of a hold-harmless clause in a contract)?

Consider: If this is a reasonable conclusion beforehand, should the individual be an employee from the onset?

Final Note: Whenever an individual is to be treated as an employee, options exist as to hiring on a limited-term, short-term, or other basis or category of employment.