

## **I. INTRODUCTION**

## BACKGROUND

Hawaii State law places the civil service system in the Department of Human Resources Development (DHRD). The civil service law states that civil service employees shall fill all positions, now existing or hereafter established, and shall perform all personal services provided to the State unless specifically exempted by law. Section 76-16 of the Hawaii Revised Statutes (HRS) permits the exemption from civil service of certain positions and services performed by individuals. Two of these exemptions specifically allow contracts for services under certain circumstances.

Having DHRD review all personal services contracts created a logistic and resource nightmare for the department. In February 1982, in the interest of efficiency, economy and timeliness and under the provisions of Section 14-1-9 of the State's Personnel Rules, DHRD issued a memorandum stating that the department heads were delegated the authority to exempt the services of certain individual contractors. The delegated authority was applicable only to those contracts which fulfill the three conditions as follows: (1) Involve the delivery of completed work or product by or during a specified time; (2) There is no employee-employer relationship; and (3) The authorized funding for the services was from other than General Funds or personal services cost element. The third condition was later amended to include General Funds.

This question of employee-employer relationship has been an employer concern since the early 1960s. In the private sector, the distinction between independent contractor and employee has been an Internal Revenue Service (IRS) audit target for many years. Currently, the IRS has shifted its focus to state and local governments. The possible consequence of incorrectly classifying an employee as an independent contractor is additional Social Security and Medicare Taxes (both employer and employee's share), income tax withholding, and possible penalties and interest.

To address the State's accounting policy regarding employee-employer relationship between the State and the contractor that is an individual, in February 1989, the State Comptroller issued Comptroller's Memorandum 1989-7, *Determining Employer-Employee Relationship*. The memorandum states that there is no single, simple definition of employee that can be used to determine whether an employer-employee relationship exists. Instead, the determination must be made under common law tests on employee status.

The determination is not based on the title used by an individual performing the personal services. The individual may be called an agent, consultant, firm, independent contractor, or some other such term, but still meet the definition of an employee. The determination is based on whether a department directs and controls the manner in which an individual provides the service (the particulars of how, when, and where the service is performed) as well as the end-result of the services provided, and then an employer-employee relationship exists. Therefore, if the common law tests indicate that an employer-employee relationship exists, the individual is a common law employee for Federal employment tax purposes. Conversely, if the common law tests indicate that an employer-employee relationship does not exist, the individual performing the services is an independent contractor, not an employee.

## BACKGROUND, continued

This memorandum established the procedures used by State agencies in determining whether an employer-employee relationship exists for personal services. If the procedures determine that no employer-employee relationship exists and the other two DHRD mandated conditions were met, then the department's director could exempt the personal services from civil service. The individual would be an independent contractor and not an employee entitled to State employee benefits.

The IRS is similarly interested in the State's policy of determining employer-employee relationship. Employment taxes are the primary sources of revenue for the Federal government. Approximately three out of four dollars collected by the IRS comes from employment withholding taxes.

The IRS follows the Common Law Standard to evaluate employer-employee relationship. The Common Law Standard states that in determining a worker's status, the primary question is whether the worker is an employee or independent contractor under the common law standard. The common law, a major part of the justice system in the United States, flows chiefly from court decisions. Under the common law, the treatment of a worker as an employee or independent contractor originates from the legal definitions developed from court cases. Factors from these court cases are used to determine whether a worker is an employee or independent contractor.

The employment tax regulations (Treasury Regulations 31.3121(d)-1(c)) provide: (1) Every individual is an employee if under the usual common law rules the relationship between individual and the person for whom the individual performs services is the legal relationship of employer and employee; and (2) Generally, such relationship exists when the person for whom services are performed has **the right** to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the work is accomplished.

The IRS uses the "Control Test" to determine if there is a right to direct and control the work and also the details and means by which the results are accomplished. To determine if the control test is satisfied, the facts and circumstances of the case must be analyzed. This analysis relies on three elements of control: (1) Behavioral control, (2) Financial control, and (3) Relationship of the parties. Relevant evidence in all three elements must be weighted to determine the worker's status.

In May 2006, the State Comptroller issued Comptroller's Memorandum No. 2006-10, rescinding three previously issued comptroller's memorandums on determining employer-employee relationship and establishing the new procedures to determine employer-employee relationship.

In October 2006, DHRD issued a new memorandum that supersedes the February 1982 memo setting forth-new procedures to department heads to approve exemptions from civil service under both Section 76-16(b)(15) and Section 76-16(b)(2), HRS.

**ACCOUNTING AND AUDIT REVIEW COMMITTEE EVENTS  
RELATED TO EMPLOYER-EMPLOYEE RELATIONSHIPS  
AND PERSONAL SERVICES CONTRACTS**

The following is a concise chronological timeline of events regarding the Department of Accounting and General Services, Accounting and Audit Review Committee's (AARC) activities regarding employer-employee relations and personal services contracts.

- **March 2004** – The State of Delaware (DE) makes a presentation at the National Association of State Comptrollers (NASC) Conference informing state comptrollers of its two (2) ongoing Internal Revenue Service (IRS) audits. DE notifies states that the IRS intends to audit every state and that DE is the pro forma case. DE's discussion of its audit focuses on employer-employee relationships and the IRS's objective of determining whether the state workers were properly accounted for as independent contractors or common-law employees for Federal employment tax purposes.
- **April 2004** – The Comptroller establishes the Accounting and Audit Review Committee (AARC) - <http://aarc.hawaii.gov/>. The AARC ensures compliance with the State Comptroller's established accounting system and internal controls, and promotes efficiency in the Executive Branch by helping State departments and agencies comply with applicable laws, rules, regulations, policies, and practices.
- **October 2004** – The AARC begins discussions about DE's IRS audit on employer-employee relationships (independent contractor versus employee).
- **November 2004** – The AARC begins planning for training on independent contractors versus employees.
- **December 2004** – AARC determines that the issue of independent contractors versus employees is generated by the use of Personal Service Contracts (PSC) and initiates its first survey to determine the extent of the issue.
- **January 2005** – Survey is distributed, but results are not clear. AARC/PSC determines that use of PSCs is inconsistent and no guidelines are available.
- **March 2005** – DE makes a follow-up presentation informing NASC members that the IRS is still auditing the state after two (2) years and has assessed the state \$20k in penalties for not properly accounting for independent contractors who were common-law employees for Federal employment tax purposes. DE recommends that states "Self-Audit" and reminds members that the IRS plans to audit all states.

Michigan notes that its "Self-Audit" resulted in compliance issues that were immediately presented to the IRS. Because MI was forthcoming, the IRS did not penalize the state. MI recommends that all states take this proactive approach.

The Attorney General, after learning of issues on Hawaii State contracts in a report issued by

**ACCOUNTING AND AUDIT REVIEW COMMITTEE EVENTS  
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AND PERSONAL SERVICES CONTRACTS, continued**

the State Auditor sends a letter to the IRS notifying them of “a possible problem with some State of Hawaii contracts that may have tax implications” that “may trigger employment – related withholding required of the State” and stating “We are participating in an Audit and Accounting Review Committee (“AARC”) under the guidance of the Department of Accounting and General Services (“DAGS”).”

AARC creates a larger subcommittee, **AARC/PSC**, including members from DAGS (Audit Division, Accounting Division, State Procurement Office, Personnel Office), Departments of Human Resources Development (DHRD), Department of the Attorney General (AG), Department of Labor and Industrial Relations (DLIR) and, as the issue expands, Department of Budget and Finance (B&F). The Employee Retirement System of the State of Hawaii (ERS) attends meetings as needed.

- **April 2005** – AARC/PSC requests that the Audit Division initiate a review, “Self-Audit”, of 2004 federal Forms 1099 data issued by State agencies.
- **May 2005** – AARC/PSC develops an “Action Plan” that includes the status of the items in a memo to the Comptroller. Comptroller forwards the plan to the AG.

AARC provides training to state finance officers covering IRS, State, and procurement employee and independent contractor requirements.

- **June 2005** – AARC/PSC determines that the PSCs need further clarification. AG updates PSC contract forms, Audit Division begins working on PSC Guidelines, and AARC/PSC begins working on a graphical matrix that identifies components related to PSC workers.
- **September 2005** – IRS performs a “Compliance Check” of the Department of Health. An IRS audit is averted because the state had already demonstrated that it was taking proactive steps demonstrating its effort to comply with IRS code. The IRS provides DOH with auditable items of concern in a follow-up letter dated February 14, 2006.

IRS trains AARC/PSC.

Audit Division begins a compliance audit of DHS with intent to also audit DOH and DOT-Airports.

The AG sends a letter to IRS with a status update on the action plan, “The AARC has had six meetings over the last six months to discuss various issues relating to the State’s personal service contracts, including the issue of whether any of those contractors should be treated as employees.”

- **October 2005** – AARC/PSC forwards a memo to the Comptroller with an update on the

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action plan and recommends the use of a multiple award for staffing agencies as a resource. IRS allows staffing agencies because, although the staffing agency's relationship with the state is contractual, the staffing agency is required to withhold federal employment taxes for its employees. Consequently, any potential liability for employee non-withholding of federal tax, rests with the staffing agency.

- **November 2005** – IRS holds training sessions for finance officers, personnel officers, and deputy attorneys' general with more than 100 individuals attending.
- **February 2006** – AARC/PSC begins working on a Comptroller's Memorandum that will rescind outdated memorandums related to 'Determining Employer-Employee Relationships' and replacing with current IRS guidelines.

Survey to determine the number of leasing services (staffing agency) contracts is performed. Results are surprising with more than \$4M in contracts in prior fiscal year.

AARC/PSC (AG member) distributes draft "Interim Procedural Manual for Personal Service Contracts" to provide guidance to departments based on current legal requirements pending resolution of numerous personal service contract issues.

- **March 2006** – At the recommendation of AARC/PSC, DAGS and DHRD issue joint memorandum requiring departments to complete a survey regarding the departments' use of personal service contractors during the fiscal year 2005 including information about exemptions from civil service, contract period, amount, procurement process, payment process, governor's approval through B&F, and nature of services.
- **May 2006** – The survey on the State departments use of personal service contractors based on financial transactions for the fiscal year ended June 30, 2005 was completed and provided to the AARC/PSC, DAGS, B&F and DHRD.
- **May 2006**, the State Comptroller issued Comptroller's Memorandum No. 2006-10, rescinding three previously issued comptroller's memorandums on determining employer-employee relationship and establishing the new procedures to determine employer-employee relationship.
- **October 2006**, DHRD issued a new memorandum that supersedes the February 1982 memo setting forth new procedures by delegating additional authority to department heads to approve exemptions from civil service under both Section 76-16(b)(15) and Section 76-16(b)(2), HRS.

## IRS Action Plan

1. Survey – The AARC's first action was to survey the agencies to determine the number and type of contracts issued during the last fiscal year. The AG's letter refers to the "collecting information" phase that was the first part of the AARC's action plan. (Action - Completed)
2. Audit Division Request for Form 1099 data – On April 14, 2005 the DAGS' Audit Division requested that the agencies provide 2004 Form 1099 data by May 6, 2005. The Audit Division plans to review and test the data. (Action - Completed)
3. Training – (Action – Completed)
  - a. The AARC and IRS will provide training to:
    - i. Finance/Fiscal Officers
    - ii. Department Personnel Officers (DPO)
    - iii. Deputy Attorneys General
4. Comptroller's Memoranda – The AARC drafted a joint memoranda that states in part: (Action - In Progress)

*The purpose of this memorandum is to assist departments and agencies in determining whether an employer-employee relationship exists with respect to an individual performing services for the State. This memorandum provides in Table A, a comprehensive list of factors that should be considered when determining whether a person who is providing services to the State should be classified as an "employee" or as an independent contractor.*
5. Self – Audit – The DAGS Audit Division will select several agencies for audit purposes. (Action – Completed)
6. Guidelines – The AARC plans to prepare a guidelines manual to assist state employees. (Action – In Progress)
7. RFP for Staffing Services – The AARC recommended to the Comptroller that the state issue a Request for Proposal to seek qualified contractor(s) to provide leasing (staffing) services. (Action – In Progress)