B. State Policy on Employer-Employee Relationship
COMPTROLLER'S MEMORANDUM NO. 2006-10

TO: Heads of Departments

ATTN: Personnel and Fiscal Offices

SUBJECT: Determining Status of Individuals Hired to Perform Services for Departments and Agencies

Effective immediately, the following three memorandums titled, "Determining Employer-Employee Relationship" are rescinded:

Comptroller Memorandum No.1989-7 dated February 22, 1989,
Comptroller Memorandum No. 1989-22 dated December 6, 1989, and
Comptroller Memorandum No. 1990-4 dated March 8, 1990

This memorandum incorporates the revised Internal Revenue Service (IRS) guidelines that are to be used to determine whether an individual who is hired to provide services as an "agent", a "consultant", a "firm" or an "independent contractor", should be treated as a vendor or a vendor in an employer-employee relationship ("employee"). To facilitate this determination, program administrators should complete and sign State Accounting Form D-40, EMPLOYEE/EMPLOYER RELATIONSHIP DETERMINATION. If it is determined that the individual should be treated as an "employee", the individual must be paid through the payroll system to ensure that appropriate taxes are withheld. To place the individual on payroll, State Accounting Form D-41, AUTHORIZATION TO PAY INDIVIDUAL (NON-EMPLOYEE), should be completed to authorize and pay the "employee". This form replaces State DPS Form 5, Notification of Personnel Action, and should be submitted to your departmental fiscal office. The individual's Federal (W-4) and State (HW-4) tax withholding forms and the "Salary Assignment/Cancellation" form (SAFORM D-60) should also be attached to the authorization to pay form.

November 30, 2006
Departments are reminded that all factors must be considered in the context of the nature of the work to be performed, when completing State Accounting Form D-40, EMPLOYEE/EMPLOYER RELATIONSHIP DETERMINATION. Departments should seek legal advice from their deputy attorney general in all cases where determination of the individual's status is questionable.

Departments must inform any individual placed on the State payroll system that the individual must be treated as an "employee" for federal and state employment tax requirements only and that no additional benefits result from being placed on the State's payroll system.

Please insure compliance with the requirements of this Memorandum when considering any new, renewed, extended, or otherwise amended contracts with individuals. If you have any questions, please call Wayne Horie, Accounting Division Chief, at 586-0600 or Sheila Walters, Pre-Audit Branch Chief, at 586-0650.

RUSS K. SAITO
State Comptroller

Attachments
1) Employee/Employer Relationship Determination, SAFORM D-40, Dated 5/1/06
2) Authorization to Pay Individual (Non-Employee), SAFORM D-41, Dated 5/1/06
STATE OF HAWAII
EMPLOYEE/EMPLOYER RELATIONSHIP DETERMINATION

Name: ____________________________________________________________

Period of Service: __________________________________________________

Type of Service: _____________________________________________________

Instructions:
All marked spaces must be completed. (Incomplete forms will be returned.)
All forms must be signed and dated by the responsible State employee acquiring the services.

Behavioral Control
Would the department control or direct the individual providing services as to:

1. hours, location, and method the individual is to do the work? □ □ □

2. provision of supplies, tools, or equipment to the individual? □ □ □

3. determination of whether or what workers the individual may hire to assist the individual? □ □ □

4. type of supplies and equipment to be used to do the work? □ □ □

5. type of work to be done by other specific individuals? □ □ □

6. order or sequence of procedures to follow? □ □ □

7. training provided by the State to do the work in a particular manner? □ □ □

Financial Control
To determine if the department will have right to direct or control the business related aspects of the individual's services to the department, would the individual:

1. incur unreimbursed expenses in the performance of the work? □ □ □

2. have a significant financial investment in the performance of the work? □ □ □

3. be allowed to continue work outside of that contracted with the State? □ □ □

4. be in a position to make a profit or loss? □ □ □
STATE OF HAWAI\nEMPLOYEE/EMPLOYER RELATIONSHIP DETERMINATION

Relationship of the Parties

To show the intent of the parties concerning control:

1. Is there a written agreement between the parties describing the facts and circumstances under which the individual does the work? (Attach a copy of any proposed agreement between the individual and the State.) ☐ ☐ ☐

2. Will the individual be provided any employee type benefits? ☐ ☐ ☐

3. What is the length of the relationship?
   a. long term, specify anticipated start/end date ____________________________
   b. temporary, specify anticipated start/end date ____________________________
   c. project, specify anticipated start/end date ____________________________
   d. indefinite, specify anticipated start date/projected end date ______________

4. Are the services to be provided directly related to the department's regular business activities? ☐ ☐ ☐

Conclusion:

When determining whether an individual is an employee or independent contractor for IRS purposes, examine the entire relationship between the individual and the procuring agency. Generally, an individual is considered to be an employee for IRS purposes if the procuring agency has the right to control and direct the individual, not only as to the result to be accomplished, but also as to the details and means by which that result is accomplished. Control is a matter of degree and it is important to examine these relationships on a case-by-case basis because a factor that may be critical in one instance may not be in another instance.

I have determined that the individual should be treated as an employee. (circle one) YES NO

My determination was based on (summarize reasons for your conclusion):

________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________

_____________________________ ________________________________ ____________
Signature Title Date
Introduction:

Businesses may choose to hire employees or may use the services of independent contractors. Either worker classification can be a valid and appropriate business choice. Problems arise when a business incorrectly classifies an employee as an independent contractor.

Source of Revenue

Employment taxes are the primary sources of revenue for the government. Approximately three out of four dollars collected by the IRS comes from withholding that is required to be reported on employment tax returns.

Uses

An indicator of the importance of employment taxes is the magnitude of the programs that they finance. Revenues collected on employment tax returns are used to pay for various government programs and operations:

- FICA taxes - social security payments used for medical, retirement, disability and survivor benefits.
- FUTA taxes - used to administer state unemployment programs.
- FITW - income tax withholding used to fund government operations.
- RRTA taxes - railroad retirement program similar to social security.

Objectives:

1. Properly determine whether a worker is an independent contractor or a common-law employee for Federal employment tax purposes.
2. Identify other employment situations.
Definitions of Employee per Internal Revenue Code:

IRC § 3121(d) - Definition of employee for FICA tax purposes
IRC § 3401(c) - Definition of employee for wage withholding purposes
IRC § 3306(i) - Definition of employee for FUTA tax purposes

IRC § 3121(d) contains four categories of employees for the purposes of FICA:

(1) any officer of a corporation; or
(2) any individual who, under the common law rules applicable in determining the employer-employee relationship has the status of an employee; or
(3) any individual who performs services for remuneration for any person -- as
   (A) Certain agent/commission drivers
   (B) Full-time life insurance sales persons
   (C) Home workers
   (D) Traveling or city salesperson.
(4) any individual who performs services that are included under an agreement entered into pursuant to section 218 of the Social Security Act.

The common law test applies for purposes of FUTA, federal income tax withholding and the Railroad Retirement Tax Act.

IRC § 3401(c) defines employees for the purposes of income tax withholding as:

(1) any individual performing services if the relationship is the legal relationship of employer and employee determined by the right to direct and control the details and means of the work.
(2) elected and appointed officials
(3) officer of a corporation.
Common Law Employee: Control Standard

Common Law Standard

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 Right to Control and Direct

Treas. Reg. 31.3121(d)-1(c) Common Law Employees.

Following the common law standard, the employment tax regulations provide:

(1) Every individual is an employee if under the usual common law rules the relationship between him and the person for whom he performs services is the legal relationship of employer and employee.

(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 that result is accomplished.

It is not necessary that the employer direct or control the manner in which the services are performed; it is sufficient if the employer has the right to direct what must be done and how it must be done.

Control Test

The legal test is whether there is a right to direct and control the means and details of the work. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be analyzed.

Over the years, the IRS and Social Security Administration compiled a list of 20 factors used in court decisions to determine workers status. These 20 factors were eventually published in Rev. Rul. 87-41, 1987-1 C.B. 296. Some of these factors are no longer relevant and the IRS now uses an analysis that relies on three elements of control: Behavioral Control, Financial Control, and the Relationship of the Parties. See Publication 1779, Independent Contractor or Employee.
Developing the facts and weighing the evidence.

1. Look at the entire relationship.
   - A relationship often has several facets, some indicating the business has control, while others indicate it does not. Need to weigh this evidence.

2. Control is a matter of degree.
   - Even in the clearest case of an independent contractor, the worker is constrained in some way. Conversely, employees may have autonomy/independence in some areas.

3. Need to consider the evidence of both autonomy and the right to control.
   - The absence of a fact that would indicate control may be as important as its presence.

4. Factors that are relevant in one employment relationship may not be relevant in another.

Important preliminary points

1. There is no "magic number" of relevant evidentiary facts.

2. Whatever the number of facts, they should be used in evaluating the extent of the right to direct and control.

3. ALL relevant information needs to be explored and weighed before answering the legal question of whether the right to direct and control associated with an employer-employee relationship exists.

4. The evidence that gathered must be factual and well documented.
Employer - Employee Relationships

Other Types of Employment Relationships

This text focuses on the common law relationships of employer and employee but there are other types of employment relationships.

Two-Party Relationship

Third Party Relationships

Deemed Employer - IRC § 3401(d)

Deemed Employer - State Agency
Person having legal control of the payment of wages. Responsible for withholding, filing and reporting employment taxes.

Example: State agency that pays wages to childcare provider on behalf of welfare client to enable the client to work. Welfare the common law employer and the state agency is the "deemed" employer responsible for withholding and reporting employment taxes.

Agent of Employer - IRC § 3504

Agent of Employer - State Agency
Employer voluntarily authorizes agent who controls or pays wages to employer's employees, to withhold, file and report. Employer remains liable at the same time. Employer and agent file authorization forms with IRS.

Example: State welfare agency pays caregiver to provide in-home domestic services for welfare recipient. The welfare recipient is the employer. The agency files request to be the agent for the welfare client. State agency pays.
Types of Employment Relationships

Employee Leasing

$ Wages

Employer Leasing Company

Employer Leasing

Service Recipient

Employ
Leasing
Company

Contracted
Amount

Services

Employee Service Provider

Filing Reporting

Employee Leasing

Service recipient contracts with leasing company to provide workers. The leasing company is the employer and is responsible for paying, withholding, filing and reporting wages. The leasing company retains the right to control the worker.

Example:

A state agency contracts with a leasing company to provide computer programmers to complete a project expected to last 18 months. The leasing company pays the employees, withholds, files and reports all required employment taxes.

Caution: If a leasing agency makes taxable payments or reimbursements directly to leased employees, the agency is responsible for employment taxes and reporting.
THREE CATEGORIES OF EVIDENCE:

The following reflects primary categories of evidence and includes examples of key facts that illustrate the right to direct and control — or its absence.

**Behavioral Control**

Facts which illustrate whether there is a right to direct or control how the worker performs the specific task for which he or she is hired:

- Instruction
- Training

**Financial Control**

Facts which illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted:

- Significant investment
- Unreimbursed expenses
- Services available to the public
- Opportunity for profit or loss

**Relationship of Parties**

Facts which illustrate how the parties perceive their relationship:

- Employee benefits
- Intent of parties/written contracts
- Permanency discharge/termination
- Regular business activity
BEHAVIORAL CONTROL

The goal is to determine whether the business has retained the right to control the details of a worker's performance or instead has given up its right to control those details. Examples of key facts indicating behavioral control include instructions and training.

INSTRUCTIONS

A worker who is required to comply with another person's instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions. Virtually every business will impose on workers, whether employees or independent contractors, some form of instructions (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient to determine the worker's status. Accordingly, the weight of "instructions" in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.

Types of instructions

1. When to do the work
2. Where to do the work
3. What tools or equipment to use
4. Where to purchase supplies or services
5. Personal service required
6. Who hires and pays substitutes or helpers
7. What routines or patterns must be used
8. What order or sequence to follow
9. Required to comply with employee manuals or policies
### BEHAVIORAL CONTROL

<table>
<thead>
<tr>
<th>Types of Instructions - <em>Can be oral, procedural manuals/handbooks</em></th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. When to do the work</td>
<td>Set hours (9-5) or set # on hours required? Does worker have to call in if sick or taking day off?</td>
</tr>
<tr>
<td>2. Where to do the work</td>
<td>Can the worker work at his office, home or location of choice?</td>
</tr>
<tr>
<td>3. What tools or equipment to use</td>
<td>Particular computer software required? May be a valid reason - e.g. has to use software compatible with agency's software.</td>
</tr>
<tr>
<td>4. Where to purchase supplies or services</td>
<td>Can worker use own supplier or must use government suppliers?</td>
</tr>
<tr>
<td>5. Personal service required</td>
<td>Can worker provide replacement? Pre-approval needed? e.g. Can teacher provide sub? Consider nature of work.</td>
</tr>
<tr>
<td>6. Who hires and pays substitutes or helpers</td>
<td>Is worker required to use the business's EE as an assistant? Can the worker hire assistants?</td>
</tr>
<tr>
<td>7. What routines or patterns must be used</td>
<td>Lesson plan or monthly report in required format.</td>
</tr>
<tr>
<td>8. What order or sequence to follow</td>
<td>Travel reimbursements - worker must request approval and submit expense voucher within 60 days.</td>
</tr>
<tr>
<td>9. Oral or written reports</td>
<td>A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.</td>
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BEHAVIORAL CONTROL

Prior approval

The requirement that a worker obtain approval before taking certain actions is an example of instructions.

Example 1

Lon was hired by agency X to maintain its vehicles. According to agency X, Lon’s responsibilities are to ensure that:

- The vehicles are repaired;
- The proper parts are ordered and received; and
- The parts are safely installed in accordance to the manufacturer’s specifications.

While developing the facts listed above, you discover that agency X requires Lon to secure prior approval to:

- Commence the repair work;
- Purchase the necessary parts; and
- Have the completed work examined prior to releasing the vehicle.

X’s requirement that Lon secure prior approval is evidence of control over Lon’s behavior in the performance of his services.
**BEHAVIORAL CONTROL**

Prior approval – cont.

Example 2

Lon was hired by agency X to maintain its vehicles. According to agency X, Lon’s responsibilities are to ensure that:
- The vehicles are repaired;
- The proper parts are ordered and received; and
- The parts are safely installed in accordance to the manufacturer’s specifications.

While developing the facts listed above, you discover that X does not require Lon to secure prior approval to:
- Commence the repair work;
- Purchase the necessary parts; and
- Have the completed work examined prior to releasing the vehicle.

Rather, X allows Lon to take whatever actions he deems necessary, at his own discretion, to achieve the goals listed as his responsibility. The absence of detailed instructions as to how Lon will perform the job function is evidence of Lon’s independence in work performance.

**Degree of Instruction**

The degree of instruction depends on the:
1. Scope of instructions,
2. Extent to which the business retains the right to control the worker’s compliance with the instructions, and
3. Effect on the worker in the event of noncompliance.

All these provide useful clues for identifying whether the business keeps control over the manner and means of work performance (leaning toward employee status), or only over a particular product or service (leaning toward independent contractor status).
° BEHAVIORAL CONTROL

Degree of Instruction - continued

Example 3

T is a deliveryman who delivers for a local agency. T reports to the agency’s warehouse every morning. The warehouse supervisor tells T what deliveries are to be made, how to load the cargo in the truck, what route to take, and the order in which the various elements of the cargo are to be delivered. This is an instruction on how the work is to be performed and is consistent with employee status.

Example 4

J is an independent delivery service. J receives a call for a pick-up from a government agency to make a delivery to a local sub-agency to which J agrees. Upon arrival at the agency’s warehouse, J is given an address of where the cargo is to be delivered and advised to make the delivery before close of business that day. This is a direction of what is to be done rather that how it is to be accomplished and is consistent with independent contractor status.

Other issues regarding instructions:

- Presence of instructions or rules mandated by governmental agencies or industry governing bodies
  - If instructions to a worker are imposed by a business only in compliance with governmental regulations (e.g. municipal building codes related to construction), then little weight is given to the instructions.
Employer - Employee Relationships

BEHAVIORAL CONTROL

Other issues regarding instructions - cont.

- Instructions by customer
  - If a business passes customer instructions on to a worker, the instructions have little weight. e.g. students in a community education class ask if their class can start an hour later than scheduled. The school agrees and informs the teacher to change the hours. The school is merely passing on instructions by the customer. If the school decides that all classroom hours should change, then they have adapted the customer suggestions as their own policy and instruction to teachers to start classes later would carry more weight.

- Suggestions vs. Instructions
  - Suggestions don't constitute the right to direct and control. If there are consequences for not complying with instructions, then the "suggestions" may actually be instructions indicating the right to control.

- Business identification as instructions
  - Generally, wearing a uniform or a logo with a business's name is an indication that the wearer is an employee. If the nature of the worker's business is such that the worker must be identified with the business for security purposes, wearing the uniform or logo may be a neutral factor.

- Nature of occupation for instructions
  - The nature of a worker's occupation affects the degree of control. Highly trained professionals, such as, doctors lawyers, computer specialists require very little instruction on how to perform their work. Evidence of financial control and the relationship of the party tend to be more important elements in determining whether the business retains the right to control.

- Nature of work for instructions
  - Certain work, such as, janitor, can be done with a minimum of direction and control. The absence of control should not be confused with the right to control.

- Evaluation Systems
  - If an evaluation system measures compliance with performance standards concerning the details of how the work is performed, the system is evidence of control over the worker's behavior.
Employer - Employee Relationships

**BEHAVIORAL CONTROL**

Government Entities

When the service recipient is a government entity and the position is created by a constitution or statute, we look at the law establishing the position and its duties to determine whether the statute creating the position creates a right to control the worker, typical of the employer-employee relationship. See ILM 200113024 for a discussion of whether elected and appointed officials are employees or independent contractors.

Example 5

In District XYZ, the position of school superintendent and its duties are established by statute. A school superintendent is required to administer a district in accordance with policies the school board prescribes by bylaw. The school superintendent is required to select, appoint and control all school district employees, subject to the approval of the school board. These facts show that a school superintendent is an employee under the control of a school board with supervisory control over teachers.

**TRAINING**

Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. This is true even if the training was only given once at the beginning of the work relationship. Periodic or on-going training provided by a business about procedures to be followed and methods to be used indicates that the business wants the services performed in a particular manner -- strong evidence of an employer-employee relationship.

Not all training rises to this level. The following types of training, which might be provided to either independent contractors or employees, do not carry the same weight as periodic or on-going training.

1. Orientation or information sessions about the business's policies, new product line, or applicable statutes or government regulations.
2. Programs that are voluntary and are attended by a worker without compensation.
Employer - Employee Relationships

FINANCIAL CONTROL

In this section, we consider evidence of whether the business has the right to direct or control the economic aspects of the worker's activities. Control is obviously a matter of degree: a business has more economic control over an employee than over an independent contractor. Moreover, an independent contractor has a genuine possibility of profit or loss beyond that of an employee, who receives a salary as long as he works.

Financial control focuses on who has the right to control the business aspects of the worker's performance. The items that usually need to be explored are:

1. Significant investment  
2. Unreimbursed expenses  
3. Services available to the relevant market  
4. Method of payment  
5. Opportunity for profit or loss

Significant investment

- A significant investment is evidence that an independent contractor relationship may exist. But, a significant investment is not necessary for independent contractor status.
- Lack of investment by a worker in facilities or equipment used in performing services for another indicates dependence on the employer.
- There are no precise dollar limits that must be met in order to have a significant investment but the investment must have substance. The term "significant investment" does not include tools, instruments, and clothing commonly provided by employees in their trade; nor does it include education, experience, or training.

An independent contractor may be considered to have a significant investment if he/she rents equipment at the fair rental value, even if renting from the service recipient.

Example 6

Carol is a computer programmer for the Department of Housing (DOH). She is treated as an independent contractor. After attending a presentation given by the IRS, the DOH decides that, in order to meet the significant investment rule, it would lease a computer and specialized software to Carol. DOH claims that Carol has a significant investment in the $5,000 computer and software that she leases. Further investigation finds that Carol leases the computer at less than fair rental value and can turn it in at any time without liability for further payments. DOH pays for liability insurance and regular maintenance on the computer. Carol has expenses for the computer rental but, based on these facts, evidence of a significant investment has not been established.
Employer - Employee Relationships

◆ FINANCIAL CONTROL

Business expenses

A worker choosing to incur expenses and bear their costs impacts his/her opportunity for profit or loss. Although not every independent contractor need make a significant investment, almost every independent contractor incur an array of business expenses

These MAY include:

- Rent and utilities
- Tools and equipment
- Training
- Advertising
- Payments to business managers and agents
- Wages or salaries of assistants
- Licensing, certification, professional dues
- Postage and delivery
- Repairs and maintenance
- Supplies
- Travel
- Leasing of equipment depreciation
- Inventory/cost of goods sold
- Insurance

Expenses -- Reimbursed v. Unreimbursed

1. Businesses often pay business or travel expenses for their employees.

2. Independent contractors’ expenses may also be reimbursed.

3. Focus on UNREIMBURSED expenses, which better distinguish independent contractors and employees, inasmuch as independent contractors are more likely to have unreimbursed expenses.

4. If expenses are unreimbursed, then the opportunity for profit or loss exists.

5. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are strong indicators of the opportunity for profit or loss.

Services available

1. An independent contractor is generally free to seek out business opportunities.

2. Independent contractors often advertise, maintain a visible business location, and are available to work for the relevant market. But, these activities are not necessary for independent contractor status. For example, a contractor may have a long-term contract and find advertising unnecessary.
FINANCIAL CONTROL

Services available - continued

3. The absence of advertising, maintaining a visible business location or being available to work for others may be a neutral fact.

Example 7

A school district hires Pat to perform landscaping services on the grounds of its district office. Such services consist of weekly lawn mowing and the annual trimming of hedges. Pat advertises these services in the Yellow Pages. The fact that Pat advertises would indicate that he is available to perform services for the relevant market. Consider, however, that Pat negotiates a long-term contract with the school district to maintain all of the district schools. Pat decides not to continue advertising, yet he is still available to perform services for the relevant market.

Method of payment

The method of payment may be helpful in determining whether the worker has the opportunity for profit or loss.

Salary or hourly wage

A worker who is compensated on an hourly, daily, weekly, or similar basis is guaranteed a return for labor. This is generally evidence of an employer-employee relationship, even when the wage or salary is accompanied by a commission.

In some lines of business, such as law, it is typical to pay independent contractors on an hourly basis.

Flat fee

Performance of a task for a flat fee is generally evidence of an independent contractor relationship, especially if the worker incurs the expenses of performing the services.

When payments are made (daily, weekly, or monthly) is not relevant.

Commissions

1. A commission-based worker may be either an independent contractor or employee.

2. The worker's status may depend on the worker's ability to realize a profit or incur a loss as a result of services rendered.
FINANCIAL CONTROL

Realization of profit and loss

- The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of services rendered. "Profit or loss" implies the use of capital by a person in an independent business of his or her own.

- The facts already considered -- significant investment, unreimbursed expenses, making services available, and method of payment -- are all relevant in this regard.

- Consider whether the worker is free to make business decisions which affect the worker's profit or loss.

- It is sometimes asserted that because a worker can receive more money by working longer hours or receive less money by working less, the worker has the ability to incur a profit or loss. Profit or loss does not arise unless there is an investment cost (not your own labor) against which revenues are measured.

Economic Dependence

Although the economic aspects of the relationship between a worker and a business are significant in determining worker status, the question of whether the worker is economically dependent on or independent of the business for which services are performed is not relevant. This analysis has been rejected by Congress and the Supreme Court as a basis for determining worker classification.

Covenant Not To Compete

If a worker is prohibited from offering services to other firms or customers while performing services or during any later period, the worker's ability to make a profit or loss is affected.
Employer - Employee Relationships

RELATIONSHIP OF THE PARTIES

The relationship of the parties is generally determined by examining the parties’ agreements and actions with respect to each other, paying close attention to those facts which show not only how they perceive their relationship but also how they represent their relationship to others.

Relationship of business and worker

Most of the factors in this category reflect how the worker and the business perceive their relationship to each other. It is much harder to link the facts in this category directly to the right to direct and control HOW work is to be performed. The relationship of the parties is important because it reflects the parties’ INTENT concerning control.

Written contract/intent of the Parties

1. A written agreement describing the worker as an independent contractor is viewed as evidence of the parties’ intent that a worker is an independent contractor.

2. A contractual designation, in and of itself, is not sufficient evidence.

3. The facts and circumstances under which a worker performs services are determinative of the worker’s status. The substance of the relationship, not the label, governs the worker’s status.

4. In close cases, the intent of the parties, as reflected in the contractual designation, is an effective way to resolve the issue.

Employee benefits

Facts which illustrate how the parties perceive their relationship include the intent of the parties as expressed in the provision of, or lack of, employee benefits

1. If a worker receives employee benefits, such as paid vacation, health or life insurance, pension benefits, this constitutes evidence of employee status.

2. If a worker provided with employee benefits under a tax-qualified retirement plan, 403b annuity, or cafeteria plan, this is strong evidence that the worker is an employee since these benefits may only be provided to employees is excluded from a benefit plan because the worker is not considered an employee by the business, this is relevant (though not conclusive) in determining the worker’s status as an independent contractor.

3. If the worker is excluded on some other grounds, the exclusion is irrelevant in determining whether the worker is an independent contractor or an employee.
RELATIONSHIP OF THE PARTIES

Incorporation

It is important to consider any written contract in which the parties state the type of relationship they intended to create. If the relationship of employer and employee exists, however, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial.

1. The corporate form is generally recognized for both state law and Federal law, including Federal tax, purposes if:
   - corporate formalities are properly followed, and
   - at least one non-tax business purpose exists.

2. Disregarding the corporate entity is generally an extraordinary remedy, applied by most courts only in cases of clear abuse. But, the statutory right to control cannot be waived by private contract.

3. The fact that a worker receives payment for services through the worker's corporation does not automatically require a finding of independent contractor status with respect to those services. See ILM 200147006.

State Law Characterization

State laws or determinations of state or Federal agencies, may characterize a worker as an employee for purposes of various benefits. Characterizations based on these laws or determinations should be disregarded because the laws or regulations involved may use different definitions of employee or be interpreted to achieve particular policy objectives.

For example, state laws determine whether workers are employees for purposes of workers’ compensation rules and unemployment insurance. Because the definition of "employee" for these purposes is often broader than under the common law rules, eligibility for these benefits should be disregarded in determining worker status.

Because of the differences in definitions, it is possible for a worker to be an employee for Federal employment tax purposes and an independent contractor for state purposes and vice versa.

Prior Services for Firm

If a worker previously performed services for the firm as an employee and is rehired as an independent contractor performing similar services, there will have to be a clear differentiation between the type of services performed and the degree of control exercised for the rehired worker to be considered an independent contractor.
RELATIONSHIP OF THE PARTIES

Discharge/termination

The circumstances under which a business or worker can terminate their relationship has traditionally been considered useful evidence bearing on the status the parties intended the worker to have. In today's work environment, the ability to terminate a working relationship is impacted by modern business practices and legal liability.

Employees

In the past, a business's ability to discharge an employee without penalty provided a highly effective method to control the details of how work was performed and, therefore, tended to indicate employee status. Or, an employee could terminate employment without any legal risks.

In today's environment, businesses rarely have complete flexibility in discharging an employee. The business may be liable for pay in lieu of notice, severance pay, "golden parachutes," or other forms of compensation when it discharges an employee. On the other hand, businesses may successfully sue employees for substantial damages resulting from their failure to perform the services for which they were engaged.

As a result on the increased liability on employers and employees, the presence or absence of limits on a worker's ability to terminate the relationship, by itself, no longer constitutes persuasive evidence in determining worker status.

Independent Contractor

In a traditional independent contractor relationship, a business could terminate the relationship without the risk of legal liability only if the worker failed to provide the intended product or service. If the contractor terminated work, the business could refuse payment or sue for nonperformance.

In practice, independent contractors often enter contracts for which nonperformance remedies are inappropriate or may negotiate limits on their liability for nonperformance. For example, professionals, such as doctors and attorneys, are typically able to terminate their contractual relationship without penalty.

On the other hand, a business's ability to refuse payment for unsatisfactory work continues to be characteristic of an independent contractor relationship.

Discharge/termination – limited usefulness
Because the significance of facts bearing on the right to discharge/terminate is so often unclear and depends primarily on contract and labor law, this type of evidence should be used with great caution.
Employer - Employee Relationships

◆ RELATIONSHIP OF THE PARTIES

Length of Relationship

Permanency

Courts have considered the existence of a permanent relationship between the worker and the business as relevant evidence in determining whether there is an employer-employee relationship.

Indefinite relationship

1. If a business engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence of their intent to create an employment relationship.

2. An indefinite relationship should not be confused with a long-term relationship.

Long-term relationship

1. A long-term relationship may exist between a business and either an independent contractor or an employee.

2. The relationship between the business and an independent contractor may be long-term for several reasons:
   • the contract may be a long-term contract
   • contracts may be renewed regularly due to superior service, competitive costs, or lack of alternative service providers

3. A business may also have a relationship with an employee that is long-term, but not indefinite. This could occur if temporary contracts are renewed.

4. A relationship that is long-term, but not indefinite, is a neutral fact that should be disregarded.

Temporary relationship

A temporary relationship is also a neutral fact that should be disregarded. An independent contractor will typically have a temporary relationship with a business, but so too will employees engaged on a seasonal, project, or "as needed" basis.
Employer - Employee Relationships

◆ RELATIONSHIP OF THE PARTIES

Regular business activity

When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.

The mere fact that a service is desirable, necessary, or even essential to a business does not necessarily mean that the service provider is an employee. For example, a water district hires a landscaper to maintain its property. Landscaping is not the regular business activity of the business and the landscaper may not be an employee.

It is possible that the work performed is part of the principal business of the firm, yet it has hired workers who are outside specialists and may be independent contractors. For example, a law firm hires an attorney who specializes in maritime law for advice on a particular lawsuit involving a client in the shipping industry. Although the work of attorneys is part of the regular business activity of the law firm, the services of the maritime specialist may be provided by an independent contractor.

◆ FACTORS OF LESSER IMPORTANCE

Part-time or full-time work

1. Performing services on a part-time basis or working for more than one person or business was once thought to be significant evidence indicating that the worker was an independent contractor.

2. Whether a worker performs services on a full-time or part-time basis is a neutral fact.

3. There are several reasons for this change.
   - With cutbacks and downsizing in business and industry, many companies hire workers on a part-time basis.
   - These workers may be either independent contractors or employees.
   - Working full-time for one business is also consistent with either independent contractor or employee status.
FACTORS OF LESSER IMPORTANCE

Place of work

Whether work is performed on the business's premises or at a location selected by the business often has no bearing on worker status. Even when it is relevant evidence, it will be relevant because it illustrates the business's right to direct and control how the work is performed and will have been considered in connection with instructions.

One location
1. In many cases, services can be provided at only one location.

2. This requirement may be inherent in the result to be achieved and are not evidence of the right to direct and control how the work is performed.

Different locations
1. Off-site work is consistent with either an independent contractor or employer-employee relationship.

2. The place where work is performed is most likely to be relevant evidence in cases in which the worker has an office or other business location, which would have been considered in evaluating significant investment, unreimbursed expenses, and opportunity for profit or loss.

Hours of work

1. If relevant, has already been considered in connection with instructions.

2. Some work must, by its nature, be performed at a specific time. This relates to the result to be achieved, not how the work is performed.

3. Flexible hours are consistent with either independent contractor or employee status.
WEIGHING THE EVIDENCE

Control and autonomy both present

1. Some facts will support independent contractor status and other facts will support employee status.

2. This is because independent contractors are rarely totally unconstrained in the performance of their contracts, while employees almost always have some degree of autonomy.

Which predominates?

You will need to weigh the evidence in order to determine whether, looking at the relationship as a whole, evidence of control or autonomy predominates.
Employer - Employee Relationships

◆ DUAL STATUS WORKER

A worker may perform services for a single business in two or more separate capacities. A dual status worker performs one type of service for a business as an independent contractor, but performs a different type of service for the business as an employee. See Rev. Rul. 58-505, 1985-2 C.B. 728.

Example 8

A high school science teacher has a woodworking shop in his home where he does carpentry work for family and friends at no charge other than to cover the costs for materials. The high school where he is an employee asks the teacher to build bookshelves for the teachers' lounge after work hours. They provide no instructions other than the date when they want the job completed. The teacher is paid a lump sum for the work. The teacher is an independent contractor for the carpentry services because the school has not retained the right to control the way the work is performed.

Example 9

A high school English teacher is hired to work after school hours collecting entrance fees and tickets at a school basketball game. She is paid a lump sum for the services. The school sets the entrance fees and requires the teacher to turn over the money to the athletic director after the game. No instructions are provided on how to perform the services. The teacher is considered an employee for the services at the game. She retains the responsibilities and status of a teacher. Detailed instructions on how to perform the services are not required because of the nature of the work.

◆ VOLUNTEERS

The common-law rule for determining whether a worker is an employee applies to the services of volunteers. The issue is whether the service recipient has the right to direct and control the volunteer as to the manner and means of the worker's job performance. In other words, does the entity have the right to tell the volunteer not only what shall be done but how it shall be done?
Employer - Employee Relationships

✦ ELECTED AND APPOINTED OFFICIALS

Officers, employees and elected officials of states and their political subdivisions and instrumentalities are employees for purposes of federal income tax withholding. (IRC § 3401(c)) But for FICA purposes, the common-law rules apply to determine whether an individual is an employee. IRC §3121(d)(2). Section 218 of the Social Security Act also factors into the determination of whether social security and/or Medicare to the wages of employees.

Elected officials are generally classified as employees while appointed officials may be either employees or independent contractors. See the cited memorandum for a discussion of the issue. ILM 200113024

Board or commission members may be employees or independent contractors. If you are not sure of the status of a board or commission member, it may be necessary to consult the statutes or ordinances establishing a position to determine whether that position is a public office. In the case of school boards, the statutes or ordinances likely provide ample evidence that the school board members are public officials. Public officials are usually subject to a degree of control that is characteristic of an employer-employee relationship. For example, the president of the United States is an employee subject to control by the Constitution and the people.
POSSIBLE CONSEQUENCES OF INCORRECT TREATMENT (TAXES & PENALTIES):

If an employer misclassifies an employee as an independent contractor, the employer may be responsible for additional taxes, interest, and penalties, as well as liability for pension benefits.

### Potential Additional Taxes and Penalties

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Employer is liable for:

- Social Security and Medicare Taxes – both employer and employee’s share
- Income Tax Withholding – at supplemental rate or rate per employee’s W-4
- FUTA tax if the entity is a third-party employer
- Possible penalties and interest

### Relief or Reduction of Additional Taxes and Penalties

If the employer misclassifies employees as independent contractors, the liability for additional taxes and penalties may be reduced or relieved if:

- If the employer had a reasonable basis for treating workers as non-employees and required information returns were consistently filed (Forms 1099 MISC), and/or,
- The employer enters into a closing agreement with the IRS.

### Other Potential Employer Liability to Pay

- Pension benefits
- Profit sharing
- Stock options
Employer - Employee Relationships

- Leave accruals


The Internal Revenue Service will determine whether a worker is an employee if a worker or firm files Form SS-8. The IRS will contact the firm and worker(s) involved to get information from all parties. The information will be reviewed, the law applied and a decision will be rendered. The IRS will generally issue a formal determination letter to the firm and worker. The letter applies only to the worker or class of workers involved and the decision is binding on the IRS. See the instructions on the form for detailed information and instructions.

SUMMARY

1. In determining a worker's status, you need an understanding of the way a business operates and the relationship between the business and the worker.

2. Areas to consider while developing the evidence are:
   - What the business does and how the job gets done.
   - The relationship between the business and its clients or customers.
   - Facts that indicate whether the business has the right to control HOW work is done.

3. Evidence that may be the most persuasive can be identified within three specific categories -- Behavioral control, Financial control and Relationship of the parties.

4. Behavioral control focuses on whether there is a right to direct or control HOW the work is done. The presence or absence of instructions and training on how work is to be done are especially relevant.

5. Financial control focuses on whether there is a right to direct or control how the BUSINESS aspects of the worker's activities are conducted. Significant investment, unreimbursed expenses, services available to the relevant market, method of payment, and opportunity for profit or loss are factors relevant to financial control.

6. Relationship of the parties focuses on how the parties perceive their relationship. intent of parties/written contract, employee benefits, discharge/termination, permanency, and regular business activity are relevant to how the parties perceive their relationship.

7. Relevant evidence in all three categories must be weighed to determine the worker's status.
Office of Federal, State and Local Governments (FSLG)

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FSLG Specialists - Sue Ann Jansen, sue.jansen@irs.gov
Marilee Basaraba, marilee.basaraba@irs.gov
Customer Account Services - (877)829-5500 (for governmental entities)

Other IRS Contacts

IRS Taxpayer Information - (800)829-1040
IRS Taxpayer Information (TDD) - (800)829-4059
IRS Taxpayer Advocate - (877)777-4778
(For assistance with long-standing tax issues)
IRS Forms Ordering - (800)829-3676
IRS Forms Ordering (TDD) - (800)829-4059
Fax Ordering - (703)368-9694
IRS Information Returns (W-2, 1099) Assistance
Toll Free (866)455-7438 (8:30 am - 4:30 pm Eastern Time)
E-mail inquiries to mccirp@irs.gov
Foreign Tax Questions - (215)516-2000
Publication 1779, Independent Contractor or Employee...

Internet

http://www.irs.gov/govts - FSLG Newsletter
http://www.fedworld.gov/ Fedworld Information Network
(Good for searching, locating, ordering and acquiring government and business information)

Social Security Administration

Tim Beard, Seattle (206)615-2125, FAX (206)615-2643