

Classification of Independent Contractors versus Employees

Overview

The University classifies and pays individuals who provide services as Employees, unless the nature of the services and other circumstances satisfy the criteria for Independent Contractor status. Section 3121(d) (2) of the Internal Revenue Code (IRC) provides that the term "employee" means any individual who, under the common law rules applicable in determining the employer-employee relationship, has the status of employee. The Internal Revenue Service (IRS) ignores contract labels, and instead examines the facts and circumstances of each situation and analyzes specific characteristics, such as behavioral and financial control and the relationship between the employer and the individual performing services, before a determination can be made whether the individual is classified as an employee or an Independent Contractor under common law.

An example of **behavioral control** is when the Department/School provides direct instruction/supervision of the contracted provider. Service Providers are **Independent Contractors** and as such are not overseen by the contracting party in this manner. They supervise their own actions to accomplish the goals and expectations articulated through an agreement and Scope of Work.

Once an employer-employee relationship is established, the employer is required to withhold the appropriate income and employment taxes. Penalties may be imposed by the IRS in instances where the employer fails to properly withhold such taxes.

This section incorporates the IRS guidelines that are currently in effect.

Classification of Service Providers

Before the performance of services commence, departments contracting for services must assess the relationship with the individual providing services to ensure that individuals hired or contracted to perform services are properly classified as an employee or an Independent Contractor. An initial misclassification may result in a substantial delay in payment.

It is the University's responsibility to designate an individual's status as an employee or an Independent Contractor. Please refer to IRS website for a detailed explanation.

<http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>

Employee — an individual who performs services subject to the employer's right to direct and control the work is classified as an employee. The employer can allow the employee considerable discretion and freedom of action, provided that the employer has the legal right to direct or control the work.

Former University Employee — a former employee whose services are requested by the University to perform the same or similar service within twelve (12) months from the date of the last pay period is usually classified as an employee. However, each situation should be analyzed first from the IRS's perspective and written approval must be provided by General Council and Human Resources.

The three main categories for determining whether a relationship should be categorized as an employee or Independent Contractor are:

- Behavior Control
- Financial Control
- The Individual's Relationship with the University

(See the section Common Law Rules for additional information).

Also, the 20 Common Law Factors (see section in this document) should be evaluated before making the determination of Contractor versus employee.

Independent Contractor — An individual who performs services wherein the employer has the right to control or direct **only the result of the work**, but not the means and methods of accomplishing the result, is classified as an Independent Contractor.

Withholding Requirements

Unless otherwise exempt from required withholdings, the University is required to withhold certain deductions from University-based wage payments. If the individual is classified as an Independent Contractor, the University is not responsible for withholding income and employment taxes. However, the University is responsible for reporting compensation over \$600 paid to individuals who are classified as Independent Contractors on Form 1099-MISC, Miscellaneous Income to the IRS.

Penalties for Misclassification

The IRS may assess penalties for misclassification of an individual providing service to the University. If an individual is determined by the IRS to be an employee instead of an Independent Contractor, the University may be held liable for the individual's employment taxes, penalties and interest assessed for not withholding income and employment tax, and a separate misclassification penalty.

Note: As provided under IRC Section 3509, an employer is liable for 1.5 percent of wages paid if the employer erroneously treats the individual as a nonemployee for Federal income tax withholding purposes, and the penalty increases to 3 percent if no information returns were filed.

The department will be responsible for the payment of additional taxes, penalties, and interest assessed.

However, liability for Federal employment taxes may be relieved under Section 530 of the Revenue Act of 1978, also commonly referred to as Section 530 Safe Haven Relief. Section 530 Safe Haven Relief protects employers who have consistently treated workers as Independent Contractors. The rule provides that an individual who has not been treated as an employee will not be reclassified as an employee if (1) the employer had a reasonable basis for not treating the individual as an employee, (2) the employer did not treat the individual or any individual in a similar position as an employee for payroll tax purposes, and (3) the employer has filed all required Federal tax returns, including information returns, in a manner consistent with the individual not being an employee.

Common Law Rules

Prior to 1997, the IRS used twenty common law factors derived from case law and rulings in determining whether an individual performing services is classified as an employee or an Independent Contractor. However, all factors were not necessarily pertinent or present in all situations. Also, as previously mentioned all the facts and circumstances of each case need to be considered. Additional relevant information that assists in determining the extent to which the individual or employer for whom services were performed retained the right to control should also be considered.

Therefore, although the twenty common law factors referenced below are still taken into account, simply another way of analyzing the pertinent factors is to focus on (1) behavioral controls, (2) financial controls, and (3) the relationship between the employer and the individual performing services. These three main categories are described below and additional detailed information may be found at [IRS Publication 1779, Independent Contractor or Employee](#) and at [IRS Publication 15-A, Employer's Supplemental Tax Guide under the "Employee or Independent Contractor?"](#) section.

Behavioral Control

Behavioral controls are evidenced by facts that determine whether the employer has a right to direct and control how the individual performs the tasks for which the individual is hired, including the type of instructions the employer gives the individual and how the individual obtains training for providing such services.

Financial Control

Financial controls are evidenced by facts that determine whether the employer has a right to direct or control the financial/business aspects of the individual's business activities, including (1) the extent to which the individual is reimbursed for business expenses, (2) the extent of the individual's investment in the business and whether a profit or loss is realized, (3) the extent to which the individual offers similar services to the relevant market, and (4) how the employer pays the individual, such as hourly, salary, or a flat fee.

Type of Relationship

The relationship between the individual performing services and the employer is evidenced by examining how the employer and the individual perceive their relationship, including:

1. Whether a written contract exists explaining the employer's and individual's intent,
2. The provision of, or lack of employee benefits,
3. The permanency of the relationship,
4. The right to terminate the relationship, and
5. The extent to which services are performed that are a part of the employer's regular business activities.

Twenty common Law Factors

Revenue Ruling 87-41, 1987-1 Cumulative Bulletin 296 (Rev. Rul. 87-41) provides the list of [20 Common Law Factors](#) to assist in determining whether an individual should be classified as an employee or an Independent Contractor. These factors are intended as guidelines, not as strict rules. In fact, Rev. Rul. 87-41 states, "The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed." Listed below are five basic questions that capture the essence of the twenty common law factors, which may assist in clarifying the determination of employment status:

- Will this individual provide essentially the **same** service as provided by a University employee?
- Has the individual previously been paid as a University employee to perform essentially the **same** tasks?
- Will the University have a legal right to control how the individual will perform or accomplish the service?
- Will the individual **supervise or direct** University Employees as part of the service provided?
- Is it currently expected that the University **will hire** this individual as an employee immediately following the termination of the contractual service provided?

If the answer to **any** of these five questions is yes, then the individual provider in question most likely should be classified as an employee, and the person certifying the status should contact the Human Resources.

Contracting Procedure

If the answers to all of the above five questions are no, an Independent Contractor relationship may be established. The Purchasing Department reserves the right to request verification of the individual's classification as an Independent Contractor from the Human Resources.

Twenty Common Law Factors Used to Determine Employment Status: Independent Contractor versus Employee

Revenue Ruling 87-41, 1987-1 Cumulative Bulletin 296, lists the twenty factors that have been identified to serve as an aid when determining whether an individual is an Independent Contractor or an employee. The importance of each factor is dependent upon the facts and circumstances of every case.

If the majority of questions 1-14 are answered as "no" and the majority of questions 15-20 are answered as "yes", then the relationship may be that of an Independent Contractor rather than an employer-employee. For additional information and assistance in applying these common law factors, contact the Purchasing Division.

1. Instructions

Will you instruct the individual (or have the right to instruct) on when, where, and how the work will be done?

An employee must comply with instructions about when, where, and how to work. Even if no instructions are given, the control factor is present if the employer has the right to give instructions.

2. Training

Will you train or provide training to the individual on performing services in a particular manner?

An employee is trained to perform services in a particular manner. Independent Contractors ordinarily use their own methods and do not receive training from the purchaser of their services.

3. Integration

Are the services that this individual will be providing a part of the business operations?

An employee's services are integrated into the business operations because the services are important to the success or continuation of the business. This shows that the employee is subject to direction and control.

4. Services rendered personally

Will the individual be personally performing the services?

An Independent Contractor has the capability of hiring someone to personally perform the work. An employee renders services personally. This shows that the employer is interested in the methods, as well as the results.

5. Hiring, supervising, and paying assistants

Will you be hiring, supervising, and paying others to assist the individual?

An employee works for an employer who hires, supervises, and pays assistants. An

Independent Contractor hires, supervises, and pays assistants under a contract that requires him/her to provide materials and labor, and to be responsible only for the result.

6. Continuing relationship

Will this be an ongoing relationship?

An employee has a continuing relationship with an employer. A continuing relationship may exist where work is performed at frequently recurring, although irregular, intervals.

7. Set hours of work

Will you be setting the individual's hours of work?

An employee has set hours of work established by an employer. An Independent Contractor is the master of his/her own time.

8. Full time required Will the individual be working only for you?

An Independent Contractor is free to work when and for whom he/she chooses.

9. Doing work on employers premises

Will the individual work on the premises or at a location you designate?

An employee works at a location or on a route designated by an employer. Generally an Independent Contractor would not be required to work at a location designated by the Contractor, unless required by the nature of the work to be performed.

10. Order or sequence set

Will you define the order or sequencing of the work?

An employee must generally perform services in the order or sequence set by an employer, which shows that the employee is subject to direction and control.

11. Oral or written reports

Will the individual be asked or required to submit a report to you describing his/her actions?

An employer may require an employee to submit report. This indicates that the employee must account to the employer for his/her actions. An Independent Contractor may submit a report or demonstrate accurate completion of the work performed by the Contractor.

12. Payment by hour, week, month

Will you be paying the individual by the hour, week, or month?

An employee is generally paid by the hour, week, or month. An Independent Contractor is generally paid by the job or on a straight commission or a set fee for services performed.

13. Payment of business and/or traveling expenses

Will you be paying any expenses for the individual?

An employer generally pays an employee's business and travel expenses. This shows the employee is subject to regulation and control.

14. Furnishing of tools and materials

Will you be furnishing the individual with tools, materials, equipment, etc.?

An employer generally furnishes employee significant tools, materials, and other equipment.

15. Significant investment

Will the individual have any investment in the facilities he/she will be using?

An Independent Contractor has a significant investment in the facilities he/she uses in performing services for someone else.

16. Realization of profit or loss

Will the individual realize a profit or suffer a loss?

An individual who can realize a profit or suffer a loss is generally classified as an Independent Contractor.

17. Working for more than one firm at a time

Can the individual be working for more than one employer?

Individuals may work for more than one employer and still be classified as an employee; however, an Independent Contractor may provide his/her services to multiple unrelated persons or firms at the same time and generally has a significant client base.

18. Making services available to general public

Does the individual offer his/her services to the general public?

An Independent Contractor makes his/her services available to the general public.

19. Right to discharge

Have you given up your right to discharge the individual?

An employee can be fired by an employer. An Independent Contractor cannot be discharged as long as he/she produces a result that meets the specifications of the contract.

20. Right to terminate

If the individual quits, will he/she incur a liability for work not completed?

An employee can quit his/her job at any time without incurring liability. An Independent Contractor usually agrees to complete a specific job and is responsible for its satisfactory completion, or is legally obligated to make good for failure to complete it.