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TO: Local Government Officials and Certified Public Accountants

FROM: Sharon Edmundson, Director, Fiscal Management Section

SUBJECT: Worker Status: Employee or Independent Contractor?

This memo covers the concerns and issues associated with the classification of local government workers as either employees or independent contractors. The Internal Revenue Service (IRS) has examined the worker status decisions of several North Carolina local governments and where they have identified instances of employees incorrectly classified as independent contractors they have assessed back taxes, interest and penalties. This memo will review the differences in the treatment of employees and independent contractors and the consequences of misclassifying a worker. It will discuss the factors for determining worker status as set forth by the courts and the IRS. It will also discuss the classification of different types of local government workers.

When a worker is classified as an employee, the employer is required to withhold the employee share of social security and Medicare taxes, and usually income taxes, from the employee's pay. The employer also pays the employer share of social security and Medicare taxes along with unemployment taxes. The employer is required to report the employee's earnings and tax withholdings on form W-2 for the calendar year. The employer also must pay the taxes due at a certain frequency based on the tax liability of the unit as a whole. In most cases, the payments are made by a tax deposit with a commercial bank. In addition, the employer is subject to other legal requirements related to worker's compensation, overtime (wage and hour laws) and anti-discrimination rules. Employees also may be eligible for coverage under various benefit programs offered by the employer.

When a worker is classified as an independent contractor, the contracting organization is not required to withhold income, social security, and Medicare taxes or pay the employer portion of social security and Medicare taxes. Also, they are not liable for unemployment taxes. The contracting organization reports earnings of $600 or more on Form 1099-MISC. In addition, the contracting organization is not subject to worker's compensation, wage and hour laws and most other anti-discrimination rules that employers are subject to.

To a local government, it may first appear there is a significant savings in classifying workers as independent contractors instead of employees. However, there is a potential significant cost

should the IRS challenge that treatment and prevail that the worker was an employee and income, social security and Medicare taxes should have been withheld and paid on the worker. Worker status determination is not based on convenience or cost savings to the employer. Instead, the determination is based on applying tests and factors cited in case law and IRS regulations to the facts and circumstances of the particular job. The existence of a written agreement between the government entity and an independent contractor has no significance in support of the independent contractor status. If the local government loses a challenge to the classification of a worker as an independent contractor, the local government may be assessed back taxes, penalties and interest totaling an amount greater than what otherwise would be due if the worker had been treated as an employee. Following an IRS determination that a worker is an employee, the Workers Compensation Industrial Commission sometimes rule that the worker also should be covered for workers compensation.

Worker Status Determination

The Internal Revenue Code (Code) does not formally define the term employee. However, the Code in Section 3121(d)(2) provides some guidance by describing an employee as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." The determination of worker status is based on the facts and circumstances that exist in light of existing common law. The common law rule for determining worker status is whether the local government has the right to direct and control the worker as to the manner and means of performing a job. A local government must consider all the facts and circumstances in deciding whether a worker is an independent contractor or an employee. The facts will fall into three main categories: (1) whether the local government has the right to control worker behavior; (2) whether the local government has financial control over the worker; and (3) the relationship between the local government and the worker.

In a 1987 Revenue Ruling (87-41), the IRS compiled a list of 20 factors that the courts had considered in the right-to-control test. These factors were:

1) Whether the worker must comply with another person's instructions about the work;
2) Whether the worker requires training in order to do the work;
3) Whether the work performed by the worker is integrated into the hiring organization's operations;
4) Whether the worker must perform the services personally;
5) Who hires, supervises and pays the worker's assistants, if any;
6) Whether the worker and hiring organization have a continuing relationship;
7) Whether the work must be performed during set hours;
8) Whether the worker must devote most of his or her time to the work for the hiring organization;
9) Whether the work must be performed on the employer's premises or can be done elsewhere;
10) Whether the worker must perform services in an order or sequence set by the hiring organization;

11) Whether a worker must submit reports;
12) Whether the worker is paid by the hour, week or month;
13) Whether the worker's business or traveling expenses are paid by the hiring organization;
14) Whether the worker furnished the tools, material and equipment needed to perform the work;
15) Whether the worker has a significant investment in facilities needed to do the work;
16) Whether the worker can make a profit or suffer a loss as a result of performing the services for the hiring organization;
17) Whether the worker can work for more than one firm at a time;
18) Whether the worker makes his or her services available to the general public;
19) Whether the hiring organization can discharge the worker;
20) Whether the worker has the right to terminate the relationship with the hiring organization.

Recent IRS publications refer more to the previously mentioned three categories - behavioral, financial, and relationship factors instead of the 20 factors of Revenue Ruling 87-41. Yet, the 20 factors can be helpful to a local government in making a status determination.

The behavioral control factors refer to facts that indicate if the local government has the right to direct and control how a worker performs the specific job. Does the local government have the right to dictate the manner and means for completing a job? Facts that indicate the right to control are the employer sets rules for employee conduct, sets the time to begin and end work, provides training or instructions on how to perform a job and monitors the progress towards the completion of the job.

The financial control factors refer to facts that indicate if the local government controls the business and financial aspects of the workers' activities. Employees generally have no capital investment in providing the services, have no opportunity for profit or risk of loss in providing the services, do not advertise their services to the general public, do not provide the same services to other entities at the same time and do not incur unreimbursed expenses in providing the services.

The relationship factors refer to facts that evidence the relationship of the worker to the local government. The relationship is generally evidenced by examining how the parties perceive their relationship and how that relationship is represented to others. Is there evidence of permanency in the relationship? Are the services provided by the worker integral to the local government's operations? Can the worker quit or be terminated without warning and without liability except for unpaid wages?

There may be a written agreement between the worker and the local government that describes the worker as an independent contractor and provides evidence of an independent contractor relationship. **However, a contractual designation will not, in and of itself, provide sufficient evidence for determining worker status.** The substance of the relationship, not the label, is determining.

Examples Cited in IRS Publications

Mayor and Governing Board: The IRS has been clear that public officials, both elected and appointed are employees. Any compensation other than reimbursement of expenses under an accountable plan would be reported as W-2 wages with income, social security, and Medicare taxes withheld. The mayor and governing board are considered public officials. A municipal clerk also is considered a public official and should be treated the same. Expense reimbursements paid under an accountable plan, that is one in which the employee is required to produce receipts or mileage records and is reimbursed based on those receipts and mileage records, are not included in W-2 wages nor are they reported on a 1099-MISC.

Umpires and Referees for Local Government Sponsored Recreation Leagues: There seems to be confusion regarding umpires and referees as some entities may be treating them as employees and others may be treating them as independent contractors. The IRS appears to be taking a strict position towards employee treatment. The local government entity should treat umpires and referees as employees if they are recruiting them, paying them directly, assigning them to games and instructing the officials in policies and procedures. This is an indication of the right of control that tips the scale to employee treatment. If the local government contracts with an association to provide umpires/referees and they do not have workers compensation, the local government will have to cover them as an employee.

Instructors: It is common for recreation departments to offer classes to citizens in various subjects using part time instructors from the community with expertise in the subject matter. This is another situation where entities may be treating the instructors as independent contractors when they really should be employees. Once again, the entity must consider the right of control over the instructors and the class. If the organization is providing the space, handling the registration fees, providing materials and audio visual equipment, and setting the minimum participation required for the class then the instructor should be considered an employee of the entity. If the government is simply renting space to an instructor and that instructor is directly handling all the other aspects of administering the class then you could make the case for classification as an independent contractor.

Volunteer Firefighters and Emergency Medical Technicians: Volunteer firefighters are considered employees and their remuneration is generally subject to all withholding taxes. However, if the payment is a nominal reimbursement for out-of-pocket expenses actually incurred, and the payment is accounted for according to the requirements of Reg. 1.62-2 regarding accountable plans, then the payment could be excludable from the firefighter's W-2.

Day Laborers: The IRS does not recognize casual labor as these workers are still considered employees. Even if a worker only works one day, he or she is still an employee as the entity has control over when and where the person reports to work and control over how the person does the job as well as what type of job the person does.

City/County Managers: Regardless of whether they are part time, full time, or interim, managers are still considered employees as the entity has right of control over how they do their job. Appointed officials serve at the pleasure of the governing board and follow state law and city/county ordinances (G.S. 160A – 147-150).

City/County Attorneys: There has been a case in North Carolina where the IRS said an attorney on retainer to a unit was an employee although the person worked for a private law firm. The issue here also is related to the right of control. By appointing the city/county attorney, the governing board will have some control over when that attorney provides services. Usually, the attorney is required to attend all board meetings and provide set services to the board. Due to this level of control, the IRS argues that this is an employer – employee relationship. Unit's may wish to contract with a law firm instead of an individual member of that firm and any of the attorneys in the firm may then provide services to the unit. This arrangement is more indicative of a contract relationship rather than an employer-employee relationship.

Local governments must be diligent when contracting for services of anyone that they are going to treat as an independent contractor to make sure they are clearly independent and that the unit has no behavioral control, financial control or relationship control that would result in an IRS adverse decision should they be challenged. In order to prove this diligence, the local government should develop some form of documentation system and checklist to use in every establishment of an independent contractor relationship. This documentation should cover each of the three areas of concern to the IRS – behavioral, financial, and relationship control. Documentation of the decision-making process is essential, and the unit should strive to be consistent in its application of the law.

As with any payroll-related issue, please seek the assistance and guidance of your payroll advisor and independent auditor before making any changes to your policies and procedures.

If there are questions or comments regarding this memo, please contact Ken Wease at (919) 807-2391 or ken.wease@nctreasurer.com.