

**Division of Accounting
Payroll Compliance Group**

Worker Classification Bulletin

INTRODUCTION

The Division of Accounting (DOA) is responsible for working with State of Delaware (State) Organizations to ensure appropriate application of regulations when determining if a worker should be classified as an employee or non-employee (i.e. independent contractor).

FACTS

It is critical for any entity paying compensation to understand the proper classification of its workers as either employees or independent contractors. Under the Internal Revenue Code (IRC), an employer must withhold income, social security and Medicare taxes from employees' wages and it must match the withheld social security and Medicare taxes with employer funds.

Misclassification of workers as independent contractors rather than employees has cost the federal government significant revenue losses in uncollected employee/employer taxes. To mitigate this risk, the IRS has put additional resources on payroll tax audits with a focus on worker misclassification. Generally, when an employer erroneously classifies an employee as an independent contractor and does not withhold Federal payroll taxes, the employer could be liable for the employer and employee shares of all applicable Federal payroll taxes, as well as various penalties and interest.

FINDINGS

State Organizations periodically hire workers as independent contractors. The circumstances of the engagement dictate the appropriate classification of the workers.

REGULATORY REFERENCES

Applicable Code, regulations, and laws as cited substantiate information provided in this bulletin.

IRS

Pub.963-Federal-State Reference Guide (Rev. Nov. 2014)

The *Federal-State Reference Guide* provides government employers a comprehensive reference on Social Security and Medicare coverage and Federal tax withholding issues. Determination of worker status is included in Chapter 4 of this publication.

When determining worker status, the primary question is whether the worker is an employee or an independent contractor under the common-law standard. Workers categorized as employees are subject to employment taxes that must be withheld and paid through the payroll system. Employers are not required to withhold and pay employment taxes on behalf of workers who are independent contractors.

Common-Law Standard

IRC 3121(d) (2) states that an employee is "any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee."

The IRS has interpreted the common-law test as examining the employer's right to direct and control the worker as to the manner and means of the worker's job performance to determine if the worker is an employee. In other words, does the employer have the right to tell the worker not only what is to be done, but also how it is to be done?

All facts and circumstances must be considered to determine whether a worker is an independent contractor or an employee. The facts fall into three main categories:

- 1) Does the Organization have the right to control the behavior of the worker;
- 2) Does the Organization have financial control over the worker; and
- 3) What is the relationship of the parties, including how they perceive their relationship?

Additional details about these facts, with emphasis on governmental situations, are as follows:

Behavioral Control

Under this category, facts show whether the Organization has a right to direct and control how the worker performs specific tasks. When workers perform their tasks satisfactorily, the Organization does not appear to exercise much control. However, the critical question is whether there is a *right* to control. If the Organization has the right to do so, it is not necessary that it actually direct and control the manner in which the services are performed.

Elements of behavioral control with respect to government employees:

Instructions, Training, and Required Procedures

An employee is generally subject to the Organization's instructions about when, where, and how to work. The employer has established policies, which workers are required to learn and follow. Periodic or ongoing training about procedures indicates that the employer wants the services performed in a particular manner. These facts are indicative of a right to control.

The work of government employees is often subject to regulations and policies specifying how jobs are to be performed. Therefore, some type of training or minimal instructions may be provided to either an employee or an independent contractor, including orientation or information sessions about the Organization's policies and programs for which there is no compensation.

Government Identification

Government workers may be required to identify themselves by wearing a uniform, driving a marked vehicle, etc., which is highly indicative of employee status.

Nature of Occupation

The nature of the worker's occupation affects the degree of direction and control necessary to determine worker status. Highly trained professionals such as doctors, accountants, lawyers, engineers, or computer specialists may require very little instruction to perform their services. However, attorneys, doctors and other professionals *may* be employees. In such cases, the Organization may not train the individuals or tell them how to practice their professions, but could retain other kinds of control such as requiring work to be performed at government

offices or control scheduling, holidays, vacations, and other conditions of employment.

On the other hand, professionals can be engaged in an independent trade, business, or profession in which they offer their services to the public including government entities. In this case, they may be independent contractors and not employees. In analyzing the status of professional workers, evidence of control or autonomy with respect to the financial details is important.

Evaluation Systems

Organizations commonly use evaluation systems to monitor the quality of work performed. This is not necessarily an indication of employee status. In analyzing whether an Organization's evaluation system provides evidence of the right to control work performance, consider how the evaluation system may influence the worker's behavior in performing the details of the job. If there is a periodic, formal evaluation system that measures compliance with performance standards concerning the details, the system and its enforcement are evidence of control over the worker's behavior.

Financial Control

This category includes evidence of whether the Organization controls the business and financial aspects of the workers' activities. Employees do not generally risk incurring a loss in the course of their work, but receive a salary for as long as they work. An independent contractor has a genuine possibility of profit or loss. Facts indicating the possibility of profit or loss include significant investment in equipment, tools or facilities; unreimbursed expenses, including the requirement of providing materials or hiring helpers; working by the job rather than on a continuous basis; paying fixed costs regardless of whether the individual works; and payment based on contract price, regardless of the cost to accomplish the job.

Elements of financial control:

Method of Payment

An individual paid a contract price, regardless of the job cost, has a genuine possibility of profit or loss. An individual paid by the hour, week, or month is typically an employee. However, this is not always true. For example, independent contractor attorneys usually bill by the hour. An individual paid by the unit of work, such as a court reporter, may or may not be an independent contractor, depending on the facts.

Offering Services to the Public

Another factor favoring independent contractor status exists when the individual makes his or her services available to the public or a relevant segment of the market. Consider the following:

- Does the individual advertise?
- Does the individual use a private business logo?
- Does the individual maintain a visible workplace?
- Does the individual work for more than one entity?

Corporate Form of Business

If the individual is incorporated and observes corporate formalities associated with this status, it is unlikely that he or she is an employee of the Organization. However, the mere fact of incorporation or use of a corporate name does not translate to the worker status of independent contractor. The corporation must serve an intended business function or purpose or be engaged in business.

Part-Time Status

The fact that individuals work on a part-time or temporary basis, or work for more than one entity, does not make them independent contractors. A part-time, temporary, or seasonal worker may be an employee or an independent contractor under the common-law rules.

Relationship of the Parties

The third category used to determine worker status is evidence of the relationship between the parties, including how they view their relationship. The relationship of the parties is generally evidenced by examining the parties' agreements and actions with respect to each other, paying close attention to those facts that show not only how they perceive their relationship, but also how they represent their relationship to others.

For example, a fact illustrating how the parties perceive their relationship is the intent of the parties as expressed in a written contract. A written agreement describing the worker as an independent contractor is evidence of the parties' intent; and, in situations where it is unclear whether a worker is an independent contractor or employee, the intent of the parties, as reflected in the contract, may resolve the issue.

However, a contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative. The substance of the relationship, not the label, governs the worker's status. See Employment Tax Regulation §31.3121(d)-1(a)(3).

The following items may reflect the intent of the parties:

- Providing employee benefits, such as paid vacation, sick days and health insurance, is evidence that the Organization regards the individual as an employee.
- The evidence is strongest if the worker is provided with benefits under a tax-qualified retirement plan, section 403(b) annuity or cafeteria plan because, by statute, these benefits can be provided only to employees.

Elements of the relationship of the parties:

Discharge or Termination

The reasons a business and a worker can terminate their relationship is useful evidence concerning the classification of the worker. An Organization's ability to terminate the work relationship at-will, without penalty, is a highly effective method to control the worker indicating an employee status. In the traditional independent contractor relationship, the Organization could terminate the relationship only if the worker failed to provide the intended product or service, indicating the Organization had no right to control how the work was performed. The reasons an Organization can terminate an employee may be limited by law, contract, or its own practices. Therefore, inability to freely discharge a worker, by itself, no longer constitutes persuasive evidence that the worker is an independent contractor.

Termination of Contracts

Independent contractors may enter short-term 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. Accordingly, the worker's protection from liability for terminating the relationship does not necessarily indicate employee status.

Permanency

The permanency of the relationship between the worker and service recipient is somewhat relevant to determining whether there is an employer-employee relationship. If a worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this generally indicates an employment relationship. However, a long-term relationship may exist between a government entity and an independent contractor. There may be a long-term contract, or contracts may be renewed regularly due to superior service, competitive costs, or lack of alternative service providers.

Part-time, seasonal or temporary workers may also be employees under the common-law test. The fact that workers do not have full-time, permanent status is irrelevant to their classification.

Common-Law Standard - Summary

In many cases, some facts support independent contractor status and others support employee status. Independent contractors are rarely completely unconstrained in the performance of their contracts, and employees usually have some degree of autonomy. The determination of a worker's status rests on the weight given to the facts as a whole, keeping in mind that no one factor is determinative.

Employee Status for Income Tax Withholding

The primary legal basis for defining government employees for income tax withholding purposes lies in IRC §3401(c), which states, "the term employee includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof." Therefore, an officer, employee, or elected official of a state government is an employee for income tax withholding purposes. As explained above, for purposes of Social Security and Medicare taxes, employee status is determined under the common-law control test, unless a Section 218 Agreement is in place and specifically covers the position.

Section 218 Agreement

If an existing Section 218 Agreement (governed by the Social Security Administration) classifies a position as that of an employee, covered by the agreement, then an individual in that position is an employee, subject to OASDI, Medicare, and income tax withholding, the common-law tests are not considered. Positions not covered by a Section 218 Agreement should be evaluated under the common-law tests.

Classification Issues Involving Government Employees Public Officials

The term "public official" refers to someone who has authority to exercise the power of the government and does so as an agent and employee of the government. Holders of public office are presumed to be employees. An exception applies for certain public officials paid solely on a fee basis. The regulations provide the following specific examples of positions that constitute "public office":

- Member of a legislature or elected representative (i.e. elective office)
- State or local judge, or justice of the peace
- County or city attorney, marshal, sheriff, constable
- Road commissioners
- Members of boards and commissions, (i.e. school boards, zoning boards, and boards of health)

Elected Officials

Under section 3401, elected officials are employees for income tax withholding purposes. For Social Security and Medicare purposes, elected officials (also referred to as "individuals in elective positions") are subject to a degree of control that typically makes them employees under the common-law test.

Independent Contractor Reporting Responsibilities

Independent contractors are subject to Social Security and Medicare taxes under the Self-Employment Contributions Act (SECA). Generally, payments to independent contractors of \$600 or more during a calendar year are reported on Form 1099-MISC, Miscellaneous Income. Independent contractors are required to register with the State using the eSupplier portal. The Taxpayer ID and supplier name are submitted to the Internal Revenue Service for "matching."

Worker Providing Services as an Employee and as an Independent Contractor

When individuals provide services as employees, they may not be employees with respect to all services they provide. For example, an employee hired as a teacher may be retained to remove snow from school property. This individual may be an independent contractor in the snow-removal activity. In order to determine whether the snow-removal activity is an independent trade or business, apply the common-law test. Revenue Ruling 58-505, 1958-2 C.B. 728, explains that, for an individual to work in two capacities (employee and contractor), the services must not be interrelated. In other words, an individual does not work in two capacities when the same type of work, such as legal services, is divided into two components, one in an employee capacity and one in an independent contractor capacity. The services and remuneration for the two activities must be separate. If the services or compensation are interrelated, then the individual is not acting in two separate and distinct capacities.

TAX ADVICE DISCLAIMER

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