



Employee or Independent Contractor

Recent tax examinations of universities by the Internal Revenue Service (IRS) have emphasized the need to properly distinguish payments to individuals as either independent contractors or employees. If an individual is identified as an independent contractor that than an employee, the employer should not withhold FICA, Medicare or other taxes from its payment for services nor pay the employer's share of these taxes. If an individual is determined to be an employee, however, failure to properly withhold and remit employment taxes could result in a significant tax liability to the employer. Employees are paid through the Human Resource System (HRS) in accordance with normal pay procedures. Independent Contractors are paid as vendors by Accounting.

Departments, under the purview of the college/division Administrative Officer, are responsible for making the determination of whether the individual is an employee or independent contractor. Guidelines to assist with this determination are attached. If, after review of the guidelines, the department is unsure of whether the individual is an employee or independent contractor, the department would discuss with the Administrative Officer, who in turn would contact Human Resources/Payroll. In the event that there is a difference of position on whether the individual is an employee or independent contractor, the Administrative Officer can submit a request to the Internal Revenue Service, form SS-8. If payment cannot be delayed until a determination is received from the IRS, Human Resources/Payroll's determination will be followed.

As a general rule, if the individual is an OSU employee or retiree, payment should be made through the payroll system. The state internal auditor has determined that the relationship between the OSU Foundation and OSU requires that any payments to employees be considered payments from OSU and reported through the OSU payroll system. Human Resources has established procedures with both the OSU Foundation and Accounting to check for inappropriate payments to individuals who are employees. However, the full responsibility for an accurate determination remains with the originating department.

All payments processed through the OSU Foundation in which the payee's taxpayer identification number is a social security number are routed through Human Resources/Payroll. If the payment is determined to be an employee type payment, the Foundation voucher is returned to the originating department with instructions to process the payment through the university payroll system. If the payment is determined to be a contractor type payment, Human Resources/Payroll approves as appropriate to be paid through the Foundation, initials, dates, and returns the voucher to the Foundation.

All payments processed as an accounts payable payment, such as requisitions, are reviewed by University Accounting staff to be sure they are a legitimate vendor payment. Payments that appear to be for employment are referred to Human Resources/Payroll for a determination. If the determination is that the payment is employment related, the request for payment is returned to the originating department with instructions to pay through the university payroll system.

Guidelines for Determining Employee or Contractor Status

The classification of individuals as employees or contractors is very important for employers. If an individual is classified as an employee, the employer has the responsibility to calculate and withhold income taxes, FICA taxes, and contribute the employer FICA and unemployment taxes. If an individual is classified as a contractor, the hiring party usually will not need to withhold taxes or have any employment related taxes. Since an employer can avoid the withholding of taxes and save employment related taxes when an individual is classified as a contractor, many may be tempted to do so, even when the individual should be classified as an employee. However, improperly classifying individuals as contractors may lead to severe penalties being imposed by the Internal Revenue Service (IRS) upon not only the company but also the person responsible for the classification.

If an employee is improperly classified as a contractor, the Internal Revenue Service may impose a 100% penalty against the company. Employees who were responsible for the incorrect classification are personally liable for the payment of taxes and are penalized an equal amount. The IRS will and has imposed these penalties. This is a key area of interest for the Internal Revenue Service. Without a doubt, the IRS will audit these payments; it is only a question of when.

IRS Twenty Question Test

Common law rules indicate a worker is an employee if the person for whom he works has the right to direct and control him/her in the way s/he works, both as to the final results and as to the details of when, where and how the work is to be done. The employer does not need to exercise the control; it is sufficient that the employer has the right to do so. Because of the need to properly classify employees and contractors, the IRS has developed a 20-question test designed to help employers determine a worker's status. This test is not intended to provide a conclusive determination of a worker's status but should be used as a guide.

- 1. Is the worker required to comply with instructions on where, how, and when the work is to be done?¹**

A person who is required to comply with instructions about when, where and how s/he is to work is ordinarily an employee. While contractors may be given a deadline, they usually have the freedom to determine how, when and where the work will be performed, as long as the end results meet the requirements of the contract.²

- 2. Is the worker provided training to perform the job in a particular manner?**

Training by an employer is a factor of control because it indicates that the employer wants the services performed in a particular method or manner. Contractors are usually hired because of their expertise or knowledge in an area and they may use their own methods to accomplish a project.

- 3. Are the services performed an integral part of the organization's operations?**

Integration of the person's services in the business operations generally shows that s/he is a subject to direction and control. That is, when the success or continuation of a business depends to an appreciable degree on the performance of certain kinds of services, those performing the services must necessarily be subject to a certain amount of control by the owner of the business.

- 4. Must the services be rendered personally?**

If services must be rendered personally and if the employer is interested in who does the

job as well as in getting the job done, it indicates that the employer is interested in the methods used as well as the result of the services rendered. Contractors generally have the latitude to assign associates or employees, if any, to perform a task.

5. **Does the business hire, supervise and pay assistants to help the worker on the job?**

Hiring, supervising and payment by an employer generally shows control over the workers on the job. Independent contractors generally are responsible for providing their own assistants along with their pay and supervision.

6. **Is there a continuing relationship between the worker and the business?**

The existence of a continuing relationship between an individual and the person for whom s/he performs services is a factor tending to indicate the existence of an employer-employee relationship. Services may be continuing even though they are performed at irregular intervals, on a part-time basis, seasonally, or over a short term. Contractors are generally hired for a particular job and the relationship ends when the task is completed.

7. **Does the organization set the work schedule?**

Establishing a work schedule is indicative of control. Independent contractors may have a deadline imposed on their work; however, they establish their own work schedule.

8. **Is the worker required to devote his/her full-time to the organization?**

If the worker must devote full-time to the business of the employer, rather than engaging in other gainful work, s/he is probably an employee. Note that full-time does not necessarily mean an eight-hour day or a five-day week. Its meaning will vary depending on the intent of the parties. Contractors are generally free to work when, for whom and for as many employers as they please.

9. **Is the work performed at the company's place of business or at a specific place designated by the company?**

Doing the work on an employer's premises implies control, especially if the work is of such a nature that it could be performed elsewhere. Conversely, however, the fact that work is done off the employer's premises does not, of itself, mean that no right to control exists.

10. **Does the organization direct the sequence in which the work is performed?**

If a person must perform services in a prescribed sequence, it shows that s/he may be subject to control. Here, too, it is the right to set the sequence, not the exercise of that right, that is controlling. Contractors generally have the right to perform a task as they choose --the result of the task being the important factor, not how it was performed.

11. **Are oral or written reports required to be submitted?**

Submitting reports is an indication of control.

12. **Are payments to the worker made by hour, week, or month?**

Payment for work by the hour, week, or month is usually the manner for the compensating employees; independent contractors are customarily paid by the job in a lump sum or on a commission basis. The guarantee of a minimum salary or the granting of a drawing account at stated intervals with no requirement for repayment of the excess over earnings tends to indicate the existence of an employer-employee relationship.

13. **Are travel and lodging expenses reimbursed?**

Since the employer may exercise control of expenses, reimbursement of business and/or travel expenses is indicative of control and an employee. Independent contractors are usually responsible for their own expenses.

14. **Does the organization furnish tools and materials?**

Employers provide tools, equipment or material to employees, thus exercising control

over how the work will be performed. Independent contractors usually have the expertise and equipment needed to perform the tasks for which they are hired. This is subject to recognition that in some jobs it is customary for employees to use their own hand tools.

15. Does the worker have an investment in equipment or facilities?

A significant investment by a person in facilities used by him in performing services for another tends to show an independent contractor status. Facilities include, generally, equipment or premises necessary for the work, but not the tools, instruments, clothing and the like that are provided by employees as a common practice in their trade.

16. Does the worker stand to realize a profit or a loss as a result of the work?

Employees are generally paid a salary or wage and are not in a position to realize a profit or loss. Realizing a profit or loss as a result of services performed is usually an indication of an independent contractor.

17. Does the worker work exclusively for the employer?

See questions 8 and 18.

18. Does the worker work predominantly for the organization (or are services available to the general public)?

A worker who makes his/her services available to the general public is usually an independent contractor. "Making services available" may include hanging out a "shingle", holding one's own business licenses, supplying one's own advertising and telephone directory listings, etc.

19. Can the worker be discharged for reasons other than nonperformance of contract provisions?

The right to discharge is an important factor in determining whether the one possessing that right is an employer or an employee. An employer exercises control through threat of dismissal. An independent contractor, on the other hand, cannot be fired so long as s/he produces a result that measures up to his contract specifications. The fact that a right to discharge may be limited under a collective bargaining agreement does not detract from the existence of an employer-employee relationship.

20. Can the worker terminate the relationship without liability?

An employee has the right to terminate the relationship with his/her employer 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 the job.

IRS Form SS-8

No one or small group of the factors is necessarily controlling. Factors that indicate the right of direction and control exists in a given situation should be weighed against the factors that independent contractors status. The relative importance of any one factor may vary depending on the occupation under consideration. If after considering all factors, a reasonable employee/contractor determination cannot be made, employers may complete IRS Form SS-8 Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding and the IRS will make a determination of the worker's status.

Reasonable Basis Tests³

In addition to the common law rule there are also reasonable basis tests that an employer may use to designate a worker's status. The reasonable basis tests are essentially procedural tests established by Congress in 1978. If any one of the following tests applies, the government (and the courts) would consider that a reasonable basis for classifying a worker as an independent contractor has been made.

There is judicial precedent (i.e., court decisions) for treating workers in a similar circumstances as non-employees. The IRS has ruled that such workers are not employees. Your company has received a specific exemption from the IRS (e.g., a Private Letter Ruling) Past IRS audits did not disallow this status. There is a long-standing practice in your industry for treating such workers as non-employees.

Additionally, the worker status of some salespeople has been determined by law.

Statutory non-employees (independent contractors), Real estate agents and direct sellers of consumer products in private homes (or anywhere outside of retail stores) are considered independent contractors. Statutory employees Life insurance agents and outside salespeople who work full-time for a company, perform the work personally, and have no substantial investment in the business (other than the expense of a car) are considered employees.

Backup Withholding on Payments to Contractors⁴

While employers are usually not required to withhold taxes on payments to contractors, there is an exception. If an independent contractor fails to provide a taxpayer identification number (TIN), then backup withholding is due. Once payments have reached \$600, they are subject to a 31% backup tax if the payee hasn't furnished a TIN or if the TIN is incorrect. Further, without a TIN, if payments exceeded \$600 in the prior year, then the first payment of the new year is subject to 20% backup withholding. Backup withholding must be reported to the IRS on Form 1099-Misc and the quarterly Form 941.

The information in this letter is a compilation from several sources as listed. While every effort has been made to provide accurate information, this letter should not be used as a sole source for classification of workers. It is intended to be used only as a guide to emphasize the importance of proper worker classification and some factors that can be considered in that classification. It is the responsibility of the employer to properly classify workers as employees or contractors.

^{1.} Questions are from the CUPA News, Vol. 18, No. 18, September 16, 1991, "Are Your Workers Employees or Contractors?"

^{2.} Answers are from the Commerce Clearing House Payroll Management Guide, Para 861, "The Common Law Rule"

^{3.} American Payroll Association 1991 CPP Guide To Payroll Practice and Management, pp. 1-2, 1-3

^{4.} American Payroll Association 1991 CPP Guide To Payroll Practice and Management, p. 1-48, "Backup Withholding", and Commerce Clearing House Payroll Management Guide, Para. 1596, "Failure to supply identifying number - Backup Withholding"