

## ***Excerpt From IRS Publication 963, Federal-State Reference Guide (Rev. 10-2006)***

### **Common Law Standard**

For employment tax purposes, an employee is defined as “any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee” (Internal Revenue Code (IRC) §3121(d)(2)). The common-law rule for determining whether a worker is an employee is whether the service recipient (i.e., the government entity) has the right to direct and control the worker as to the manner and means of the worker’s job performance. In other words, does the entity have the right to tell the worker not only what shall be done but how it shall be done?

All the facts and circumstances must be considered in deciding whether a worker is an independent contractor or an employee. The facts fall into three main categories: whether the entity has the right to control the behavior of the worker; whether the entity has financial control over the worker; and the relationship of the parties, including how they see their relationship. These facts are discussed in the charts below, with special emphasis on those affecting government employers.

### **Behavioral Control**

Under this category, facts show whether the entity has a right to direct and control how the worker performs the specific task for when he or she is engaged. Many times, when workers perform their tasks satisfactorily, the entity does not appear to exercise much control. The question, however, is whether there is a right to control. If the entity has the right to do so, it is not necessary that it actually direct and control the manner in which the services are performed.

### **Instructions, Training and Required Procedures**

An employee is generally subject to the government entity's instructions about when, where, and how to work. The employer has established policies, which the workers are required to learn and follow. Daily or ongoing instructions regarding the expected tasks are especially indicative of employer status. Training is a classic means of explaining detailed methods and procedures to be used in performing a task. Periodic or ongoing training about procedures to be followed and methods to be used indicates that the employer wants the services performed in a particular manner. This type of training is strong evidence of an employer-employee relationship. For instance, police and firefighters must be trained to comply with departmental rules and regulations. They do not have the independence characteristic of independent contractors. A state statute requires that animal control officers receive state-sponsored training. A statute requires that inspectors of sanitary facilities be trained and state-certified. These facts are indicative of a right to control. Election workers are trained to follow uniform procedures established for the polling place. They are directed by a supervisor. These facts suggest they would typically be employees. Government employees often work subject to regulations and manuals, which specify how their

jobs are to be done. Teachers are required to receive periodic training in departmental policies. They are required to attend meetings, to follow an established curriculum, to use certain textbooks, to submit lesson plans, and to abide by departmental policies concerning professional conduct. However, some types of training or minimal instructions may be provided to either an employee or an independent contractor, including orientation or information sessions about a government entity's policies and voluntary 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. When an individual represents himself or herself as an agent of a government that gives the individual an appearance of authority. Wearing a uniform, displaying government identification, or using forms and stationary that indicate one is representing a government are 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, if any, instruction on how to perform their specific services.

Attorneys, doctors and other professionals can be employees, however. In such cases, the entity may not train the individuals or tell them how to practice their professions, but may retain other kinds of control, such as requiring work to be done at government offices, controlling scheduling, holidays, vacations, and other conditions of employment. Again, consult state statutes to determine whether a professional position is statutorily created. 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 especially important, as is evidence concerning the relationship of the parties as discussed below.

### **Evaluation Systems**

Evaluation systems are used by virtually all government entities to monitor the quality of work performed. This is not necessarily an indication of employee status. In analyzing whether a government entity's evaluation system provides evidence of the right to control work performance, consider how the evaluation system may influence the workers' 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 performance, the system and its enforcement are evidence of control over the workers' behavior.

## **Financial Control**

This second category includes evidence of whether the entity controls the business and financial aspects of the workers' activities. Employees do not generally have the risk of incurring a loss in the course of their work, because employees generally receive a salary as long as they work. An independent contractor has a genuine possibility of profit or loss. Facts showing 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 day or by the job rather than on a continuous basis; having fixed costs that must be paid regardless of whether the individual works; and payment based on contract price, regardless of what it costs to accomplish the job.

## **Method of Payment**

The method of payment must be considered. An individual who is paid a contract price, regardless of what it costs to accomplish the job, has a genuine possibility of profit or loss. An individual who is paid by the hour, week, or month is typically an employee. However, this is not always the case; attorneys, for example, usually bill by the hour, even when they work as independent contractors. An individual who is 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 is whether the individual makes his or her services available to the public or a relevant segment of the market.

- 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 the corporate formalities, this makes it unlikely that he or she is an employee of the government entity. (A corporate officer will be an employee of the corporation.) The mere fact of incorporation or use of a corporate name, however, does not transform an employee into an independent contractor. The corporation must serve an intended business function or purpose, or be engaged in business.

## **Part-time status**

The fact that workers 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 illustrative of 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.

A contractual designation, in and of itself however, 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. (Employment Tax Regulation §31.3121(d)-1(a)(3)) The following items may reflect the intent of the parties:

- Filing a Form W-2 indicates the employer's belief that the worker is an employee.
- doing business in corporate form, with observance of corporate formalities, indicates the worker is not an employee of the government entity.
- Providing employee benefits, such as paid vacation, sick days and health insurance, is evidence that the entity 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.

### **Discharge or Termination**

The circumstances under which a business and a worker can terminate their relationship have traditionally been considered useful evidence on the status of the worker. Today, however, business practices and legal standards governing worker termination have changed. Under a traditional analysis, a government entity's ability to terminate the work relationship at will, without penalty, provided a highly effective method to control the worker. The ability to fire at will is indicative of employee status. In the traditional independent contractor relationship, the government entity could terminate the relationship only if the worker failed to provide the intended product or service, thus indicating that the business did not have the right to control how the work was performed. Today a government entity rarely has complete flexibility in discharging employees.

The reasons a government entity can terminate an employee may be limited by law, by contract, or by its own practices. Consequently, inability to freely discharge a worker, by itself, no longer constitutes persuasive evidence that the worker is an independent contractor.

### **Termination of Contracts**

A worker's ability to terminate work at will was traditionally considered to illustrate that the worker merely provided labor and tended to indicate an employer-employee relationship. In contrast, if the worker terminated work, and payment could be refused, or the worker could be sued for

nonperformance, this traditionally tended to indicate an independent contractor relationship. Today, however, 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 workers protection for liability for terminating the relationship does not necessarily indicate employee status. However, the government's ability to refuse payment for unsatisfactory work continues to be indicative of independent contractor status.

### **Nonperformance of Employees**

Employers may successfully sue employees for substantial damages resulting from their failure to perform the services for which they were engaged. As a result, the existence of limits on a worker's ability to terminate the relationship, by itself, is less relevant in determining worker status. On the other hand, a government entity's ability to refuse payment for unsatisfactory work continues to be characteristic of an independent contractor relationship. Because the meaning of the right to discharge or terminate is so often unclear, and depends primarily on contract and labor law, these facts should be viewed with great caution.

### **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 is generally considered evidence of intent to create an employment relationship. A long-term relationship may also 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. The fact that workers do not have full-time, permanent status is irrelevant to their classification.

### **Worker Classification – Summary**

As is the case in almost all worker classification cases, some facts will support independent contractor status and others will support employee status. This is because independent contractors are rarely totally unconstrained in the performance of their contracts, and employees almost always have some degree of autonomy. The determination of a worker's status, therefore rests on the weight given to the facts as a whole, keeping in mind that no one factor is determinative.

### **Public Officials**

Questions arise as to whether workers performing services for a government are contractors, or act as agents and employees of the government and hold public office. For employment tax purposes,

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the primary legal basis for defining 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.” In other words, an officer, employee, or elected official of a state or local government is an employee for income tax withholding purposes. For purposes of social security and Medicare (FICA) taxes, employee status is determined under

the common-law control test, unless a Section 218 Agreement is in place and specifically covers the position.

The IRC does not define the term “public official,” but Regulation §1.1402(c)-2(b), which indicates the application of self-employment tax, indicates that holders of “public office” are not in a trade or business and therefore not subject to self-employment tax. This Regulation states that the performance of the functions of a public office does not constitute a trade or business. The one exception of certain public officials paid solely on a fee basis (see Section 5). Otherwise holders of public office are excepted from self-employment tax and are presumed to be employees receiving wages. The following specific examples are given of positions that constitute “public office”: a mayor, member of a legislature, county commissioner, state or local judge, justice of the peace, county or city attorney, marshal, sheriff, constable, or a registrar of deeds. Other examples include tax collectors, tax assessors, road commissioners, and members of boards and commissions, such as school boards, utility districts, zoning boards, and boards of health.

A public official has authority to exercise the power of the government and does so as an agent and employee of the government. For this reason, the Supreme Court has held that public officials are employees. A public official performs a governmental duty exercised pursuant to a public law. A public office is a position created by law, holding a delegation of a portion of the sovereign powers of government to be exercised for the benefit of the public. Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926).

If there is some question as to whether a worker is a public official and employee, a critical factor to consider is whether there is a state constitution or statute establishing a position. State statutes should be reviewed to determine whether they establish enough control for the individual to be classified as an employee under the common-law test.

Statutes may state that a specific position is that of a public official, in which case there is likely to be a right to control sufficient to make the individual an employee. Statutes specify the duties of a public office and generally establish the officer's superiors and subordinates, if any. Statutes establish an official's term of office and sometimes the compensation. They may require that a public official take an oath of office. Statutes often establish general and specific penalties for dereliction of duty. For instance, members of boards who are paid for each meeting they attend may face termination if they fail to attend a certain number of meetings.

As an example of the degree of control under which a public official works, consider city attorneys in State A. State statutes establish the position and define it as that of an officer and employee. These statutes define the duties of the position: the city attorney is required to direct all litigation in

which the city is a party, including prosecuting criminal cases; to represent the city in all legal matters in which the city or a city officer is a party; to attend meetings of the commissioners, advise commissioners, mayors, etc., on all legal questions, and approve all contracts and legal

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documents. A city manager appoints, supervises and controls the work of the city attorney. The city attorney must take an oath of office. These facts show the importance of state statutes in establishing a right of direction and control of a public official to classify them as a common law employee.

Many other positions, such as teacher and school superintendent, are established by statute. The duties of these positions like those of public officials are statutorily established. The qualifications, training and policies, which they must observe and enforce, are established by statute or statutorily established public bodies.

**Elected Officials**

For the same reason, elected officials are subject to a degree of control that typically makes them employees under the common law. Elected officials are responsible to the public, which has the power not to reelect them. Elected officials may also be subject to recall by the public or a superior official. Very few appointed officials have sufficient independence such that they will not be considered common-law employees. In any event, elected officials are employees for income tax withholding purposes under section 3401(c).