



RISK MANAGEMENT SERVICES

DAVID E. REYNOLDS BUILDING
308 WEST JONES STREET
RALEIGH, NORTH CAROLINA 27603
P.O. BOX 1310 (27602-1310)

PHONE: (919) 733-1212
TOLL FREE: (800) 228-0986
WWW.NCLM.ORG

Employee or Contractor?

Are the people who work for your city or town part-time or on a special project employees or independent contractors?

You may think you know who are employees and who are contractors, but the Internal Revenue Service may not agree with your answers. Knowing the right answer is important. As we all know, there are different IRS reporting requirements for employees and independent contractors. Employees get a W-2 form and Social Security and taxes are withheld; you must pay the employer's share of Social Security. For contractors, you issue a 1099, and the contractor is responsible for paying all the taxes that he or she owes.

What you may not know is that the IRS is looking at how North Carolina local governments answer "employee or contractor" questions. And when they determine that you have made errors, they are imposing fines.

Today, we are going to review the IRS rules on how an independent contractor is defined. We are going to look at some typical situations you face and whether in these instances you have part-time employees or are working with an independent contractor. And we will discuss if you have alternatives in some situations.

Before we start, I should emphasize the "why care" First, your organization is a public entity and therefore should strive to adhere to applicable regulations. Second, if you violate the IRS rules, your organization will be penalized. It will cost you more in the long run to violate the law than to comply. So compliance is a goal.

Compliance is also the goal of the IRS. IRS believes that these questions of "employee or contractor" are compliance issues. Collecting all the taxes owed the government obviously is the mission of the IRS, and people who receive W-2s are 99 percent compliant. People who receive Form 1099 are 75 percent compliant.

That means that significant amounts of federal taxes, Social Security and Medicare taxes are never collected. Ultimately, those of us who do pay our taxes then have to pay more for the cost of government programs because others are not paying what they owe.

Now, let's move from the why to the question itself. Here's a common situation. Your parks and recreation department hires umpires to officiate at youth baseball league games. Your recreation supervisor recruits these folks each year, holds a meeting to pass out rule books, uniforms and go over rules. The supervisor sets the game schedule and notifies the umpires who will be working what game. Each umpire works a few hours a week during the season, gets paid per hour and you issue a Form 1099 at tax time. How many of you think the umpires are part-time employees? How many think the umpires are independent contractors?

Under this set of circumstances, the IRS would consider the umpires part-time employees. We will discuss this more later, but first let's look at the IRS rules themselves. I will go through the rules quickly in order to have time for discussion about typical situations. You have a handout with this information. I hope that most of your questions will be answered by the case studies, but if not, we have time for questions at the end of the session.

Control is the key issue. Look closely at the definition of control: *The right to control and direct the worker who performs the services not only as to the results to be accomplished but also as to the details and means by which the result is accomplished. (Not only what work but how it is done.)*

The IRS has a three step determination for whether someone is an employee or an independent contractor. Many of you are familiar with the 20 common law tests, but the IRS in 1996 rewrote its training manual and made the determination a three-step test.

Those three steps are:

1. Behavioral control
2. Financial control
3. Relationship of the parties

Behavioral Control

- Is there a right to direct or control how the person performs his duties?
- If the employer has the right to direct not just the results but the details and means by which the result is accomplished, then the worker is subject to the will and control of the employer.
- That worker, in the eyes of the IRS, is an employee, not an independent contractor.
- It is not necessary that you as the employer actually direct or control the manner in which the services are performed; just that you have the right to do so.
- A simple example would be that you hire a laborer to clean up after a storm. The foreman tells the laborer where to clean up and could direct how the laborer did the work if needed. That day laborer would be an employee.

Financial Control

- If a person can make a profit or take a loss as a result of the services provided, the person usually is an independent contractor
- Being employed by different employers at the same time is an indication that the person is an independent contractor.
- If the person advertises their availability for work to the general public, that is an indication they are an independent contractor.

Relationship of the Parties

- At issue is the continuity of the relationship. Are the worker's services an integral part of the governmental unit versus an independent trade or business of the individual?

If you believe, you are hiring independent contractors you should:

- Document that you do not control how the work is done.
- Maintain a folder on a person classified as an independent contractor with a questionnaire detailing what results are to be accomplished and whether the worker has the authority to use his or her own judgment on how to accomplish those results.
- Remember that a worker who is required to comply with other peoples' instructions about when, where and how to work is an employee.

Following are some factors that weigh in on the question of employee versus independent contractor

Employee

- Training is an indication of an employee because it tells the worker how management wants the job done.
- If the worker is integrated into the existing workforce, this indicates the worker is under the direction and control of a manager.
- A continuing relationship indicates employee
- Establishing set hours indicates control
- Prohibition of doing work for others indicates employee

- If the person can only work on the employer's premises, this indicates control.
- If the employer can require the work to be done in a specific sequence, this shows control.
- If a regular report – either written or oral – is required, this indicates control.
- The furnishing of tools or material indicates control.
- Payment by the hour or week indicates employee.
- If a worker can quit without incurring a liability, this indicates that the worker is an employee.

Independent Contractor

- If the worker is required to do the work by himself, this indicates that the employer is not interested in methods but results.
- Payment by commission or by the job indicates independent contractor.
- An independent contractor usually is required to complete a specific job and is responsible for satisfactory completion of the job. If a person is legally obligated to make good for the failure to complete a job satisfactorily, this is an indication of an independent contractor.
- Determining whether someone is an employee or independent contractor is a facts and circumstance test. The decision maker – the IRS staff – plays a major role in what facts will control the decision. In each case, are there more factors pointing toward employee, or contractor?

Case Studies

Case 1. Mayors and Governing Board Members

This is straight forward. If your city or town pays your mayor and other elected officials, they must receive a W-2 form.

Alternative – If you don't pay them, but only reimburse these elected officials for their actual expenses incurred in performing their duties, then a W-2 is not required. But the official must submit receipts for all expenses and the expenses must be reviewed in the same manner other expense payments for municipal employees are reviewed.

Case 2. Municipal Clerk of a small town with no full-time employees

Municipal clerks are appointed officials of a municipality. Based on the IRS Code and Regulations, the Public Employer Tax guide (attached publication) states that appointed officials are employees for withholding of federal income taxes, Social Security and Medicare taxes. The Internal Revenue Code provides that employee includes an officer or elected official of a political subdivision. In 2001, a legal memo of the IRS determined that elected and appointed officials, town assessors, animal control officers and road commissioners were employees and appraising firms are independent contractors.

Alternatives: There are none. Clerks are employees and must receive a W-2.

Case 3. Umpires

You remember at the start of our discussion my question about the umpires. You recruit them, give them the rules, schedule them and pay them by the hour. After hearing some of the factors the IRS uses, you probably understand why I said the umpires are part-time employees rather than independent contractors.

An IRS ruling concluded that parks and recreation department basketball referees were employees. They were paid a specific amount for each game. They could quit at any time and the department could fire the referee at any time without incurring liability. Each referee had to go through a training session. Each year, municipal officials reviewed with the referees rule changes and how the town expected them to work. The referees were supervised by a town employee, who monitored the games.

In another ruling, the IRS determined that officials who refereed intercollegiate games for an athletic association were employees.

If your umpires and referees generally work under similar circumstances, the IRS will most likely consider them employees.

Alternative – Change the way you do business. Develop written guidelines that give referees and umpires more freedom and control. They should have the right to control and direct how they referee a game. They should be paid a fixed fee per game. They should be allowed to select which game they will referee. The referees and umpires should be hired from an agency, with all those in agency with credentials and references. The employer would not provide training, but the agency would certify that the umpires and referees know all new rules each year. If an official cannot make a game, that official or the agency finds a qualified substitute. Umpires and referees would furnish their own rulebooks, uniforms and necessary equipment. The municipality should document all the details of how the umpires and referees are hired and what their responsibilities are.

Case 4. Instructors

Your town hires a local high school art teacher to teach an art course at the recreation center. The town has set the time, date and location for the course. The teacher will be paid a lump sum for her instruction and must teach the course herself (no substitutes). You don't provide training, but the instructor is required to meet with the recreation supervisor periodically. The town provides the

classroom space, advertises the course, enrolls the students, handles the fees and provides student materials. The instructor provides her own materials.

Employee or Independent Contractor?

Based on previous IRS ruling, most probably an employee.

Alternative: The town and its parks and recreation department would have to give up significant control to have this instructor or instructors in similar situations qualify as independent contractors. The more control the town has, the less likely the classification as a contractor. Suggested steps would include hiring a qualified person who can accept the responsibilities. There should be documentation that the instructor has the right to run the course. If possible, the instructor would set the days and time of classes, as well as the course fee. Materials fees should be set and paid to the instructor, who would bear the loss if the fees were too low. The instructor would be able to provide instruction in other communities. Students in the course would evaluate the instructor, and the instructor could be released because of a bad evaluation.

Case 5. Volunteer Firefighters

If you provide any pay to your volunteer firefighters, the IRS considers them employees. This is straightforward.

Alternative: A town may reimburse volunteer firefighters for out-of-pocket expenses actually incurred if reimbursements are based on receipts and federal guidelines. Note: If a town wants to reimburse firefighters for cell phones (monthly fees and cost of phones), use of the phones must be restricted to firefighter-related matters.

The town can find ways to compensate firefighters in non-taxable income. These might include facility improvements, providing food after a fire, training courses, etc.

Case 6. Emergency Medical Technicians

Emergency medical technicians would be similar to volunteer firefighters. If they receive any pay from the municipality, they are employees.

Alternatives: The EMTs could incorporate, much as emergency room physicians do. The town then could contract with and pay the corporation. Then the EMT is an employee of the corporation.

Case 7. Contract Workers

You hire some students to clean up a park or some day laborers to cut some trees.

Employees or contractors?

The IRS Public Employee Tax Guide states: "Federal law does not recognize the term 'casual laborer'." The students or day laborers are employees, and you must withhold taxes, pay applicable employer taxes and issue W-2s.

Again, it is a matter of control. If you have the right to control and direct the way the person performs the service, then the worker is an employee. That is, if a worker is subject to the control of the employer not only about what is to be done but how it shall be done, then the worker is an employee. The town does not have to actually exercise that authority; it just has to have the right to do so.

Case 8. City Managers

A city manager retires from work from a particular town. He wants to continue to work in some capacity, and he takes a job as an interim manager.

Employee or contractor?

The tests are the same: behavioral control, financial control and relationships of the parties. The manager is told when to work, where to work and must follow the rules for municipalities as established by the state and federal governments. The manager is an employee. He or she must be issued a W-2. Finance officers working under similar circumstances would be employees also.

While there may be tax advantages under the IRS guidelines for an individual to form a LLC or "S" Corporation to serve as an interim manager or to return to work after retirement; please review the Local Government Employees' Retirement System's return to work guidelines carefully with regards to limitations on annual compensation and annual hours worked. Retirees should consult with LGERS prior to engaging in any work with a participating LGERS unit of government.

Case 9. Municipal Attorney

A recent ruling determined that a county attorney in North Carolina was an employee even though he was a member of a private law firm on retainer to the county. There are other indications that attorneys in private practice on retainer to a local government may be considered employees. If you require your retained attorney to attend council meetings, for example, this time will probably count as employee time.

Here are some steps you may consider if you want your attorney to be classified as an independent contractor.

The town should have an independent contractor working agreement to spell out the duties and responsibilities of the attorney and the town, detailing that the attorney is in business for him/herself.

The contract could specify that legal work could be sent to other attorneys.

The contract could provide that the attorney will attend meetings, except when ill, out of town or on vacation. In those instances, the firm will send another qualified attorney. The idea here is that the town is just another client of the law firm and is treated accordingly.

The attorney should not use the services of any municipal employee unless the attorney's firm is billed for the expense on an agreed-upon hourly fee.

The attorney would pay all his/her own bills. The town could reimburse the attorneys for travel expenses if out-of-town travel of municipal business is required. These would be reimbursed after receipts submitted and under an accountable plan.

Conclusion

The IRS uses a three-part test to determine if a worker is an employee or independent contractor.

You may need to re-examine your designations of independent contractors. Look at each situation with these three factors in mind: behavioral control, financial control and relationship of the parties. Where do most of the circumstances fall? On the side defining employee? Or as an independent contractor? You may find your city or town issues a lot more W-2s once you have completed this examination.

Resource: Alan Weinberg, Duke University School of Law, for NCLM Risk Management Services

The North Carolina Industrial Commission may have a different opinion in determining the status (independent contractor versus employee) of the individual. If the Independent Contractor does not have a Workers' Compensation Policy, the Industrial Commission may consider the Independent Contractor an employee for Workers' Compensation insurance purposes.

Disclaimer: This presentation is intended to provide general information only and should not be construed as legal advice regarding any specific facts and circumstances. Please consult with your attorney when faced with a specific legal problem or question.

NCLM
February 2007

ENTITY: _____

INDEPENDENT CONTRACTOR vs. EMPLOYEE CHECKLIST:

Whenever any public entity retains an independent contractor who does not carry workers' compensation insurance and the owner or an employee of that contractor is injured, a determination must be made as to whether the injured worker is truly an independent contractor or, in fact, is an employee of the public entity and, thereby, eligible for worker's compensation benefits through the entity. The NC Industrial Commission and NC Courts have used the following tests to make this determination. Please complete the information below for each independent contractor that has **NOT** provided you with a Certificate of Insurance for Workers Compensation (proof of Workers' Compensation policy).

Name of Independent Contractor: _____

Type of Work Performed: _____

How many total employees does the contractor employ (excluding owner)?

	Yes	No
--	-----	----

- | | | |
|--|-------|-------|
| (a) Is the person employed engaged in an independent business or occupation? | _____ | _____ |
| (b) Does the person employed have a federal tax ID number? | _____ | _____ |
| (c) Does the person employed perform similar work for any other business? | _____ | _____ |
| (d) Does the person employed have the freedom to use assistants/helpers as he/she may think proper? | _____ | _____ |
| (e) Does the person employed have full control over such assistants/helpers? | _____ | _____ |
| (f) Does the person employed select his own time to perform work?
(for example, your entity does not tell the person to work specific hours during the day) | _____ | _____ |
| (g) Does the person employed have the independent use of his special skill, knowledge, or training in the execution of the work? | _____ | _____ |
| (h) Is the person employed paid for the job in a lump sum amount (not paid by the hour)? | _____ | _____ |
| (i) Does the person employed have the freedom to use their method of doing the work rather than another and is not subject to discharge because they adopt one method over another method? | _____ | _____ |
| (j) Is the person employed furnished tools or equipment owned by you? | _____ | _____ |

None of these factors is controlling, but each is to be considered in determining the relationship between the parties. The essential issue is whether the alleged employer has the right to control the method and means by which the "employee" performs their work. RMS will attempt to determine whether an employment relationship exists for **insurance purposes only**.

Signature of Contractor

Date

Scenarios where coaches, referees, and class instructors will most likely be considered Independent Contractors.

1. The Town uses a booking agent to retain soccer referees and officials. Town staff tells the booking agent the dates, times of the soccer games, and how many referees and officials needed for each game. The booking agent arranges with the referees and officials to show up for the games. The Town does not know in advance what referees or officials are scheduled to work the game. After the game, the booking agent gives the Town a list of the referees and officials who worked the game and the Town pays the individual referees and officials directly (a per-game fee) as an independent contractor. The booking agent is also paid a fee for his services. The booking agent is responsible for training the referees and officials who follow the Soccer Rules and Regulations of the NC High School Athletic Association when officiating the game. The referees and officials also have to supply their own uniforms and equipment used during the games. If the Town is unhappy with a particular referee, the Town would ask the booking agent not to schedule that individual for any future games in the Town.

2. The Town has instructional programs through the Town Community Center. (These include exercise classes, art classes, dance classes, gymnastics, CPR.) The Town allows the instructors for these classes to set the participant fee for the class with the understanding that the instructor gets 60% of the participant's fee, and the Parks and Recreation department gets 40% of the fee. In addition, the instructor gets to select the dates, and the times of the classes as long as the facility is available. Instructors are free to find a substitute for their classes if they are not available to teach. The instructor supplies all materials for the classes and may charge a supply fee to collect material costs from participants. For an exercise class, the instructor may have access to the Town's stereo system or gym mats for use during the class. The class participants pay the Town for the cost of the class, and the Town pays the instructor as an independent contractor the agreed upon per participant rate at the end of the class session. In addition, the instructor can set the minimum and maximum number of participants necessary for the class. Many, although not all, of the instructors also teach the same classes at other community centers or local gyms or studios.

Disclaimer: This presentation is intended to provide general information only and should not be construed as legal advice regarding any specific facts and circumstances. Please consult with your attorney when faced with a specific legal problem or question.

The North Carolina Industrial Commission may have a different opinion in determining the status (independent contractor versus employee) of the individual. If the Independent Contractor does not have a Workers' Compensation Policy, the Industrial Commission may consider the Independent Contractor an employee for Workers' Compensation insurance purposes.