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Independent Contractor vs. Employee

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THE UNIVERSITY of TENNESSEE
MUNICIPAL TECHNICAL ADVISORY SERVICE

In cooperation with the Tennessee Municipal League

TECHNICAL bulletin

March 13, 2008

INDEPENDENT CONTRACTOR vs. EMPLOYEE

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TYPES OF EMPLOYMENT RELATIONSHIPS

All employers hire others to perform services. Some services must be performed routinely whereas others are needed less frequently, perhaps only once. Those hired by the employer to perform routine activities generally are considered to be employees and are paid taxable wages based on a salary or an hourly rate. Other services needed by the employer that occur infrequently generally are performed by contractors. Contractors have more than one employer and typically are paid by the job instead of with wages.

Most employment relationships are clearly identifiable by whether the one hired is an employee of the organization or a contractor. Other times, however, depending on the services needed by the employer, the distinction is not easily defined.

The following discussion is presented to help the employer determine the distinctions between employment relationships.

EMPLOYER/EMPLOYEE RELATIONSHIP

Municipalities offer a variety of services to their citizens relating to public safety, health and welfare. Typically, these activities are labor intensive and require the talents of individuals who have specialized skills and training. Because these services are part of the ongoing mission of the organization, individuals charged with delivering the services are hired as employees of the municipality.

As with any other employer, a municipal government is required to follow Internal Revenue Service guidelines regarding payroll reporting responsibilities. Standard application of payroll tax withholding from employees' gross wages based on the IRS *Publication 15, Circular E, Employer's Tax Guide* must be followed, including routine tax filings and annual reporting of employee wages.

EMPLOYER/INDEPENDENT CONTRACTOR RELATIONSHIP

Situations also occur that require knowledge and skills exceeding the ability of those employed by the city. In these cases, the decision makers of the local government find it necessary to hire on a one-time basis person(s), firm(s), or corporation(s) who are specialists in a specific field of endeavor to solve a problem or provide a service. Since the need is tied specifically to a single event,

there is no need to employ the provider on an ongoing basis. Here, the one providing the service is engaged as an independent contractor under terms defined by a written agreement or contract.

The employment contract between the party requiring the service and the party providing the service defines the nature of what is to be performed and the amount of compensation to be paid to the contractor. If the contractor is not a corporate entity, the IRS requires the municipality to prepare a federal Form 1099 reporting the amount paid to the person or firm providing the service.

EMPLOYEE OR INDEPENDENT CONTRACTOR?

The circumstances mentioned above clearly define the employment relationship between the person or persons needing the service performed and the person or persons delivering the service. Other situations, however, are recurrent, and the employment relationship is more difficult to determine.

It is critical that a city properly classify the employment relationship with those hired to perform services. Improper classification of an employee as an independent contractor may result in the city being held liable for the employee's taxes plus additional penalties.

DETERMINING THE EMPLOYMENT RELATIONSHIP

How can a municipality determine whether the employment relationship between the city and the one hired is that of employer/employee or employer/independent contractor?

The Internal Revenue Service provides guidance to help one hiring the services of another determine the classification of the employment relationship. This guidance can be reduced to the evaluation of three factors or categories of control. These categories are:

1. Behavioral control;
2. Financial control; and
3. Relationship of parties.

BEHAVIORAL CONTROL

Behavioral control relates to the amount of direction and control the one who hires exercises over the one who performs the services. Questions to be answered include:

1. How much instruction is given to the one who performs the service?
2. How much training is provided by the hiring party to the one who performs the service?
3. How much supervision does the hiring party exercise over the one who provides the service?

If the hiring party provides direct supervision, training, and instruction and schedules the time when services are to be performed, the relationship is probably that of employer/employee.

If the one who hires does none or very little of the aforementioned, the relationship is probably that of employer/independent contractor.

FINANCIAL CONTROL

Financial control relates to the financial risk taken by the parties in the relationship. Who of the two is most likely to risk a loss from the employment relationship?

1. Who owns most of the equipment and other assets used in the delivery of the service to be performed?
2. Does the one hired to perform service have other customers for whom similar services are performed?
3. Does the one hired to perform the service have the potential to earn a profit or the risk of loss in delivering the service?

If the one who hires owns most of the equipment used in the delivery of the service, is the only one, or one of a very few, for whom the one hired performs the service, and takes the financial risk of profit or loss associated with the service, the relationship is probably that of employer/employee.

If the one who is hired to perform the service provides the equipment, has many customers for whom similar services are performed, and takes the financial risk of earning a profit or suffering a loss on the venture, the relationship is probably that of employer/independent contractor.

RELATIONSHIP OF THE PARTIES

What is the nature of the relationship between the hiring party and the one who is performing the service?

1. Is there a written contract between the parties specifying the scope of services to be provided, compensation method and length of time?
2. How long is the service to be provided?
3. Does the one who hires the services of another provide benefits for the one who provides the service?

If the hiring party has an expectation that the services needed will be ongoing, pays the one providing the service by the hour or some other routine method, and provides fringe benefits such as health insurance or workers' compensation to the one hired to perform the service, the relationship is probably that of employer/employee.

If the hiring party issues a written contract specifying the scope of services, length of time, and compensation without ongoing fringe benefits such as health insurance and workers' compensation, the relationship is probably that of employer /independent contractor.

ADDITIONAL RESOURCES

IRS Revenue Ruling 87-41

IRS Revenue Ruling 87-41 contains additional material to assist in the determination of the employer/employee relationship. This ruling presents 20 factors for the employer to consider to determine whether a worker is an employee or an independent contractor.

IRS Form SS-8

If you are not confident of making the employment relationship determination based on the information presented here and you prefer to let the IRS make that determination for you, IRS Form SS-8 with instructions for completion is available online at www.irs.gov.

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Resources:

1. Independent Contractor vs. Employees, Internal Revenue Service, online article
2. Publication 15 (Circular E), Employer's Tax Guide, Department of the Treasury, Internal Revenue Service
3. Publication 15-A, Employer's Supplemental Tax Guide (Supplement to Publication 15 (Circular E), Employer's Tax Guide, Department of the Treasury, Internal Revenue Service

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