



GAO Technical Bulletin

Arizona Department of Administration ♦ General Accounting Office

Subject: *Employee vs. Independent Contractor*

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TO: Technical Bulletin Administrators
All Agencies

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AUTHORITY

A.R.S. § 35-131; 41-722; Personnel Rule R2-5-305.C.1; Internal Revenue Code

BACKGROUND

An independent contractor is defined as an individual who contracts to work for others without having the legal status of an employee. By engaging independent contractors, employers can avoid many of the high costs associated with hiring employees, such as paying Federal and State payroll taxes, providing workers' compensation insurance and other benefits. An individual does not qualify as an independent contractor, however, simply by being called one or by the mere existence of an independent contractor's agreement.

To determine whether an individual is an employee or an independent contractor under common law, the relationship between the worker and the business must be examined. All facts that provide evidence concerning the extent of control and the degree of independence must be considered. Such fall into three categories: behavioral control, financial control, and the nature of relationship between the parties. The 20-factor test used by the Internal Revenue Service (IRS), which has historically been used to measure control and independence, is a good example of this.

In accordance with Internal Revenue Code §6672, an employer or responsible individual who willfully fails to withhold employee FICA and Federal income taxes may be held personally liable for both the employer's and employee's portions of the tax, as well as penalties and interest. The IRS concludes that one has acted willfully, and is a responsible individual, if he/she should have known the worker involved was improperly classified as an independent contractor.

POLICY

I. Independent Contractor Criteria

- A. All State agencies must use caution when labeling an individual as an independent contractor rather than as an employee. The State, specifically the hiring agency, will be liable for all back employment taxes if it is determined that an individual was misclassified as an independent contractor. In addition, any individual who willfully prevents the IRS from collecting unpaid payroll taxes may be held personally liable for unpaid portions of both the employer's and the employee's taxes as well as for any penalties and interest imposed by the IRS.

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- B. Prior to engaging an individual, agencies should determine the nature of the working relationship that will be established. According to the IRS, there are 20 characteristics that distinguish an independent contractor from an employee. In general, an individual is an independent contractor if:
1. The individual can earn a profit or suffer a loss as a result of the service being performed.
 2. The individual can choose where to perform the service.
 3. The individual offers services to the general public.
 4. The agency does not have the right to fire the individual. (However, an independent contractor can be terminated in accordance with the agreement.)
 5. Tools and materials necessary for completing the job or performing the service are provided by the individual.
 6. The individual is paid a flat rate and/or submits invoices for payment.
 7. The individual has more than one client.
 8. The individual works on one project and then severs the relationship.
 9. The individual has an investment in the equipment and facilities appropriate for his or her business.
 10. Business and travel expenses are paid by the individual.
 11. The individual is legally obligated to complete the work he/she agreed to do.
 12. The individual decides how to perform the service.
 13. The individual decides in which sequence to perform the service.
 14. Training is not provided for the individual.
 15. The individual is able to hire another person to complete or perform services.
 16. The individual is able to hire, supervise and pay assistants.
 17. The individual is able to set his/her own time; time sheets are not used.
 18. The individual is free to work when and for whom he/she chooses.
 19. Regular oral or written reports are not required from the individual, he/she is only responsible for the end results.
 20. Services performed by the individual are not an integral part of the agency's operations.
- C. If a significant number of these statements are false, the individual in question is likely to be considered an employee for Federal and State income tax purposes, FICA, unemployment insurance, workers' compensation, etc.

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There is no predetermined number of factors necessary to determine whether an individual is an employee or an independent contractor. Each factor should be evaluated to determine an individual's proper classification. **Employer control over a worker, or the mere ability to control a worker, is likely to indicate employee status.**

- D. If, after applying these statements, the individual is deemed an independent contractor, the agency must complete and sign an independent contractor's agreement with the individual. Incorporate the pertinent information from the 20 factor test into the agreement to support the decision and maintain the documentation for review purposes.

Note: This policy also applies to current and former employees hired to do work (off-duty) as an "independent contractor".

- E. All arrangements with independent contractors are subject to applicable State procurement requirements.

II. Dual Employee

- A. When hiring a current (off-duty) employee of another State agency (the employee's primary agency) to perform duties substantially the same as his/her position at the primary agency, the individual is **not** considered an independent contractor for the secondary agency but a dual employee of the State, and must be compensated through the Human Resource Management System (HRMS). This will ensure that all Federal and State payroll taxes, unemployment insurance, applicable overtime, workers' compensation fees, etc., are properly paid.

When the individual is performing other duties for the secondary agency that are not directly related to those duties performed at his/her primary agency, conduct the 20 factor test to determine whether he or she should be classified as an employee or independent contractor.

- B. The HRMS does not permit one employee to be carried on its system in more than one agency. Only the primary agency has access to and the ability to enter information on the employee's time and attendance record. Therefore, in the case of a dual employee, an interagency service agreement should be executed between the primary and secondary agencies. The primary agency shall make all payroll-related payments through the HRMS for the employee. The secondary agency shall then reimburse the primary agency for the regular wages, overtime wages (if any) as well as the costs of any employee-related expenses for the off-duty work. This can be done using an interagency transfer form GAO-514 or GAO-614. Contact your agency's Attorney General representative for more information on interagency service agreements.

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- C. In accordance with Personnel Rule R2-50305.C.1, dual employees working in positions covered by the Fair Labor Standards Act who work in excess of 40 hours (overtime) shall be compensated by either additional pay or compensatory leave -- time and one-half for FLSA non-exempt employees and straight time for FLSA exempt employees. For the FLSA non-exempt employees, the secondary employment agency is responsible for checking with the primary employment agency to determine whether or not the employee actually worked 40 hours during the week. If the employee worked fewer than 40 hours during the work week for the primary agency, the secondary agency will pay the employee at the straight time rate until the combination of hours worked in both agencies reaches a total of 40 hours. As soon as a total of 40 hours have been worked by the employee, the secondary employing agency will pay the employee at the time and one-half rate for all additional hours worked during that same work week.

AREAS IMPACTED

All State agencies, specifically those hiring and paying individuals through the AFIS vendor file rather than dealing with them as employees through the HRMS employee file.

CONTACTS

The determination of whether a person performing services for the State is, in fact, an independent contractor or an employee is exceptionally important. This determination affects not only the taxes withheld and remitted to the State and Federal governments, but also an individual's qualification for and participation in health, welfare, retirement and other benefit programs. Over time, the fiscal impact of this determination may become very significant. In cases of uncertainty, agency personnel should thoroughly discuss matters with their GAO liaisons. If circumstances are such that any doubt remain, agency personnel should also consider referring the matter to the Attorney General's Office for review.