



State of Arizona Accounting Manual

Topic 55 Payroll and Personnel

Issued 07/01/15

Section 06 Employee vs. Independent Contractor

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INTRODUCTION

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. These facts 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 Social Security, Medicare or 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 should have known the worker involved was improperly classified as an independent contractor.

An adverse determination that an agency has categorized an employee as an independent contractor can result in unfavorable financial consequences for the State.

The application of this policy extends to current and former employees hired to do work as in "independent contractor."

POLICIES

1. State agencies must use caution when treating 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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2. Prior to engaging an individual, agencies should determine the nature of the working relationship that will be established. According to the IRS, there are twenty (20) characteristics that distinguish an independent contractor from an employee. In general, an individual is an independent contractor if the individual:
 - 2.1. Can earn a profit or suffer a loss as a result of the service being performed.
 - 2.2. Can choose where to perform the service.
 - 2.3. Offers services to the general public.
 - 2.4. Cannot be fired by the agency. (However, an agreement with an independent contractor can be terminated in accordance with the governing contract.)
 - 2.5. Provides at his own expense the tools and materials necessary for completing the job or performing the service.
 - 2.6. Is paid a flat rate and/or submits invoices for payment.
 - 2.7. Has more than one client or customer.
 - 2.8. Works on one project and then severs the relationship.
 - 2.9. Has an investment in the equipment and facilities appropriate for his business.
 - 2.10. Pays his own business and travel expenses.
 - 2.11. Is legally obligated to complete the work he agreed to do.
 - 2.12. Decides how to perform the service.
 - 2.13. Determines in which order to perform tasks comprising the service.
 - 2.14. Is not provided training.
 - 2.15. Is able to hire another person to complete or perform services.
 - 2.16. Is able to hire, supervise and pay assistants.
 - 2.17. Is able to set his own hours for the performance of the work.
 - 2.18. Is free to work when and for whom he chooses.
 - 2.19. Is not required to submit regular oral or written reports and is responsible only for the end results.
 - 2.20. Performs services that are not an integral part of the agency's operations.

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3. If a significant number of the above characteristics are not met, the individual in question is likely to be considered an employee for Federal and State income tax purposes, Social Security, Medicare, unemployment insurance, workers' compensation, etc.
4. There is no predetermined number of characteristics necessary to decide whether an individual is an employee or an independent contractor. Each characteristic 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.
5. If, after considering the preceding characteristics:
 - 5.1. The individual is deemed to be an independent contractor, the agency must complete and sign an independent contractor's agreement with the individual. Incorporate the pertinent information from the twenty (20) factor test into the agreement to support the decision and maintain the documentation for review purposes.
 - 5.2. If the nature of the working arrangement remains unclear, the agency should consult with ADOA GAO, HRD or SPO for guidance.
6. Any individual who provides service to the State who is an employee of another entity that is, itself, an independent contractor or a personnel leasing company are not State employees.
7. All arrangements with independent contractors are subject to applicable State procurement requirements.
8. If a current employee of a State agency (the employee's primary agency) is hired by another State agency (the employee's secondary agency) to perform duties substantially the same as his position at the primary agency, the individual is generally not considered an independent contractor for the secondary agency but an employee of both agencies and must be compensated through HRIS. This will ensure that all Federal and State payroll taxes, unemployment insurance, applicable overtime, workers' compensation fees, etc., are properly paid.