INTRODUCTION

Properly classifying workers as employers or independent contractors has serious financial implications. When a worker is classified as an employee, the employer is responsible for paying collecting, remitting and paying Federal and State payroll taxes, providing workers’ compensation insurance and other benefits.

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 costs associated with hiring employees.

It must be noted, however, that an individual does not qualify as an independent contractor simply by being called one or by the mere existence of an independent contractor’s agreement. Also to be recognized is the fact that Federal laws and the determination of those Federal agencies whose mission it is to enforce those laws will generally prevail over state or local laws.

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. Historically, a 20-factor test (informally expanded by the contents of Federal Form SS-8) has been used by the Internal Revenue Service (IRS) to measure control and independence. Additionally, the application of the economic reality test, discussed in SAAM 9051, is a valuable tool in evaluating the nature of the relationship between a service provider and the State.

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 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 significant unfavorable financial consequences for the State. Determinations, adverse or otherwise, as to worker status are made by the IRS, the Social Security Administration, the U.S. Department of Labor and/or certain state and local authorities involved with taxation or employment.
This section of SAAM is one of several, including SAAM 9051 and 9052, dealing with individuals who are not employees of the State, but who, nonetheless, do perform services for the State. To gain the best understanding of this subject matter, it might be of value to read these three related SAAM sections in numerical order.

The distinction between an independent contractor, as discussed herein, and a temporary worker, which is the focus of SAAM 9052, is not always clear. Often the difference is one of intent at the time of engagement: a temporary worker, as the name implies, is engaged for what is anticipated to be a relatively brief period of time. Moreover, a temporary worker is often engaged in activities normally performed by an employee under the same conditions and degree of oversight that would apply to an employee.

A worker who is truly an independent contractor provides services not normally provided by employees and who has a degree of control over his engagement and work environment that a temporary worker frequently does not.

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 may nonetheless be considered by the IRS, the Social Security Administration or the U.S. DOL to be a State employee, as well, in what is known as a “joint employment relationship.” Such a determination may result in the agency becoming liable for any unpaid employment taxes due with respect to the worker.

The application of this policy extends to former employees engaged to do work as an “independent contractor.” When a former employee, such as a retiree, is engaged as a “contractor” to do substantially the same work as he did when he was an employee, his actual status would likely be that of employee; treating him as other than an employee exposes the State, the engaging agency and that agency’s management to an adverse determination and its consequences as described in SAAM 9051.

**POLICIES**

1. State agencies must use caution when treating an individual as an independent contractor rather than as an employee. The State, specifically the engaging 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.

2. Prior to engaging an individual, agencies should determine the nature of the working relationship that will be established. Generally, one who performs work for the State is an employee when the State has the right to control how a task is to be performed. Factors that indicate that an individual may be an independent contractor include that he:

   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 and receives payments at intervals and in time frames consistent with those applicable to other vendors, rather than those applicable to employees.

2.7. Has more than one client or customer. (See SAAM 9051 for a discussion of the “economic realities” test.)

2.8. Works on one time-limited project and then severs the relationship. (This does not prohibit re-engagement of the contractor to work on a different, preferably unrelated, time-limited project.)

2.8.1. Projects should be well-defined as to objectives, duration, scope and indices of completion.

2.8.1.1. The engagement of an independent contractor or should only exceed two (2) years when he is working on a multiple-year project that has a definite and identifiable completion date or event that will be realized after the normal two-(2-) year limit.

2.8.1.2. To ensure compliance with the two- (2-) year or project completion limit, agency management must review the status of independent contractors every six (6) months. Documentation of these reviews and their conclusions are to be retained in accordance with LAPR’s retention schedule for accounting records. (See SAAM 9052 for additional details.)

2.9. Has an investment in the equipment and facilities appropriate for his business.

2.10. Pays his own business and travel expenses. (This does not prohibit entering into a contract that calls for the reimbursement of such expenses when directly attributable to a given project.)

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 of a general nature; any instruction provided must be limited to that involving highly proprietary systems or operations.

2.14.1. By way of example, it might be necessary and proper to familiarize an independent contractor with a proprietary accounting system, but it would be improper to teach an independent contractor the programming language in which the accounting system is written or to train him in a publicly available or off-the-shelf accounting system.

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. Provides skills or a level of expertise not continuously required by the agency.

2.20. Performs services that are not an integral part of the agency’s operations.

2.21. Did not perform services for the State as an employee before being engaged as an independent contractor.

2.22. Is assigned projects and project goals, but not specific daily tasks, by the State. Generally, such projects and goals will be specified in writing and will, if necessary, require an amendment to the contract under which the services are provided.

2.23. Is not required to attend—and is generally excluded from—employee meetings if those meetings primarily deal with matters other than the project being undertaken by the contractor.

2.24. Does not receive any benefits from the State that are provided for its employees. Such benefits include, but might not be limited to: paid annual and sick leave; paid holidays; retirement; insurance; bus and light rail subsidies; etc.

2.25. Does not represent himself to be and is not represented to be an employee of the State. Such representation includes how the contractor is introduced to others, how the contractor is identified on business cards, etc.

2.26. Obtained the contract under which services are provided in a manner consistent with those prescribed by SPO.

2.27. Is not paid, directly or indirectly, an overtime premium by the State for hours worked in excess of forty (40) per week.

2.28. Does not participate in certain events or take advantage of offers intended specifically for employees. Such events would include, but not necessarily be
limited to, employee recognition events, holiday parties, years-of-service and retirement celebrations. Such offers would include, but not necessarily be limited to, employee discount programs.

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 taken into account when determining an individual’s proper classification.

5. If, after considering the preceding characteristics:

5.1. The individual is deemed to be an independent contractor, the individual must complete and sign a declaration of independent business status as defined in A.R.S. § 23-1601. The agency must retain an originally signed copy of this declaration for a period consistent with that prescribed by LAPR for accounting records.

5.2. If the nature of the working arrangement remains unclear, the agency should consult with the relevant divisions of ADOA—GAO, HRD or SPO—or the OAG for guidance.

6. All arrangements with independent contractors are subject to applicable State procurement requirements. Agencies should consult ADOA SPO for guidance in procurement matters.

7. 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. See SAAM 5507 for additional information about employment at multiple agencies.