



State of Arizona Accounting Manual

Topic 90 Special Topics

Issued 08/27/18

Section 52 Contractors: Considerations and Concerns

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INTRODUCTION

This section of SAAM expands upon and complements, but does not replace, SAAM Sections 9050 and 9052. To gain the best understanding of this subject matter, it might be of value to read these three related SAAM sections in numerical order.

Among the purposes of this section of SAAM is to highlight some of the consequences that may befall an employer in the event that the U.S. Department of Labor (USDOL) determines a worker, who has been treated as an independent contractor or temporary worker, should have been treated as an employee.

The format of this section of SAAM is somewhat different from most other sections of SAAM due to its informative, rather than directive, nature. All those involved with hiring employees and engaging the services of independent contractors or temporary workers should familiarize themselves with the contents of this section of SAAM, as well as SAAM Sections 9050 and 9051. Of particular note is the example of the historical and ongoing practice of “grossing up” compensation as carried out by the USDOL, the Internal Revenue Service (IRS) and/or the Social Security Administration (SSA) when one of these organizations reclassifies a worker from independent contractor or temporary worker to employee.

In the discussion that follows, the term “contractor” extends to an “independent contractor,” as discussed in SAAM 9050 and a “temporary worker,” as discussed in SAAM 9051. The term “principal” is used for the entity that receives the benefit of the contractor’s services.

DISCUSSION

Preliminary remarks.

At any moment, a number of contractors may find themselves engaged by the State of Arizona. In many cases, these individuals should and could not be considered “employees.” This is particularly so when the services of such individuals are acquired through contracts with commercial enterprises in the business of providing numbers of contractors to an array of customers or by engaging an individual for a single set of relatively well defined, self-contained, short-term projects. The use of contractors may, irrespective of any other determinations, obligate the principal to pay Alternate Contributions as described in SAAM 5545.

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An agency might find it convenient to temporarily engage, as a contractor, the services of a specific individual, perhaps a retiree with specialized knowledge or someone with requisite technical skills, on what evolves into a fairly permanent or indeterminate basis. Over time, moreover, this individual's role can become a more and more integral to the agency's operation. In the opinion of the USDOL and other Federal and State agencies, this individual, under common law, is or may ultimately be determined to be an "employee." In such cases, the recipient of the services, the principal, may find itself designated, depending upon the circumstances, as the contractor's "employer" or "co-employer" and liable for unpaid payroll taxes.

The determination that an individual who has been treated as contractor should have been treated as an employee is much more than a mere technicality—it is an adverse determination that results in substantial costs to the entity determined to be the employer or co-employer.

Reasons for engaging an contractor.

There are a number of reasons to have business services provided or performed by one who is not an employee. As discussed below, some of these reasons are wholly appropriate and necessary; others are not.

Appropriate reasons for engaging the services of a contractor.

An appropriate reason for engaging the services of a contractor is most often characterized by one or more of the following conditions, constraints or circumstances:

- The contractor is engaged for a relatively short period of time. It is understood and accepted by all parties to the arrangement that the engagement is not ongoing or indefinite in nature. These types of engagements last from a few days up to as long as two years. Longer arrangements such as these indicate that an employment situation may exist. (See SAAM Sections 9050 and 9051.)
- The project for which the contractor is engaged has a very specific and identifiable deliverable, such as the development or construction, but not the ongoing maintenance, of a website or a bridge.
- An immediate and largely unanticipated need arises for highly specialized expertise that cannot be filled by currently employed personnel. (If the need becomes ongoing or permanent and is not intermittent in nature, then the relationship is to be evaluated to determine whether the worker should be correctly treated as a contractor or an employee.)
- The departure of an employee necessitates that a contractor be engaged to perform certain tasks until an employee can be hired to undertake the work.

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- The undertaking for which the contractor is engaged is somewhat peripheral to the engaging entity's operations and has not typically been performed by employees in the past. Activities that are integral to an entity's operations or that have historically been accomplished by employees should generally be performed and/or continue to be performed by employees.

Inappropriate reasons for treating an employee as a contractor.

Entities engage contractors for a number of reasons that, at best, may be characterized as inappropriate. Such inappropriate reasons include, but may not be limited to:

- Evading the withholding of and especially the payment of payroll taxes, such as Social Security and Medicare taxes as well as Federal and state unemployment taxes.
- Attempting to avoid contributing to employee benefit programs such as retirement and medical insurance.
- Overcoming certain administrative restrictions, such as a hiring freeze or limitations imposed on headcount.
- Circumventing personnel rules and limitations placed on pay grades or classifications.
- Avoiding the payment of overtime premiums for weekly work that exceeds forty hours.
- Evading the payment of a legally established minimum hourly wage.

The "economic realities" test.

When determining whether an individual (i.e., not a person who is an employee of a service provider) providing service to the State is properly categorized as an employee or a contractor, the "economic realities" test should be applied in addition to the criteria set forth in SAAM 9050 or other considerations contained in SAAM 9051. The economic realities test focuses on whether the worker is economically dependent on the State (and thus the State's employee) or is in business for himself (and, thus, in fact, a contractor). The following six (6) factors are used in determining whether an individual has sufficient economic independence to be considered a contractor or is so economically dependent on the State that he must be treated as an employee.

1. The extent to which the work performed is integral to the employer's business. An important factor taken into consideration here is whether work once performed by an employee is now performed by a contractor. If so, the worker should be categorized as an employee.

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2. The extent to which the worker's managerial skills affect his opportunity for profit or loss. This involves the worker's business decisions to hire others, purchase materials, advertise, and manage finances that affect his opportunity for profit or loss beyond the current job. The ability to work more or fewer hours on the current job is not a managerial skill in this context.
3. The relative investments in facilities and equipment by the worker and the entity for which or whom he works. If the worker's investment is relatively minor, this will weigh in favor of the individual being an employee rather than a contractor.
4. The worker's business skills, judgment and initiative. This factor relates to the worker's business acumen in operating an independent business. The lower these skills, the less likely the individual is, in fact, a contractor. Technical skills are not considered relevant.
5. The permanency of the worker's relationship with the State. Unless the worker is engaged for a limited period or a set number of projects, his status is likely to be that of employee. See SAAM Sections 9050 and 9051.
6. The nature and degree of control exercised by the State over his work. A changing work environment—telework, flexible schedules, etc.—has changed the character of control. Because of this, while aspects of control will continue to be taken into account, this factor may no longer be the most important factor in the analysis. With respect to contractors, the nature and degree of control, however, are factors that help to distinguish an independent contractor from a temporary worker. See SAAM Sections 9050 and 9051.

While the objective of the economic realities test is to ascertain whether the individual under consideration is economically dependent upon the entity for which he works, the six factors appear to approach the matter indirectly by determining whether the individual is economically independent from the principal.

Adverse determinations.

The primary outcome of a finding that a worker who has been treated as a contractor should have been treated as an employee—an adverse determination—is that various Federal and State authorities will retroactively treat the individual as an employee, possibly going back to the start of the business relationship.

One of the results of an adverse determination is that all the money paid to an individual will be treated as his net pay. The process of restating the worker's earnings is known as "grossing up" and is best illustrated by an example.

A worker who had been treated as an independent contractor was paid \$1,000.00 a week. The USDOL, after its investigation and applying the economic realities test, determined that the worker is actually an employee and should have been treated as such. The weekly compensation grossed up for taxes, long-term disability and pension is shown in the table that follows. The example uses the rates in effect for 2005 and assuming the employee elected single marital tax status and no

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dependents for withholding. (While the passage of time will certainly result in fluctuations of the amounts shown in this example, the principles behind “grossing up” are likely to remain essentially unchanged.)

So, in addition to the \$1,000.00 net that was already paid for the week’s work, an additional \$675.14, representing the employee’s taxes, long-term disability and retirement contribution that would and should have been withheld from the employee, must now be paid by the employer. The employer must also pay the employer’s share of what would have been due, in the amount of \$320.28, representing the employer’s share of Social Security and Medicare Taxes, retirement contribution and long-term disability. Additionally, unemployment taxes as well as workmen’s compensation premiums become due on the newly grossed up gross pay. Moreover, stiff penalties and interest are charged for the employer’s failure to properly report, withhold and remit the various taxes when due.

Grossed Up Employee Gross Pay	\$1,675.14
Less Withheld Items Listed Below:	
Federal Withholding Tax	279.12
State Withholding Tax	75.74
Social Security Tax	103.86
Medicare Tax	24.29
Long-term Disability	2.01
Arizona State Retirement System	190.13
Original Contractor Payment / Grossed Up Employee Net Pay	\$1,000.00
Employee’s Share of Withheld Items to Be Paid by Employer	\$675.14
Employer’s Share of Employment Taxes, Long-term Disability and Retirement	\$320.28

This example deals with a single week’s pay to a single wrongly categorized worker. A payment of \$1,000.00 that was made some time ago, suddenly incurs additional liabilities of \$995.42, essentially doubling the originally contemplated outlay. Consider the impact when this practice covers several weeks, several months or several years and applies to more than one worker.

The above example, as costly as it becomes to the employer, does not include additional liabilities related to employee benefits, such as, annual leave, sick leave, holiday pay, insurance coverage, etc., all of which may be due to the employee and will be paid by the employer. Nor does it include substantial penalties and interest that may be assessed against the employer. Other risks to the employer include possible retroactive disqualifications of employee benefit plans, which may result in litigation from other negatively affected employees.

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Common investigation initiators.

A number of events can lead to the initiation of an investigation of the status of a contractor, among these are:

- The services of a contractor are no longer required. He attempts to qualify for and collect unemployment benefits, which he is denied. He asserts that he should have been treated as an employee.
- Tips to the USDOL, the IRS, the SSA, or another governmental agency are made for the purpose of collecting a reward.
- An individual, working under the guise of contractor for years, or his beneficiary applies for retirement or life insurance benefits. Being denied such benefits, a claim of employment is made.
- The contractor is the victim of an accident or disease. He does not have hospitalization insurance. Facing mounting medical bills, he asserts that he misunderstood his relationship with the entity for whom he worked, was actually an employee and should have been provided health insurance by his employer.
- The contractor prepares his income tax return. He discovers that he owes significant amounts of income and self-employment taxes which he cannot pay. He asserts that he should have been treated as an employee and had his taxes withheld.
- The services of a long-serving contractor are no longer required. He understands he should have been dealt with as an employee. Out of revenge, he reports the conditions of his working relationship to the appropriate authorities.
- The contractor is hurt on the job and files a worker's compensation claim; the claim is denied since the individual was not an employee.
- A contractor is determined to be jointly employed or co-employed by the service provider and the principal, i.e., the service consumer. The service provider fails to pay all required employment taxes; the principal is held liable for the balance.
- An investigation can result from nothing more than a random selection by the investigating authority.

Even when these events involve a single individual, they often lead to an investigation of all those who are working in similar capacities for the organization. In the majority of these cases, the USDOL, the IRS and/or the SSA determines that many, most or all those claimed to have been contractors were in actuality employees; the courts have generally supported these adverse determinations.

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Employers have literally been put out of business by the costs of an adverse determination.

Miscellaneous considerations.

The correct way to avoid adverse determinations is to appropriately treat employees as employees and contractors as contractors. In part, that can be accomplished by making sure all those who hire employees or engage contractors are familiar with SAAM Sections 9050, 9051 and 9052 and comply with the provisions of these policy statements. It is also important that agencies consistently deal with contractors differently than they do with employees.

Appropriate treatment of contractors.

- Contractors must not be issued business cards that identify them as employees of the State of Arizona. If, for dealing with the public, it is necessary to issue a contractor some form of State of Arizona identification, that identification should clearly articulate that the carrier is a not an employee of the State of Arizona.
- A valid written State contract should be in place with, as may be appropriate, any individual acting in the capacity of contractor or the company employing the contractor.
- Agencies should not directly pay the expenses, such as travel, of contractors. The State has a contract with a worker's employer, not the worker himself. The worker's employer should bill the State and the State pay the worker's employer.
- Contractors should, except in the rarest and briefest of cases, not directly manage or supervise employees. While a contractor may provide consultation and technical direction, he should not hire or fire State employees or prepare their employee evaluations.
- Contractors should not be given awards of the type normally given to employees for such things as performance or length of service. Such recognition activities are matters between the contractor and his employer, if any.
- Contractors should not be included or allowed to participate in State-sponsored events, such as employee recognition events, designed for employees of the State.
- Contractors should generally not be issued email accounts associating them with the State. If, for the benefit of the State, they must have a secure email managed by the State, all emails sent by contractors should clearly and consistently identify them as contractors.

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- As established in SAAM 0540, a contractor, vendor or temporary worker must not be granted a role in any statewide automated system that can result in the disbursement or transfer of State monies.