


**NORTH CAROLINA  
PRIVATE PROTECTIVE SERVICES BOARD**

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TO: Members of the Private Protective Services Board

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RE: Employee v. Independent Contractor

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On occasion, licensees have claimed that they are not responsible for the conduct of certain individuals because they are not an "employee," but an "independent contractor." The Board has asked for guidance on how to best determine whether the individual is an employee of the licensee or an independent contractor. Although this question is more specifically an issue of the common law theory of agency, it most often arises in the area of tax liability.

The IRS has, through the years, addressed this issue frequently and the IRS guidelines have become a universally accepted standard for making this determination. These same individuals are often times referred to as "W-2 workers" v. "1099 workers," a reference to the IRS form used by a business to report a worker's income.

The IRS has given guidelines to its agents, as well as businesses, to help determine worker status. In the past, a list of 20 factors compiled by the IRS had been used in court decisions to determine worker status. The list, sometimes called the "20-factor test," is still used as an analytical tool, although some of the factors are no longer as relevant as they once were. More recently, agents are directed to focus on the overall situation rather than to emphasize one or two of the 20 factors. These 20 factors are as follows:

1. Does the business require the worker to follow their instructions on how work is to be performed? If yes, this indicates employee status. An independent contractor will generally decide how the project should be completed and use his own methodology.
2. Does the business provide training to the worker? If you're hiring a person for a job they are not trained for and providing them with the training to carry it out, that person is probably an employee. There can be exceptions based on the facts and circumstances, but if you fail this test, you might lose no matter how many of the others you pass.

3. Are the worker's services a substantial or integral part of the business? This indicates employee status because it indicates the business maintains direction and control over the worker.
4. Does the business require the worker to perform all services personally? Independent contractors may have their own employees or at least should have the option of hiring other contractors to perform their work. Agreements for personal services indicate employee status.
5. Does the business hire, supervise and pay the worker's assistants? If so, this is a strong indication of employee status.
6. Does the business have an ongoing relationship with the worker? This one is a stretch since many businesses maintain lifelong relationships with contractors whose work they like. But the IRS views this as an indication of employee status.
7. Does the business set the worker's schedule and hours? Independent contractors generally set their own work schedules. If the contractor must work certain hours because of required interrelationships with your employees or to take advantage of down time for computer-related work, document these facts.
8. Does the business require the worker full-time? This is an indication of employee status because the business controls their availability and prevents them from working on other clients.
9. Does the business provide the workspace? Contractors who work off-site are more likely to be classified an independent contractor.
10. Does the business determine the order or sequence in which work is completed? Indicates employee status. If specific schedules are required, document them in the contract with the reasoning for doing so.
11. Does the business require oral or written reports? The IRS believes regular written or oral reports detailing the work completed indicates employee status. In reality, this is, and should be, expected from independent contractors as well.
12. Does the business pay by the hour, week or month? This indicates employee status.
13. Does the business pay expenses? This is an indication that the business is directing the Independent contractor's business activities.
14. Does the business provide tools and equipment for the worker? Independent contractors would normally provide their own tools and equipment.

15. Does the worker have a significant investment in their own facilities? If the contractor maintains his own office space, computer equipment, tools, etc., this is a good indication that they are an independent contractor.
16. Does the worker have profits and losses independent of the business? This is an indication that the contractor is running his own bona fide business and is an independent contractor.
17. Does the worker have multiple clients? Working with multiple clients generally indicates independent contractor status.
18. Does the worker market their services to the general public? Employees do not generally market their services to the general public.
19. Does the business have the right to discharge the worker at any time? This suggests employee status. An independent contractor would only be discharged for failure to meet contract specifications.
20. Does the worker have the right to quit at any time? An independent contractor is under contract and cannot quit until the project is completed

As mentioned above, the determination of whether a worker is an employee or an independent contractor is based on common law rules, which look at the relationship of the worker and the business, taking into consideration all evidence of control and independence.

The determination of worker status depends primarily on the extent to which the person receiving the services has the right to direct and control the service provider on what is to be done and how it is to be done. An employer generally has the right to control how an employee performs a service. In contrast, independent contractors determine for themselves how the work is to be performed.

Courts consider many factors in determining worker status. These factors fall into three main categories: behavioral control, financial control, and relationship of the parties. These factors are used in connection with IRS audits concerning worker status. Not all factors need to be present in any given situation, and no single factor is controlling.

### **Behavioral Control**

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

- *Instructions the business gives the worker.* An employee is generally subject to the business's instructions about when, where, and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved.

- *Training the business gives the worker.* An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

## Financial Control

Facts that show whether the business has a right to control the business aspects of the worker's job include, but are not limited to:

- *The extent to which the worker has unreimbursed business expenses.* Independent contractors are more likely to have unreimbursed expenses than employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform where they work.
- *The extent of the worker's investment.* An independent contractor often has a significant investment in the facilities or equipment he or she uses in performing services for someone else. However, a significant investment is not required.
- *The extent to which the worker can realize a profit or incur a loss.* An independent contractor can make a profit or loss.

## Type of Relationship

Facts that show the type of relationship between parties include, but are not limited to:

- *Written contracts describing the relationship the parties intended to create.*
- *Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.*

Intentionally misclassifying employees as independent contractors may result in penalties plus interest by the IRS. The exposure for unintentional misclassification of an employee is serious, but not as serious as the risk for an intentional misclassification. \*

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\* If the employer filed a Form 1099, unintentionally misclassifying an employee, the employer's liability for federal income tax withholding is limited to 1.5% of the employee's wages. The employer's liability for FICA taxes would be 20% of the employee's share, plus the entire amount owed by the employer, and the employer would have no rights to recover from the employee what is due to the IRS. If an employer has not filed any information returns that were required, such as the Form 1099, the percentage amounts are doubled. The employer must pay 3% for federal income tax withholding and 40% of the employee's portion of FICA in addition to the employer's share of FICA.

Additionally, the employer would still be liable for unemployment taxes and interest and penalties could be assessed by the IRS (but only on the amount of the employer's liability.) The employer's liability includes the percentage of tax that should have been withheld. For example, interest for failure to collect FICA would be based on the employer's share of FICA plus the 20% of the tax that should have been withheld from the employee. Intentionally misclassifying an employee could result in the following employer liabilities: the full amount of income tax that should have been withheld (with an adjustment if the employee has paid or does pay part of the tax); the full amount of both the employer and employee shares for FICA (but might receive an offset if the employee paid FICA self-employment taxes); and interest and penalties, computed on far larger amounts than in the case of an unintentional misclassification. In addition to the back taxes, criminal and civil penalties may be issued.

The most conservative approach is to classify the worker as an employee. The hiring firm has the burden of proving a worker is an independent contractor.

The IRS uses the guidelines above, as well as the 20-factor test to determine proper classification, but will also look to a written contract for independent contractor classification. Any such contract would generally set forth the terms of the relationship between the employer and the individual, and may include:

- A statement that the independent contractor is not entitled to employee benefits programs;
- A joint severability clause stating that if part of the contract is struck down, the rest of it survives; and/or
- Acknowledgment that the independent contractor is free to work elsewhere at any time.

The Board can easily do the same thing, and the Investigator can request a copy of the contract if the licensee claims the worker is an independent contractor. A contract between the employer and the worker may still be immaterial, however, depending on the facts and circumstances of the case.

The bottom line is: If the licensee has the right to control or direct not only what is to be done, but also how it is done, then the worker is likely an **employee**.