

Employee Versus Independent Contractor

by Lloyd Rain

How often has this happened to you?

A purchase order for a \$50 stipend to a violinist crosses your desk. You know the payee is an employee of your institution but she teaches biology; the payment is for a luncheon concert she gave at the Student Union. No problem here. You process with PO without further thought.

Or...

A purchase order for \$2,000 to an individual who moonlights as a graphic artist crosses your desk. You cross check your employment roster (as we all do when we see individual payees — right?) and you discover that the payee is an employee of your institution. Nevertheless, you process the PO because you ascertain that the employee is a draftsman in the Facilities Department and the payment is for the design of the cover for next semester's Class Schedule. No connection to the person's full time job at all. No problem.

Or...

The President's receptionist gives a weekend course each year in archery for the Continuing Education Department. And of course, you pay her by PO, as an independent contractor because there couldn't possibly be any connection between her desk job and the teaching of bows and arrows. No conflict here.

Or...

One of your Social Science professors works regularly as a part-time comedian in clubs around the city. Your Staff Development Department has hired the person to provide three skits for In-Service. You argue that the employee should be paid from salary but the department chair says that the comedian simply won't do the job if he's not paid as an independent contractor. You acquiesce and process the PO. After all, shouldn't the professor be allowed to have a money-making avocation without being prejudiced by the fact that he makes his primary living teaching for the institution?

This stuff happens to me almost every day. And I deny them all.

In each case, you have an employee who wants to be paid as an independent contractor. Well, doesn't everyone? After all, as an independent contractor the provider gets **all** the money. No deductions, no withholding taxes and no social security payments. Who wouldn't want that?

The answer is, as the purchasing person for your institution, you wouldn't — because, if you process any of the orders outlined above, you might as well phone the IRS tell it that you've broken the law and you want your institution to be penalized right away. Additionally, you can tell the IRS that you want to be held personally liable for the withholding taxes which were not paid by the independent contractor.

As we process purchase requisitions formulated by college and university employees, we are regularly called upon to make determinations on the qualifications of various service providers to be independent contractors. Classification as an independent contractor can be based upon the IRS 20-point test (although it is somewhat superficial) but must be made by the institution at the time of purchase.

Dilemmas regarding employees selling services arise in three areas.

First, all employees who perform tasks unrelated to their primary jobs are of continuing concern when they demand independent contractor status for their avocation. This can place the institution and the processor at risk for taxes owed to the IRS, for liability when the employee is performing the secondary function and for financial support if the employee is injured while performing the secondary function.

Second, if we, the purchasing people, refuse to permit the proposed independent contractor status to employees, the hiring administrators will have to issue additional paperwork to pay those employees and those staffers can get downright snarky when they have to take time out from their busy schedules to push five times the paperwork that a simple PO could have accomplished.

Third, the employees can get quite belligerent when they discover that federal and state taxes, FICA, retirement contributions and other deductions are going to be withheld from the anticipated earnings. Some even demand more pay to account for the deductions — which they perceive as a loss!

In all three scenarios, we, the purchasing folk making the restrictive determinations, are the offending parties. Unfortunately, there is little doubt that disallowing employees to be independent contractors in any capacity is the right and appropriate posture.

The issue is, can an employee also be an independent contractor regardless of the relationship of his/her primary duties to the independent contractor function?

The primary law on this issue is IRS Revenue Ruling 87-41; 87-1 CB 296. This is the source of the **20 point checklist**, as well as other significant principles the IRS uses in determining whether a person is an employee or a contractor. Of over thirty cases in which the US Tax Court, US District Courts, the US Courts of Appeals and the US Supreme Court have issued opinions based upon Revenue Rule 87-41, there is not a single case where a taxpayer has successfully argued that a person can be an employee and a contractor concurrently for the same employer.

One key IRS principle, **degree of control**, is used for most determinations. The courts rely on establishing the **degree of potential control** the business or institution has over the contractor. *Whether the control is actually exercised, is irrelevant.*

If the institution retains the **legal right** to use the behavior of a service provider as the basis for affecting that person's employee status, then the institution is continuing the employment relationship, and not engaging an independent contractor.

Consider the case of the comedian. He is a Social Science professor being retained by the Staff Development group to provide what are essentially theatrical performances.

While performing as an "independent contractor," he consumes copious amounts of alcohol backstage on university property and, in his stupor, assaults a student.

If he were purely an independent contractor, he would be given the bum's rush off the premises, never to be heard from again and the administration would hold its breath hoping that no lawsuits would be filed. But here, the perpetrator is an employee. Now there are issues of liability insurance, union grievances, job fitness, performance evaluations, protests to Boards of Regents or other governing boards, and so on.

And then the ultimate question: Does the institution **have the right** to consider the contractor's backstage behavior as the basis for employee discipline, perhaps including termination of employment? (At my school consumption of alcohol on college premises, except during authorized and licensed functions, is an offense which calls for termination.)

If the answer is "yes," and it unquestionably is, the institution is clearly maintaining its control as employer while the professor was engaged as a contractor. Only one relationship, that of employer/employee actually exists — the employee is merely filling two job positions. Remember, whether or not the control was actually exercised is irrelevant. The **right to control** is undeniable.

Conversely, in order for the institution to contend that it does not have an employer's control over a contractor who is also an employee, the institution would have to assert, before the "contracted" services are performed, that it surrenders all rights it might have to use the service provider's behavior, no matter how grossly outrageous or even criminal that behavior might be, as a basis for terminating the person's employment.

Authority to terminate is the ultimate legal test. The courts, including the US Supreme Court, have consistently ruled that an employment relationship can not be converted to a contractor relationship even by the free consent of both parties. The nature of the relationship is a matter defined by law, not an issue subject to negotiation within a contract.

Thus, the biology professor must be paid as an employee for his performance of the skits, even though that may mean overtime pay, additional withholding for taxes, retirement and social security contributions, insurance coverage, and a cloud of other paperwork.

There are other issues involved when an employee takes on a second function.

Consider the case of the President's receptionist who teaches archery on the side as an independent contractor. If she injures her wrist while teaching archery for the institution, is the injury covered by the institution's worker's compensation insurance or would the injury be treated as an accident — like stubbing her toe getting out of bed? If the archery instructor is considered to be a "contractor" when injured, the institution would have to deny worker's compensation coverage. Would the employee accept that determination or would she resort to litigation to obtain coverage? Both denial of coverage and acceptance of the denial are highly unlikely.

Or, worse yet, what if an arrow, shot by the instructor, ricochets from the side of a target and strikes a student. There is no way the institution is going to deny liability because

the instructor was an independent contractor. There is no way the institution's insurer is going to deny coverage on the basis of the an arm's length relationship of the instructor.

There is no court in the land which would make a determination that the instructor was personally liable and hold the institution harmless on the basis that the instructor was an independent contractor. OSHA, worker's comp, general insurance, and all manner of secondary policies and procedures would immediately come to the aid of the victim at the expense of the institution, completely irrespective of the status of the instructor. As a result of those processes, her status as an employee would be unquestionably affirmed.

In the final analysis, the archery instructor is clearly an institutional employee and must be paid as such for both primary and secondary occupations.

And so must draftspersons designing covers for class schedules, music instructors being paid as after-hour performers, landscapers doubling as part-time mechanics, security officers teaching courses in gun safety and motorcycle riding, computer science professors doing contract programming, and on and on and on.

In every case outlined above, independent contractor status must be denied in favor of regular employment.

And what if it isn't? At a minimum, the institution will be exposed to three years' back taxes for FICA, state and federal unemployment and income taxes, and penalties of up to 25% per year for failure to file a return, and up to 10% for failure to pay the tax — and then interest on all the above.

It is also possible that independent contractor permissiveness could adversely affect worker's compensation insurance premiums (if the institution is, in effect, under-reporting the covered workload). Thus, premiums could be increased, back-premiums charged and loss rates affected. Then, of course, there's the political consequences of violating federal tax law as these incidents get reported in the newspaper, to the Board of Regents, the Alumni Association, and the local taxpayers.

You don't want to be holding that bag when it catches on fire.

And as if to add insult to injury, in some instances 26 USC 6672 gives the IRS authority to hold "responsible parties" liable for a penalty equal to 100% of the employment taxes not properly collected and paid for employees. A "responsible party" can include officers, managers and any other person who exercises a controlling decision in the process of whether or not to collect payroll taxes — and that means you and me folks. There's no question that there is some degree of personal liability as a consequence of improperly classifying employees as independent contractors.

So here's the denouement — if your institution is issuing an IRS Form **1099-MISC** and a **W-2** to the **same name**, you just might be announcing that you're underpaying the tax man and you probably should prepare the welcome mat for the IRS auditors.

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