

## INDEPENDENT CONTRACTOR OR COMMON LAW EMPLOYEE FOR USE BY STATE AGENCIES

The purpose of this article is to advise State agency secretaries and directors and other State hiring authorities of the common law and statutory distinctions between an independent contractor and an employee. This article is intended for use by California State agencies. Effective immediately, this article supersedes Management Memo 95-18.

This article also advises State agency secretaries and directors that employers (including State agencies) are subject to various State and federal statutes governing the collection of payroll taxes for all employees (including contractors determined to be "employees" under common law or statutory employee definitions). These payroll taxes may include social security and medicare taxes, federal income tax withholding, unemployment insurance, State employment training tax, State nonindustrial disability, and State personal income tax withholding. The amount of taxes required by federal and State law to be withheld from State employee earnings and the related employer tax contribution (where applicable) are reported by the State Controller to federal and State tax authorities on the appropriate forms and to the employee on the *Wage and Tax Statement* ([Form W-2](#)).

However, employers, including State agencies, are not required to withhold taxes from independent contractor earnings. Instead, the State is required to file an information return, IRS [Form 1099-MISC](#), for certain payments made to independent contractors. In addition, effective January 1, 2001, California employers must report independent contractors, using the *Report of Independent Contractor(s)* ([DE 542](#)), to the Employment Development Department. For additional information regarding the reporting of independent contractors to California, contact:

Employment Development Department (EDD)  
Independent Contractor Hotline  
Telephone: (916) 657-0529

The Internal Revenue Code imposes substantial penalties on employers ([refer to page 4](#)) for improper classification of employees as independent contractors. Penalties incurred by a State agency will be paid out of the State agency's support appropriation.

## **CLASSIFICATION OF INDEPENDENT CONTRACTOR/EMPLOYEE FOR FEDERAL TAX PURPOSES**

The IRS *Employer's Supplemental Tax Guide* ([Publication 15-A](#)) provides the following guidelines, effective January 1, 2000:

- Behavioral Control. Factors related to a business's right to direct and control how the worker performs the task.
- Financial Control. Factors related to a business's right to control the business aspects of the worker's job.
- Relationship of the Parties. Factors showing the type of relationship between the worker and the business.

The application of these factors determines common law employee or independent contractor status for federal tax purposes. Consult [Publication 15-A](#) for details and examples to help properly classify the workers. For additional information, access the IRS Web site at [www.irs.gov](http://www.irs.gov) and follow the links to all IRS forms and publications.

The IRS [Form SS-8](#) (*Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*) should be used when, at the discretion of the State agency and after consultation with EDD's Audit Section, it is necessary to seek IRS assistance in determining independent contractor/employee status (refer to [Independent Contractor/Employee Determination Assistance](#) on page 3).

## **CLASSIFICATION OF INDEPENDENT CONTRACTOR/EMPLOYEE FOR STATE TAX PURPOSES**

The EDD administers California's employment tax laws. The California Code of Regulations, [Section 4304-1](#), defines an employee and lists the rules generally applicable to common law determinations of employment. The EDD has prepared a list of 24 common law elements to help State agencies distinguish between an independent contractor and an employee (refer to [Attachment I](#)).

The information in the "Employee" column of Attachment I represents situations in which the 24 elements indicate that the contractor is subject to the employer's direction and control. Therefore, when a State agency retains the right to direct and control the work performed under a contract, a common-law employer/employee relationship is created even if the State agency (employer) allows the contractor (employee) freedom of action.

To determine if an independent contractor/employee relationship exists for State of California tax purposes, it is not necessary that all 24 elements in Attachment I be considered or weighted equally. Because this determination process can be relatively subjective, program managers may find it useful to compare their working relationship with the contractor to their relationship with civil service employees. In that comparison,

if the following statements are true, it is presumed that the individual to be engaged is an employee and, once such a conclusion is made, it is not necessary to continue to apply the 24 elements:

- The worker can quit or be terminated at any time without being legally obligated for failure to complete the job.
- The manager (or designated person) assigns, reviews, and supervises the individual's work.
- The worker performs services that are a part of the regular operation of the State agency.

State program managers who contract with individuals for personal and other services must review [Attachment I](#) to determine if the State agency has effectively retained the right to direct and control the contractor or if, in the performance of contract services, the contractor is independent.

In addition, existing State law confers statutory employee status on an individual under specific circumstances in spite of the fact that the individual is determined to be an independent contractor using common law. The following are the categories of statutory employees:

- Artists, authors, and creators of copyrighted work
- Unlicensed construction workers
- Homeworkers

State agencies that intend to contract with individuals in the groups listed above should consult the *California Employer's Guide* ([DE 44](#)) or call EDD's Audit Section at (916) 464-2500 for advice regarding their employment status.

## **INDEPENDENT CONTRACTOR/EMPLOYEE DETERMINATION ASSISTANCE**

The State agency program manager who is required to certify the independent contractor/employee status based upon the criteria provided in this document may find it difficult to reach a definite determination and may need assistance. In such instances, the program manager should call:

Employment Development Department  
Audit Section  
Telephone: (916) 464-2500

In addition, at EDD's Web site ([www.edd.ca.gov](http://www.edd.ca.gov)), you can access forms and publications such as the [DE 44](#), *Determination of Employment Work Status for Purposes of State of California Employment Taxes and Personal Income Tax Withholding* ([DE 1870](#)), *Employment Determination Guide* ([DE 38](#)), [DE 542](#), and various Information Sheets.

The [DE 38](#) is a self-assessment worksheet to be used to determine whether a worker is most likely an employee or an independent contractor. The EDD will also provide verbal guidance or, if deemed necessary, a written opinion based on data provided by the

requesting State agency on the [DE 1870](#). In most cases, an employment status determination results in the same finding under both the State and federal guidelines. In rare instances where the employment status is different under the State and federal guidelines, please consult with EDD's Audit Section for assistance.

### **STATE POLICY: CONTRACT WITH INDEPENDENT CONTRACTORS ONLY**

After reviewing the contents of [Attachment I](#) and the statutory employee categories listed on page 3 of this article, the State agency program manager directly responsible for the work to be performed should determine whether the contract being reviewed creates or is likely to be executed in a manner that could create an employer/employee relationship outside the civil service system. State law and policy require that, except where exempted by the California Constitution, all State contracts should be executed in a manner consistent with the establishment of independent contractor status.

State agency contracts with common law employees **may be in violation** of Government Code [Section 19130\(c\)](#), which requires that:

All persons who provide services to the state under conditions the [State Personnel] board determines constitute an employment relationship shall, unless exempted from civil service by Section 4 of Article VII of the California Constitution, be retained under an appropriate civil service appointment.

Therefore, State program managers whose contracts appear to be less than fully consistent with this State policy should consult with EDD regarding employee and independent contractor determinations and with their agency's personnel manager regarding proper civil service or other classifications.

### **FEDERAL PENALTIES FOR INDEPENDENT CONTRACTOR/EMPLOYEE MISCLASSIFICATION**

If the IRS determines that a contractor is, in fact, an employee, the penalty assessments against the offending State agency include:

- A liability for failure to withhold income taxes, equal to 1.5 percent of the wages plus 20 percent of the social security and medicare taxes that should have been paid by the employee.
- A liability for the unpaid portion of the employer social security and medicare taxes.
- A penalty for the State agency's failure to withhold 31 percent of a noncorporate independent contractor's pay if the contractor:
  - Was paid more than \$600 annually.
  - Did not provide a federal employer identification number to the State agency.
  - Failed to pay income taxes (the penalty is equal to 100 percent of what the contractor would have paid in taxes).

Depending on the number of independent contractor/employee misclassifications committed by a State agency and the length of time the misclassification remains uncorrected, the liabilities and the penalty assessments can be substantial.

State policy is that **federal penalties** incurred by a State agency **will be paid out of that agency's support appropriation**.

Therefore, to avoid the misclassification of a worker who signs a personal services contract, carefully apply the elements listed on [Attachment I](#) or contact EDD for assistance and/or to obtain additional information.

The Financial Integrity and State Manager's Accountability Act of 1983 (Government Code [13400](#) et seq.) makes the head of each State agency responsible for establishing and maintaining systems of internal control within their agency. Management's responsibility includes communicating the system requirements to employees and providing assurance that the system is functioning as prescribed. The objectives of a system of internal control are to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and assure compliance with laws, regulations, and policies.

Although the responsibility for the internal control system cannot be delegated to an outside agency, assistance to determine that such systems exist may be provided by audits performed either by departmental internal audit functions or by the various control agencies. For example, EDD may conduct studies of policies and procedures related to employment requirements and tax administration. Also, the State Auditor, the State Controller, and the Director of the Department of Finance may perform reviews of State agencies' internal control systems to ensure that such controls are adequate to meet the objectives noted above.

If you have any questions regarding this article, please call EDD's Audit Section at (916) 464-2500.

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**INDEPENDENT CONTRACTOR/EMPLOYEE  
STATUS DETERMINATION ELEMENTS – COMMON LAW**

<b>ELEMENTS</b>	<b>EMPLOYEE</b>	<b>INDEPENDENT CONTRACTOR</b>
1. Instructions	A worker who is required to comply with instructions about when, where, and how to work is ordinarily an employee. The instructions may be in the form of manuals or written procedures that show how the desired result is to be accomplished. Some workers may perform services without receiving instructions because they are highly proficient and conscientious workers. Even if no instructions are given, the control factor is present if the employer has the right to give instructions.	An independent contractor decides how to do the job, establishes his or her own procedures, and is not supervised. The entity engaging his or her services is only interested in the end result.
2. Training	Training of a worker by an experienced employee working with him or her, by correspondence, by required attendance at meetings, and by other methods is a factor of control indicating that the employer wants the services performed in a particular manner. This is especially true if the training is given periodically or at frequent intervals.	An independent contractor ordinarily uses his or her own methods and receives no training from the principal. He or she is not required to attend meetings.
3. Integration	If the worker's services are so integrated into an employer's operations that the success or continuation of the business depends on the performance of the services, it generally indicates employment.	If the individual's performance of service and those of the assistants establish or affect his or her own business reputation and not the business reputation of those who purchase their services, it is an indication of an independent contractor relationship.
4. Services Rendered Personally	If the services must be rendered personally, it indicates the employer is interested in the methods as well as the results.	An individual's right to substitute another's services without the principal's knowledge suggests the existence of an independent relationship.
5. Hiring Assistants	A worker performs services for an employer who hires, supervises, and pays assistants. If a worker hires and supervises assistants at the direction of the employer, he or she is acting as an employee in the capacity of a foreman for or representative of the employer.	An independent contractor hires, supervises, and pays assistants under a contract that requires him or her to provide materials and labor.
6. Continuing Relationship	The existence of a continuing relationship between a worker and the person for whom he or she performs services indicates an employer-employee relationship. If the arrangement consists of continuing or recurring work, the relationship is considered permanent, even if the services are rendered on a part-time basis, are seasonal in nature, or if the person actually works for only a short time.	The relationship between an independent contractor and his or her client ends when the job is finished.

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7. Set Hours of Work	The establishment of set hours of work by the employer is a factor of control. If the nature of the occupation makes fixed hours impractical, a requirement that the worker work at certain times is an element of control.	An independent contractor is the master of his or her own time.
8. Full-Time Work	Full-time work for the business is indicative of control by the employer since it restricts the worker from doing other gainful work. Full-time does not necessarily mean an eight-hour day or a five-day week. Its meaning may vary with the intent of the parties, the nature of the occupation, and the customs in the locality. These conditions should be considered in defining full-time. Full-time services may be required even though not specified orally or in writing.	An independent contractor is free to work when he or she chooses and to set his or her daily or weekly schedule. An independent contractor would normally perform services less than full time for one principal.
9. Work Done on Premises	Doing the work on the employer's premises, on a route, or at a location designated by an employer implies employer control, especially where the work is of such a nature that it could be done elsewhere. The use of desk space and of telephone and stenographic services provided by an employer places the worker within the employer's direction and supervision unless the worker has the option as to whether he or she wants to use these facilities. However, the fact that work is done off the premises does not indicate freedom from control since some occupations (for example, construction workers) are necessarily performed away from the premises of the employer.	Doing work away from the principal's premises when it could be done on the principal's premises indicates a lack of control, especially when the work is free from supervision.
10. Order or Sequence Set	If a worker must perform services in the order or sequence set by the employer, it shows that the worker is not free to follow an independent pattern of work but must follow the established routines and schedules of the employer. Often, because of the nature of the occupation, the employer either does not set the order of the services or sets them infrequently. Control is sufficiently shown, however, if the employer retains the right to do so.	If the principal is not interested in the order or sequence by which the individual completes the work, there is an indication that there is a lack of control over the manner and means by which the work is performed.
11. Reports	The submission of regular oral or written reports indicates control since the worker must account for his or her actions.	An independent contractor is not required to file reports that constitute a review of his or her work. (However, reports related only to an end result are not an indication of employment or independence.)

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12. Payments	<p>Payment by the hour, week, or month generally represents an employer-employee relationship</p> <p>The guarantee of a minimum salary or the granting of a drawing account at stated intervals with no requirement for repayment of the excess over earnings tends to indicate the existence of an employer-employee relationship.</p>	<p>Payment on a commission or job basis is customary where the worker is an independent contractor. Payment by the job includes a lump sum computed by the number of hours required to do the job at a fixed rate per hour.</p>
13. Expenses	<p>Payment of the worker's business and travel expenses by the employer indicates control over the worker.</p>	<p>A worker who is paid on a job basis and who has to take care of all incidental expenses is generally an independent contractor. Since the person is accountable to no other person for the expenses, the person is free to work according to his or her own methods and means.</p>
14. Tools and Materials	<p>The furnishing of tools, materials, etc., by the employer indicates control over the worker. In some occupations and industries, it is customary for workers to provide their own tools, which are usually small hand tools; in that case, workers may be considered to be employees.</p>	<p>When a worker furnishes tools and materials, especially when a substantial sum is involved, there is an indication of independence.</p>
15. Investment	<p>The furnishing of all necessary facilities by the employer tends to indicate an employment relationship.</p> <p>Facilities generally include equipment or premises necessary for the work, but not tools, instruments, clothing, etc., that are commonly provided by employees in their particular trade.</p>	<p>A significant investment by the worker in facilities used by him or her in performing services for another tends to show independent contractor status.</p> <p>In order to be significant, the investment must be real, essential, and adequate.</p>

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16. Profit or Loss	When workers are insulated from loss or are restricted in the amount of profit they can gain, they are usually employees. The opportunity for higher earnings, such as from pay on a piecework basis or the possibility of gain or loss from a commission arrangement, is not considered profit or loss.	<p>The possibility of a profit or loss for the worker as a result of his or her services generally shows independent contractor status. Profit or loss implies the use of capital by the worker in an independent business. Whether a profit is realized or loss suffered generally depends on management decisions; that is, the one responsible for a profit or loss can use his or her own ingenuity, initiative, and judgment in conducting the business or enterprise. Factors that affect whether or not there is a profit or loss are whether the worker:</p> <ul style="list-style-type: none"> <li>• Hires, directs, and pays assistants.</li> <li>• Has his or her own office equipment, materials, or other facilities for doing the work.</li> <li>• Has continuing and recurring liabilities or obligations.</li> <li>• Succeeds or fails depending on the relation of his or her receipts to his or her expenditures.</li> <li>• Agrees to perform specific jobs for prices agreed upon in advance.</li> <li>• Pays expenses incurred in connection with the work.</li> </ul> <p>Independent contractors typically can invest significant amounts of time or capital in their work without any guarantee of success.</p>

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17. Works for More Than One Person or Firm	It is possible that a person may work for a number of people or firms and still be an employee of one or all of them because he or she works under the control of each firm.	Work for a number of persons or firms at the same time usually indicates an independent contractor status because the worker is usually free, in such cases, from control by any of the firms.
18. Offers Services to the General Public	If a worker performs services for only one person, does not advertise his or her services to the general public, does not hold licenses or hire assistants, and performs services on a continuing basis, it is an indication of an employment relationship.	The availability of services to the general public usually indicates independent contractor status. This may be evidenced by the worker having his or her own office and assistants, hanging out a “shingle” in front of his or her own home or office, holding business licenses, maintaining business listings in telephone directories, or advertising in newspapers, trade journals, magazines, etc.
19. Right to Fire	If an employer has the right to discharge an individual at will and without liability, that worker is considered an employee. The employer exercises the control through the ever present threat of dismissal, which causes the worker to obey instructions. A restriction on the employer’s right to discharge in a labor union contract does not detract from the existence of an employment relationship.	An independent contractor cannot be discharged as long as he or she produces a result that measures up to his or her contract specifications. However, the relationship can be terminated with liability.
20. Right to Quit	The <b>right to quit</b> at any time without incurring liability indicates an employer/employee relationship.	An independent contractor usually agrees to complete a specific job, and he or she is responsible for its satisfactory completion or is legally obligated to make good for failure to complete the job.
21. Custom in Industry and Location	If the work is traditionally done by civil service employees under the direction of a supervisor, it is an indication of employment.	If the work is done by outside specialists, it is an indication of independence.
22. Required Level of Skill	A low level of technical skill is strong evidence of employment, since as the skill level declines, there is less room to exercise the discretion necessary for independence.	A high level of technical skill is important when combined with other factors such as owning a separate and distinct business.

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23. Belief of the Parties	<p>It is an indication of employment if:</p> <ul style="list-style-type: none"> <li>• Both parties (the worker and the State) believe the relationship is employment.</li> <li>• Either party believes that the relationship is employment.</li> </ul>	<p>If the parties agree that the relationship is one of independence, it may be. However, consideration should be given to the fact that many individuals do not know how employment determinations are made and believe they are independent contractors because they are told they are.</p>
24. Business Decisions	<p>Employees cannot make business decisions that would enable them to earn a profit or incur a financial loss.</p>	<p>Independent contractors make business decisions that enable them to earn a profit or incur a loss. Investment of the worker's time is not sufficient to show a risk of loss.</p>