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Unique Employment Tax Classification issues in Government Entities

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Amy: Welcome and thank you for joining the Internal Revenue Service's phone forum on the unique employment tax classification issues in government entities. My name is Amy Myers, and I am the manager of the Mid-Atlantic Group of the Federal State and Local Government Division of the Internal Revenue Service. We ask that you do not put your phone on hold, as we may hear music playing on your end. With me today for this discussion is James Driver, a Federal State and Local Government Specialist.

James: Good afternoon. Government entities are often confused on how to determine if payments to an individual constitute payments to an independent contractor or an employee under contract. We have also seen that government entities are confused on how to report the payments to the Internal Revenue Service. Our goal today is to help each of you understand the issues surrounding worker classification. Questions we will answer are: how do you define who an employee is under the Internal Revenue Code? How can you make the determination that someone under contract is either an employee or independent contractor? How should you report the payments of these individuals to the Internal Revenue Service? What do you do if you just can't figure out their status as employee or independent contractor? And what do you do if you feel you have not properly classified a worker?

It is important to note that this presentation is not official guidance for your specific issues. We are providing general guidance to help government entities understand the employment tax treatment of unique job positions. We understand that each issue is unique and must be looked at on a case by case basis. If you had a more Specific question you would like to ask after this presentation, you can go to irs.gov and keyword search "FSLG newsletter". Within the newsletter you will see a list of FSLG specialists for your state whom you can call and ask questions unique to your entity. If you do not already receive the FSLG Newsletter, you can also sign up to receive the newsletter from this page.

Amy: We want to provide you with scenarios to think about as we go through the material; we will provide answers toward the end of the presentation.

Example one: A small city has an elected mayor and council that each receive \$100 a month and each receive a Form 1099 for \$1,200 at the end of the year. Would this be the correct way to handle this issue?

Example two: A county has employees who worked in the clerk's office full-time and a couple of employees also help the maintenance department in the summer mow the grass. The county also has a maintenance department with employees. For the work performed in the clerk's office, the employees are paid through payroll and the pay is reported on Form W-2. The employees also received a Form 1099 for the amount they earned mowing the grass in the summer. The employees do not have their own business nor do they use their own mowers, they used the county's mowers, gas and trimmers. Did the county handle the reporting of these payments correctly?

James: Example three: A county clerk's office is paid \$200 extra a day for working at the election polls. In a particular year, there were three elections due to a runoff election. The employees received \$600 reported on a Form 1099. Was this the correct reporting method?

Example four: A government entity pays an individual \$300 a month to clean the offices. All the payments are run through accounts payable and at the end of the year the government entity issues a Form 1099 for \$3,600. The individual does not work for the entity in any other capacity. The government provides the cleaning tools, paper towels and toilet paper and the cleaning agents. There is no signed contractual agreement between the individual and the government entity. The cleaning job was basically a gentleman's agreement, and the individual has cleaned the offices for as long as everyone can remember. The individual does not have a business license, but has on occasion cleaned some residential houses. Was the Form 1099 the correct way to handle the reporting of payments to that individual?

Amy: Finally example five: A county government pays board members, such as health board or water board, \$75 a meeting. In 2011, there were twelve meetings and a total of \$900 was paid to each board member. A Form 1099 was not issued, since the county government did not consider the payment as services, nor were the payments made through payroll and reported on Form W-2 as the county felt the payments were not wages. Was this the correct way to handle the payments to the board members?

James: Most workers fall under the general common-law test. In some cases, statutes indicate whether an individual is an employee. We will look at some of those situations first. If a Section 218 Agreement covers a position, the individual holding that position is an employee for purposes of social security and or Medicare taxes. You may be wondering: what is a Section 218 Agreement? We are referring to section 218 of the Social Security Act. In short, the Section 218 Agreement is the voluntary agreement between a state and local government with the federal government to participate in social security and or Medicare. When social security came about in 1935, state and local governments did not participate in social security. Beginning in 1951, states and their local governments began participating in social security via a Section 218 Agreement. If you are uncertain whether your government entity has a Section 218 Agreement, you may contact your local State Social Security Administrator. You can find who your state administrator is by going to this website: ncssa.org. You can find out more about Section 218 Agreements on irs.gov by keyword search "section 218". You can also find more information in IRS Publication 963, that is IRS Publication 963.

Recently, the IRS has conducted two webinars on section 218 that you may find educational; these can also be found on irs.gov. We will be referring to the term "FICA". FICA refers to social security and Medicare taxes, the employee share that an employer is required to withhold from an employee's wages and the employer share that is sometimes referred to as a match. Although, it does not supersede Federal Law the designation of a position as that of an employee under statute of jurisdiction is a strong indication that the position is employment. Generally, an employee for FICA is also an employee for income tax purposes, but there are exceptions. Few of these exceptions are likely to affect government employees. So we asked this question, how is employee defined?

Amy: The FICA statute provides a list of specific occupations which are considered employees, as well as those who are employees under common law. Internal Revenue code section 3121(d)(3), again that's Internal Revenue Code Section 3121(d)(3), designates certain occupations to the employees for FICA purposes. None of these categories would normally be found in government employees. Under Internal Revenue code section 3401(c), again under Internal Revenue code section 3401(c), officers, employees or elected officials of the United States or a state or local government are specifically identified as employees for income tax withholding purposes. There is a limited exception from income tax withholding for fees paid to public officials such as notaries and amounts paid to precinct workers. Holders of public office are generally considered employees of government and are not subject to self-employment act. This is because performing the functions of a public office is not considered a trade or business. We find that explanation in Internal Revenue code 1402(c) as well as regulation 1.1402(c)-2b, again that cite where we find that public officer is generally not considered a trade or business is Internal Revenue code section 1402(c) and regulation 1.1402(c)-2b.

Examples of public officials are: mayor, a legislator or elected representative, county commissioner, judge or justice of the peace, county or city attorney, marshal, sheriff, constable, a registrar of deeds, tax collector or assessor, road commissioner and board members.

James: Now that we've addressed individuals who are defined as employees by specific laws, we will look at the general common-law test that applies to other individuals, the regulations add to this definition. In any employee or independent contractor determination all information that provides evidence as to the degree of control and the degree of independence must be considered. Generally, the employer-employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result of the work to be accomplished, but also as to details and means by which that results is accomplished. The right to control and direct to worker is the key standard under the common-law test. Let's look at this control test more closely, the control test means that the worker is subject to the taxpayer's control as to what is to be done and how it is to be done. Under the common-law test, the worker must be subject to control. Note that under the test the taxpayer has the right to control, thus it is not necessary that the taxpayer actually exercise this control. The IRS recognizes three categories of facts to consider when making a determination of employee status, behavior control, financial control and relationship of the parties.

Amy: Let's look at the first one; the first category is behavioral control. Behavioral control evidence goes to how the specific tests are performed. They include such things as instruction and training provided by the taxpayer, direction over when and where to do the work, direction on what tools or equipment to use, if they can hire workers to assist with the work, what work must be performed by a specified individual and even what order or sequence to follow.

The amount of instruction needed varies among different jobs. Even if no instructions are given, in some circumstances sufficient behavioral control may exist if the employer has the right to control how the work resolved are achieved. For example, a business may lack the knowledge to instruct some highly specialize professional. In other cases, the task may require little or no instruction. An employee may be trained to perform services in a particular manner, whereas an independent contractor generally uses their own methods.

The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right to control.

James The second category is financial control. The focus of this category is whether the business has the right to direct and control the economic aspect of the worker's activities. Does the worker simply provide services for wages? Or is he or she making an investment and occurring risk? An independent contractor often has a significant investment and facilities and tools he or she uses in performing services for someone else. Does the worker have the ability to realize a profit or incur a loss? An independent contractor can make a profit or loss.

Other factors - does the worker have unreimbursed the business expenses? Independent contractors are more likely to have unreimbursed expenses than are employees. Does the worker make their services available to the public? An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location

and are available to work in the relevant market. How does the government entity pay the worker? An employee is generally guaranteed a regular wage amount for an hourly, weekly or other period of time; an independent contractor is often paid a flat fee or on a time a material basis for the job.

Amy: The third category of evidence is the relationship of the parties. This addresses how the worker and the taxpayer perceive their relationship. This category is important because it reflects the intent of the parties. Items that need to be considered include, what relationship to the parties intend to create? Can the employer refuse payment for non performance? Does the employer provide fringe benefit such as insurance, a pension plan, vacation time or sick pay? If the worker gets injured are they covered by the employer's workers compensation? Does the employer have discharge in termination rights? Is there a permanency of the relationship? The extent to which services performed by the worker are a key aspect of the regular business activity of the entity? Is the work an integral part of the business?

If a worker is engaged with the expectation that the performance will continue indefinitely rather than for a specific project or period, this is generally considered evidence that there was intent to create an employer, employee relationship. If a worker provides services that are a key aspect of the employer's regular business activity, it is more likely that the employer will have a right to direct and control his or her activity.

James: Now, let's take time to look at the examples we provided earlier. A small city has an elected mayor and council, that each receives \$100 a month and each receives a Form 1099 for \$1,200 at the end of the year. Would this be the correct way to handle this issue? The answer is: no. The example stated the mayor and council are elected. The issuing of a Form 1099 implies that that there is not an employee-employer relationship. For income tax withholding purposes, elected officials of a local government are specifically identified as employees under Internal Revenue code 3401(c). For FICA tax purposes we learned that an individual performing services in a position covered by a Section 218 Agreement is an employee. In this scenario, the elected officials may be covered by a Section 218 Agreement, if so they are employees for FICA.

Also, under our previously cited sections of the Internal Revenue Code 1402(c) and Regulation 1.1402(c)-2(b), holders of public office are not self-employed individuals subject to self-employment tax and thus are considered employees of the government entity. The mayor and council should receive a Form W-2 and have the proper employment taxes withheld and matched, because the mayor and council are employees.

Amy: Let's take a look now at example two. A county has employees who work in the clerk's office full time and a couple of the employees also help the maintenance department in the summer mow grass. The county also has a maintenance department with other employees. For the work performed in the clerk's office, the employees are paid through payroll and the pay is reported on Form W-2. The employees also received a Form 1099, for the amount they earned mowing the grass in the summer. The employees do not have their own business nor do they own their own mowers. They used the county mowers, gas and trimmers. Did the county handle the reporting of the payments correctly? Generally, the answer is no.

First, individuals in the clerk's office are employees of the county; their wages were correctly reported on Form W-2 for the services they performed for the clerk.

Second, the types of work the individuals did for the maintenance department did not change the relationship with the county as employees of the county. The employees are still employees; they simply are working in another department of the county alongside of other employees.

Third, the facts stated the clerk's office employees did not have their own personal business of mowing nor did they use their own equipment like you would generally see with independent contractors. In this instance, all the compensation to the clerk's office employees, including the wages earned from mowing, should be reported on a Form W-2 and the proper employment taxes withheld and matched.

James: In our example three, we said that employees in the clerk's office are paid \$200 extra a day for working at the election polls. In a particular year, there were three elections due to a run off election. The employees received \$600 reported on a Form 1099, was this correct? The answer is: no. Election workers are never to be considered independent contractors. Election workers are common-law employees. However, no income tax withholding is required for payments to precinct workers for services performed at election booths. Under Internal Revenue Code 3121-(b)(7)(F)(iv), again that Internal Revenue code 3121-(b)(7)(F)(iv), an exception from FICA is provided for election officials and workers who earn less than a specified amount for calendar year. In 2011, that amount was \$1500.

For example, in the state of West Virginia, election workers are covered by a statewide Section 218 Agreement that follows that rule allowances on reporting of election workers. In Internal Revenue Services Revenue Ruling 2000-6, again that's Revenue Ruling 2000-6, goes into greater examples of how to report wages to election workers. In our example, the employees from the clerk's office are still employees; they are simply assigned to work at the polls rather than the clerk's office. The \$600 in wages for election work must be reported on the Form W-2. However, the \$600 is not subject to income or FICA taxes. The regular wages earned by the employees of the clerk's office is subject to all employment tax, and the \$600 in election work of wages will appear on the Form W-2, but the \$600 in wages will not be subject to withholdings.

Amy: Take a look at example four, as you may recall the facts were stated as: a government entity pays an individual \$300 a month to clean the offices. All the payments are run through accounts payable and at the end of the year the government entity issued a Form 1099 for \$3,600. The individual does not work for the entity in any other capacity. The government entity provides the cleaning tools, paper towels, toilet paper, as well as the cleaning agents. There is no signed contractual agreement between the individual and the government entity. The cleaning job was a verbal agreement, and the individual has cleaned the offices for as long as everyone can remember. The individual does not have a business license, but has cleaned some residential houses on occasion. Was the Form 1099 the correct way to handle the reporting of the payments to the cleaning person?

In this instance, there appears to be some elements of both independent contractor as well as an employee relationship.

First, the individual has some from time to time cleaned some residential properties, thus seemingly an independent contractor. However, we must consider all the tax provided and concentrate on the unique relationship of the government entity with the individual.

First, the individual does not own the supplies. Therefore, there is no real way for the individual to realize a profit or incur a loss, which is a characteristic of independent contractors. There was no signed contract describing the relationship the parties intended to create. As long as everyone can remember, the same individual has been doing the cleaning. There is a definite appearance of a long standing employee and employer relationship. There are no expiring contracts or even renegotiating of a contract. There appears to be an expectation on both parties that this arrangement is permanent.

In this instance, with just these facts at hand, there appears to be an employee-employer relationship and the entity should have paid the individual through payroll and reported the wages on a Form W-2. In a situation such as this, where there is a question regarding the individual status as an employee or an independent contractor it might be a good idea to submit a Form SS-8 to the IRS. Again that is a Form SS-8. As we will be discussing further in a few minutes, SS-8 is a form that an entity or a worker can send to the Internal Revenue Service for the IRS to make a determination of whether the individual worker is an independent contractor or an employee.

James: In our last example, number five, a county government pays board members such as a health board or a water board \$75 a meeting. In 2011, there were twelve meetings and a total of \$900 was paid to each board member. A Form 1099 was not issued since the county government did not consider the payments as service, nor were the payments made to payroll and reported on a Form W-2 as they did not feel the payments were wages. Was this the correct way to handle the board members?

The county's payment to the board members would be considered wages and should be reported on a Form W-2 with applicable employment taxes withheld. If you remember from our discussion of Internal Revenue Code 1402(c) and regulation 1.1402(c)-2(b), board members are considered public officials. The official acts within a certain amount of independence under the law. They also are responsible to other officials, as specified in statutes and ordinances. An appointed board member is responsible to the public and the public or a superior official has the power to remove the appointed board member. A public official does not have the freedom from supervision characteristic of an independent contractor.

These examples are not all inclusive, but are meant to provide examples to help you question possible situations within your own government entity. If you simply cannot make a determination as to the status of the worker, then Form SS-8, which is the determination of worker status for purposes of Federal Employment taxes and Income Tax Withholding, is available for help in making a determination of status. However, the SS-8 is not an examination, nor can it change the results of an examination already conducted. A determination will not be issued for years for which the statute of limitation has expired. There are no appeal rights applicable to a Form SS-8 determination, but you may ask IRS to reconsider based on additional information. Form SS-8 cannot change employment status established by a Section 218 Agreement.

Amy: In some cases, the Internal Revenue Service will provide an advisory letter rather than a determination through Form SS-8. We have mentioned in some of our scenarios above the reporting payments via Form 1099 and Form W-2. It is important for you to realize when you compensate an individual that you must report the compensation on the proper reporting Form.

For employees, all compensation is reported on a Form W-2. In addition to the employees wage or salary, compensation includes awards, back pay, bonuses, severance pay, and taxable fringe benefits, just to name a few. All payments to someone who is not your employee but rather is an independent contractor would be reported on a Form 1099 miscellaneous. If you reimburse an independent contractor for expenses through a nonaccountable plan, you would also report the reimbursements on a Form 1099.

James: What do you do if you discover you have been paying someone as an independent contractor, and they should've been classified as an employee? You start by treating those individuals as employees for employment tax purposes and report their wages in payroll and report on a Form W-2 and Form 941. If it is in the current year, you may need to catch up on the employment taxes on wages already paid. If the wages were for previous years, you may be in a situation where Forms 941-X and Forms W-2 and W-3 corrections will need to be issued. This will obviously depend on the relationship you had with the individual in those prior years.

Recently, the IRS announced the new voluntary classification settlement program. That is the voluntary classification settlement program, or VCSP. This program allows eligible taxpayers to voluntarily reclassify workers as employees for future tax periods with partial relief from federal employment taxes for the past non-employee treatment. This program applies to taxpayers and may include certain government employers. You can read more about the VCSP program by going to irs.gov and typing "VCSP" in keyword search. When you received the invitation on this phone Form you had the opportunity to submit questions.

We're now going to answer a few of those questions that we received. One question we received concerned a city attorney status as an employee. This question lines up perfectly with an example we have in Internal Revenue Service Publication 963. In that publication is an example. The facts are: state A establishes the position of city attorney by statute and defines it, that as of an officer and employee. That statute defines the duties of the position; the city attorney is required to direct all litigation in which the city is a party, including prosecution of criminal cases, to represent the city and all legal matters in which the city or a city officer is a party, to attend the meetings of the commissioners, advise commissioners, mayors etc. on all legal questions, and approve all contracts and legal documents. A city manager appoints, supervises and controls the work of the city attorney. The city attorney must take an oath of office. These facts show the importance of state statute in establishing a right of direction and control over a public official and thus classifying the individual as a common-law employee.

Amy: Another question we received is: are volunteers considered employees? The common-law test applies to determine the status of individuals regardless of whether they are employees or deemed volunteers. If an individual, considered a volunteer meets the common law test, any Form of compensation or benefits he or she received is considered wages, unless a specific exception applies. Remember, the Internal Revenue Service recognizes three categories of facts to consider when making a determination of employee status and we discuss those today.

The three categories are behavioral control, financial control, and relationship of the parties.

James: Another question we received was: what are the consequences of misclassifying a worker? Generally, when an employer erroneously classifies an employee as an independent contractor and does not withhold federal payroll taxes, the employer could be liable for the employer and employee shares of all applicable federal payroll taxes, as well as various penalties and interest. As mentioned before, the IRS has announced the new Voluntary Classification Settlement Program. This program allows eligible taxpayers to voluntarily reclassify workers as employees for future tax periods with partial release from federal employment taxes for the past non-employee treatment. The program applies to taxpayers and may include certain government employers.

We want to encourage each of you to go to the irs.gov site and download IRS Publication 963, again that's IRS Publication 963. This document was specifically designed with government entities in mind, and there is a section that addresses employee versus independent contractors. In addition, IRS Publication 15-A, that's IRS Publication 15-A, discusses relevant facts and circumstances surrounding the employee versus independent contractor issue. Remember, if you have a more specific question you would like to ask, you can go to irs.gov and keyword search "FSLG newsletter". Within the newsletter, you will see a list of FSLG Specialists for your state who you can call and ask questions unique to your entity. If you do not already receive the FSLG newsletter, you can also sign up to receive the newsletter from this page.

Amy: The Internal Revenue Service office of Federal State and Local Government invites you to register for a free webinar that's coming up on Thursday September 20th and will air at 2:00pm Eastern Time. The topic will be "Avoiding Information Reporting Problems for Government Entities". This free webinar will discuss the following items: what payments should be reported on Form 1099-G, how to obtain correct taxpayer identification numbers, common mistakes that occur in filing information returns and how to avoid them, when you need to impose back up withholding, penalties for failure to file correct information return, the IRS online taxpayer identification number matching system, and filing information returned electronically.

The IRS has reported and posted several webinars on employment tax topics, such as the implications of Section 218 Agreements in the treatment of employees versus independent contractors. You can find these webinars on our video portal at www.tax.gov. That's a different website than we've been saying, so I will repeat it. The video portal is www.tax.gov. The webinars connected by FSLG will be located under the government's tab. You can find publications, Forms, and many other great resources at www.tax.gov. Those of you that are familiar with our website upon your next visit to our site, you will notice a new layout as it was recently redesigned. You can easily navigate to the government section one of two ways. You can get there directly by navigating to www.irs.gov/govt, again that's www.irs.gov/govt or to navigate to irs.gov you can click on the arrow that is in the upper right corner next to the words information for, and with the drop down select government entity.

On behalf of the Federal State and Local Government division of the Internal Revenue Service, James and I would like to thank you for attending today's session. We hope today's session has helped clarify some of the issues you have faced when making payments to individuals, determining how to classify them and the proper way to report these payments. If you desire more information we encourage you to visit our website www.irs.gov. Thank you and we hope you have a great day.

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