Important Content Note:

This technical assistance resource was developed prior to the August 2017 release of the Health Center Compliance Manual by the Health Resources and Services Administration’s (HRSA) Bureau of Primary Health Care (BPHC). The BPHC Compliance Manual, issued August 2017, indicates where PINS, PALs and other program guidance are now superseded or subsumed by the BPHC Compliance Manual.

Classifying Workers as Employees or as Independent Contractors: Why It Matters and How to Do It Correctly

A typical health center’s workforce is comprised of a mix of clinical, administrative, technical, and support staff. While most staff are likely to be bona fide full- or part-time employees, a health center also may utilize various “consultants” or similar persons who are not considered to be regular employees of the health center. Such individuals may be brought on to perform a specific function, such as a grant writer or an information technology specialist, or to provide a specific service, such as a specialty physician or an occupational therapist. From a legal perspective, every person who is compensated for providing a service to or on behalf of the health center must be classified either as an “employee” or as an “independent contractor.”

As a general matter, an employer has significantly greater legal obligations with respect to employees than with respect to independent contractors. However, there often is a strong financial incentive for an employer to classify a worker as an independent contractor as opposed to an employee.

♦ Classifying as an independent contractor enables the health center to avoid paying the employer’s share of Federal and state employment taxes and the administrative costs of withholding taxes from an employee’s wages.

♦ Independent contractors typically are not covered by workers’ compensation laws, are not entitled to overtime pay, are not covered by employer-sponsored health insurance and other employee benefit programs, which can easily increase compensation costs by 20% to 30%, and do not have the legal protections offered by Federal and state employment discrimination laws.
Workers sometimes prefer independent contractor status. The individual may be paid more than he or she would if they did the same work as an employee (on account of the employer's savings on employment taxes and employee benefits that must be paid for employees), and they may prefer not to have Federal and state taxes withheld from their pay.

That is not to say that treating a worker as an independent contractor is necessarily suspect. Hiring a worker as an independent contractor can serve a legitimate business purpose for a health center. However, misclassifying an employee as an independent contractor can prove to be a costly error. Misclassification of workers for Federal and state tax purposes is the most common classification error, and can result in an employer being liable for significant tax penalties.

Accordingly, this Information Bulletin:

- Addresses some of the legal and financial consequences of the “employee” and “independent contractor” classifications
- Focuses on the tests used by the Internal Revenue Service (“IRS”) for classifying workers as employees or independent contractors
- Describes worker classification issues raised by other Federal and state employment laws, each of which uses its own definition of “employee” versus “independent contractor”\(^1\)
- Addresses other considerations regarding worker classification

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**CLASSIFICATION BASICS**

It is important to understand that proper worker classification reflects a legal conclusion based on the analysis of relevant factors in the relationship between a worker and an employer.\(^2\) The fact that a worker has a written contract with an employer does not alone determine that the worker is an independent contractor. Many bona fide employees have employment contracts. Further, a contract provision that states that a worker is an independent contractor (as opposed to an employee), while relevant, does not determine the proper classification. All of the terms of the contract and, in particular, the control that an employer has over the worker under the contract must be considered. Thus, an employer and a worker cannot agree to treat the worker as an independent contractor if, based on all of the facts and circumstances of their relationship, the worker should be legally classified as an employee.

**Employer’s Control of the Worker**

Classification for IRS purposes, and for virtually every other statute where classification is relevant, focuses on the employer’s control over the worker, not only in terms of control of “what” the worker does, but also control of “how” (such as the means and the methods) the worker accomplishes the assigned work.

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1 Employee classification also is relevant under federal health care fraud and abuse laws. Both the anti-kickback statute and the Stark II (regarding physician self-referrals) contain “safe harbors” for bona fide employees. Both statutes use the IRS classification standards, discussed below, to determine employee status.

2 Unless the context requires otherwise, the term “employer” is used throughout this Information Bulletin to denote a person or entity that compensates a person, i.e., a worker, for the provision of services, without regard to whether the worker is an employee or an independent contractor.
The more control that an employer has as to what work will be done and how the work is performed, the more likely that the worker will be properly classified as an employee. Moreover, the employer need only have the right to exercise the requisite amount of control over the worker. The employer need not actually exercise that right.

**Control Applies to All Levels of Workers**

It is important to understand that the “right to control” test applies to all categories of workers. Professionals, such as physicians and other clinicians, may be classified as employees notwithstanding the fact that they exercise independent medical judgment when carrying out their duties. The longstanding IRS position, supported by the courts, is that physicians (and other clinicians) are properly classified as employees if they are subject to the requisite degree of control and supervision with respect to services performed.³

Accordingly, it is a mistake to automatically treat physicians and other clinicians who are contracted to work for a health center from time to time as independent contractors. Their classification status should be evaluated under the same criteria applied to all workers. These criteria are discussed below in detail.

**No Standard Classification Criteria**

If the employer’s “right to control” how the worker performs assigned tasks is not explicitly spelled out (in an employment contract, through terms and conditions of employment, in personnel policies, etc.), the courts, the IRS, and agencies administering employment-related laws will look at numerous factors to determine whether the worker should properly be classified as an employee or as an independent contractor. Usually, the classification is not based on one factor alone, but on all of the facts and circumstances of the employer-worker relationship. However, there is no uniform definition or test of “employee” and “independent contractor” status that applies across all applicable employment-related laws.

**WORKER CLASSIFICATION FOR FEDERAL TAX PURPOSES**

If a worker is classified as an “employee” for federal tax purposes, an employer must:

1. Withhold the appropriate amount of federal income tax ⁴ and the worker’s share of federal employment taxes from an employee’s pay, such as Social Security and Medicare taxes payable under the Federal Insurance Contribution Act (“FICA”),

2. Forward the withheld amount to the IRS (within the time period established by the IRS) along with the health center’s share of FICA taxes on an employee’s wages,

3. Provide minimum essential health care coverage under the Affordable Care Act if the employer has more than 50 full-time employees, or face stiff tax penalties,

4. Withhold sums from an employee’s wages and/or pay state unemployment tax, depending on state tax exemption laws.


⁴ Note that, even if a worker is properly classified as an independent contractor, an employer must withhold a minimum of 28% of the compensation due if the contractor does not provide, or provides an incorrect, Taxpayer Identification Number (“TIN”).
These obligations do not apply if a worker is an independent contractor, in which case the independent contractor has the responsibility for paying his or her FICA tax liability and for making quarterly estimated Federal (and, where applicable, state) income tax payments.

**Federal Tax Consequences for Misclassifying Employees**

Incorrect classification of workers can have significant financial consequences. If an employee is misclassified as an independent contractor, the employer must pay:

- All of the FICA taxes it owes for the period that the worker was misclassified as an independent contractor
- 20% of the FICA taxes that should have been withheld on behalf of the employee
- A penalty equal to 1.5% of the wages paid to the employee, if the employer failed to withhold income taxes.
- If the employer also failed to properly report the compensation paid to the worker (by filing IRS Form 1099-MISC), the penalty increases to 40% of the FICA tax that should have been paid and up to 3% of the worker’s earnings (for failure to withhold income tax). If the IRS can prove that there was a willful failure to withhold or to pay FICA taxes, the penalties increase dramatically. In that case, the employer is liable for a penalty equal to 100% of the taxes due and for interest on the income taxes not withheld.

Finally, the 100% penalty for willful violation can be assessed personally against anyone that the IRS determines to be a “responsible party,” such as any officer, board member, or employee who has had the responsibility to withhold and remit taxes and failed to do so, or who had authority over payment of wages and other employer obligations.

It is important to note that no penalties are assessed on a worker who is misclassified as an independent contractor. (The worker is responsible for individual tax liabilities.) Thus, virtually the entire burden of ensuring proper classification falls on the employer, along with paying any penalties imposed by state and local tax authorities.\(^5\)

\(^5\) An employer who misclassifies a worker may obtain relief from penalties under Section 530 of the Internal Revenue Act of 1978. Section 530 provides that the IRS may not assess tax penalties if the following conditions are met: (1) the employer always treated the affected worker as an independent contractor; (2) the employer filed all tax returns (including information returns) required with respect to the worker for all periods after 1978, and the returns were all consistent with independent contractor status; and (3) the employer had a reasonable basis for treating the worker as an independent contractor. A reasonable basis exists if the employer relied on any of the following: (1) judicial precedent, published IRS rulings, or IRS technical advice or letter ruling provided to the employer; (2) a prior IRS audit of the employer in which no assessment was made on account of misclassification of the affected worker; or (3) a long-standing, recognized practice of a significant segment of the industry in which the worker is employed to treat such workers as independent contractors.
IRS Worker Classification Tests

Historically, the IRS used the so-called “20-Factor Test” in classifying workers. Although IRS agents may continue to use the “20-Factor Test” for reference purposes, the IRS now focuses on evidence in three functional categories (Behavioral, Financial, and Type of Relationship) that may (or may not) demonstrate that the employer retains the right to control. The relevant “facts” for each category, as applied to health centers, can be summarized as follows.

Behavioral Control – Relevant Facts

Behavioral control refers to facts that show whether or not there is a right to direct or control how a worker does the work. Such factors include (1) types of instructions, (2) degree of instruction, (3) evaluation systems, and (4) training.

1. Types of instructions that the health center gives the worker – The more instruction that the health center gives, the more control it has over the worker and the more likely that the worker is an employee. Employees are instructed by the health center about such details as:
   - When and where to perform work
   - What tools or equipment to use
   - Where to purchase supplies and services
   - What workers will be hired to help with work
   - What work will be performed by which specific person
   - What order or sequence to follow

2. Degree of instruction – The more detailed the instructions, the more control the employer exercises over the worker. The amount of instruction necessary to establish an employment relationship will vary among different jobs. However, even if no instructions are given, the fact that the health center has the right to control indicates that an employer-employee relationship exists. A health center may lack the knowledge to instruct highly specialized professionals or the task may require little or no instruction. The key consideration is whether the health center has retained the right to control the details of a worker’s performance.

3. Evaluation system – If there is an evaluation system to measure the details of how the work is performed, that points to employee status. Conversely, an evaluation system that measures just the end result of the work can point to either an independent contractor or an employee relationship.

4. Training – A health center may train an employee to perform services in a particular manner and/or provide periodic or on-going training about procedures or methods. Both are strong evidence of an employment relationship. Independent contractors ordinarily use their own methods and receive less training.

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6 The 20 Factors were outlined in Rev. Rul. 87-41, 1984-1 C.B. 296.
7 Internal Revenue Manual, 4.23.5.6.1 (12-10-2013).
Financial Control - Relevant Facts

Financial control refers to facts that show whether or not the employer has the right to control economic aspects of the worker’s job. Such factors include: (1) unreimbursed expenses; (2) significant investment; (3) services available to the market; (4) method of payment; and (5) opportunity for profit or loss.

1. **Unreimbursed business expenses** – Independent contractors are more likely to have unreimbursed business expenses than are employees. A worker’s fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important indicators of independent contractor status, such as equipment and space leases. However, at times employees may also incur unreimbursed expenses in connection with the services they perform.

2. **Significant investment** – An independent contractor often has a significant investment in the equipment he or she uses in performing services.

3. **Services available to the market** – An independent contractor is generally free to seek out other business opportunities. Independent contractors may advertise, maintain a visible business location, and are generally available to work in the relevant market.

4. **Method of payment** – An employee generally is guaranteed a regular wage for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by incentive compensation. An independent contractor usually is paid by a flat fee for the job, although in some professions, e.g. law, it is common to pay an hourly rate.

5. **Opportunity for a profit or loss** – An independent contractor can make a profit or loss on a particular engagement.

Type of Relationship - Relevant Facts

Type of relationship refers to facts that demonstrate how the employer and the worker view their relationship to one another. The relevant factors generally include: (1) written contracts; (2) employee benefits; (3) permanency of the relationship; and (4) services performed as a key activity of the employer’s business.

1. **Written contracts** – While written agreements are relevant evidence of the nature of the relationship, the actual arrangements and conduct are the primary determinative factors, not what the parties think or say the relationship is. Regardless of what status the parties intended to create, the status they have actually created controls the classification.

2. **Employee benefits** – The provision of benefits typically available to employees, such as health insurance, a pension plan, vacation pay, sick pay, etc., indicates an employer-employee relationship. However, the absence of these benefits does not necessarily mean that the worker is an independent contractor.

3. **The permanency of the relationship** – A health center’s engagement of a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, is considered evidence of intent to create an employer-employee relationship.
4. **A key activity of the health center** – If a worker provides services that are a key aspect of the health center’s regular activity, it is more likely that the center will have the right to direct and control the worker’s activities. For example, the center is likely to have the right to direct and control how clinical services are performed through treatment protocols, quality standards, etc.

**Other Evidence of Control**

The IRS will look at all evidence and information indicating control in the employer-worker relationship. Indeed, the IRS instructs its agents reviewing employer classification issues to remember four “very important” points which all employers also should keep in mind when classifying workers:

- There is no “magic number” of relevant evidentiary factors.
- Whatever is the number of factors used, they merely point to evidence to be used in evaluating the employer’s right to direct and control the worker.
- All relevant information must be explored before answering the legal question of whether the right to direct and control associated with an employment relationship exists.
- Evidence supporting a worker’s classification must be factual and well documented and support the conclusion.

**WORKER CLASSIFICATION UNDER OTHER EMPLOYMENT-RELATED LAWS**

Worker classification is relevant under numerous other Federal laws that apply only to employees, not to independent contractors. These include:

- Americans with Disabilities Act (“ADA”)
- Age Discrimination Act (“ADEA”)
- Title VII of the Civil Rights Act of 1964 (“Title VII”)
- Employee Retirement Income Security Act (“ERISA”)
- Group health plan coverage under the Consolidated Omnibus Budget Reconciliation Act (“COBRA”)
- Family Medical Leave Act (“FMLA”)
- Fair Labor Standards Act (“FLSA”)
- Equal Pay Act
- Genetic Information Nondiscrimination Act of 2008 (“GINA”)
- National Labor Relations Act (“NLRA”)
- Labor-Management Reporting and Disclosure Act (“LMRDA”)
- Immigration and Nationality Act (“INA”)
- Occupational Safety and Health Act (“OSHA”)
- Uniformed Services Employment and Reemployment Rights Act (“USERRA”)

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Worker classification also is important for various state laws, principally workers’ compensation, unemployment insurance, and anti-discrimination statutes. Under these employment-related statutes, worker classification typically determines whether the worker and the employer are covered by the statute at all. Moreover, certain federal employment-related statutes do not apply unless an employer employs a minimum number of employees (as defined for purposes of that statute). The table below indicates the minimum number of employees necessary for an employer to be covered by the applicable statute.

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As with the federal tax laws, the consequences of misclassification can be severe. For example, an employer that finds that a worker it treated as an independent contractor is a “non-exempt” employee for purposes of the FLSA could find itself liable for significant overtime pay and penalties.

Similarly, an employer that arbitrarily terminates an older worker believed to be an independent contractor could find itself involved in an age discrimination case.

As these statutes do not contain explicit definitions of “employee,” the courts have frequently been called upon to distinguish individuals covered by the statutes from those that are not covered. In doing so, the federal courts have tended to consider the common law “right to control test” along with numerous economic factors in order to assess the relationship between the employer and the worker in its totality. The U.S. Supreme Court has noted that the following factors, in addition to the employer’s right to control, are relevant in determining if the worker should be classified as an employee:

- The skill required to perform the work
- Whether the worker supplies his or her own tools
- The location where the work is performed
- The duration of the relationship of the parties
- The employer’s right (or lack thereof) to assign additional projects
- The worker’s discretion over when and how long to work
- The method of payment
- The worker’s role in hiring and paying assistants
- Whether the work is part of the employer’s regular business
- Whether the worker is in business for himself or herself
- Whether “employee benefits” are provided to the worker
- How the worker is treated for tax purposes

In short, coverage under these statutes is highly dependent on individual circumstances and, if litigated, is subject to judicial interpretation. Accordingly, health centers should obtain legal counsel if a worker’s status under these statutes is uncertain.

OTHER CONSIDERATIONS REGARDING WORKER CLASSIFICATION

“Rule of Thumb” Determinations

It is essential to remember in applying the relevant classification tests that, usually, no one factor is determinative of a worker’s status. In close cases, it will be necessary to carefully weigh all of the factors applicable to a particular classification issue. However, in many cases it may be possible to apply a “rule of thumb” to avoid a potential misclassification. Employment situations that do not readily fall into these categories should be analyzed further by applying the appropriate tests.

Workers generally are considered to be independent contractors when they:

♦ Are sole proprietors of their own business
♦ Conduct their business thru a legally recognized business entity such as a corporation, limited liability company (LLC), etc.
♦ Work under a contract for hire, whether written, oral or implied
♦ Have the right to set the terms and conditions of their work and how they perform the assigned tasks
♦ Set a fixed fee or price for their work
♦ Set their own work schedule, subject only to agreed-upon deadlines

Workers generally are considered to be employees when they:

♦ Do not have the right to determine how they perform the assigned work
♦ Receive benefits typically reserved for employees, e.g., vacation, sick days, health insurance, life or disability insurance, etc.
♦ Perform the same services that otherwise are performed by bona fide employees, or that they previously performed for the employer as an employee, e.g., a “retired” employee providing “consulting” services
♦ Are subject to personnel policies applicable to employees such as drug testing, time and attendance, etc.
♦ Work for the health center exclusively
♦ Provide services that typically are management functions of the health center
♦ Perform work that does not require a high level of skill or expertise
♦ Perform services on the health center’s premises using the health center’s equipment and supplies
Classification Process

For federal tax purposes, either the employer or a worker can ask the IRS to classify the worker as an employee or as an independent contractor. This is done by filing IRS Form SS-8, “Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding,” with a description of the type of work being performed and information about the terms and conditions of the work sufficient to make the proper classification. The parties are bound by the IRS's decision, but only with regard to federal tax issues. Health centers also should keep in mind that the IRS strongly prefers that workers be treated as employees.

In instances when a health center prefers to engage an individual as an independent contractor, minimize risks by taking basic precautions:

1. Sign a written agreement with the independent contractor specifying the services to be provided, payment terms, deadlines, etc., but avoid language that gives the health center control over the “means and methods” of performing the services. The agreement should require the worker to comply with the tax obligations of an independent contractor.

2. Be consistent in using independent contractors. Do not engage an independent contractor to do the same kind of work provided by employees.

3. Allow the worker to determine where and how to accomplish the assigned tasks and work hours, without supervision.

4. Avoid giving the worker office space and access to the health center’s equipment and supplies, unless there is an agreement to “charge back” the costs to the worker.

5. Pay the worker on an invoice basis. Never pay independent contractors through the health center’s regular payroll system.

Terms and Conditions of Employment/Independent Contractor Arrangements

Obviously, the surest protection against the potential penalties that a health center might incur from misclassification is to classify the worker as an employee in the first instance. That would insure compliance with federal and state laws where worker classification is relevant. Note that many of the benefits typically provided to employees, such as paid vacation and/or holiday leave, paid sick leave, and severance pay are not regulated by federal (nor most state) law. Thus, a health center could treat workers as employees for the purposes regulated by law, but not necessarily for every other purpose.

However, before a health center takes that approach, it should make sure that the distinctions between, and the associated benefits provided to, its various types of employees are clearly spelled out in its personnel policies. Most importantly, the terms and conditions of employment should be clearly spelled out to the employee, preferably in a written employment letter, bearing in mind that a worker cannot agree to waive a requirement or benefit, such as tax withholding or overtime pay, if the employer is legally required to comply with the law or to provide the benefit. This is a particularly sensitive issue with regard to employee benefits subject to ERISA such as health and pension benefits and similar plans maintained by an employer for the benefit of its employees.
6. Establish a file for each independent contractor and keep good records including contracts, invoices, and other information documenting that the worker is operating as an independent contractor, such as business cards, stationery, list of other businesses for which services are performed. Always keep independent contractor records separate from the health center’s personnel files.

7. If the independent contractor will be paid with Federal funds, always follow (and document) required procurement procedures.

8. When possible, engage independent contractors that conduct their business through a legally recognized entity. In that case, the health center is hiring the company, not the individual. (Keep in mind, however, that the government takes the position that clinicians must contract individually, not through their professional corporation, in order to be covered under the Federal Tort Claims Act.)

9. Obtain taxpayer identification numbers for any unincorporated independent contractor to whom the health center pays more than $600.00 in a year, and file an IRS Form 1099.

CONCLUSION

Misclassification of health center workers may result in serious legal and/or financial consequences, under Federal tax law as well as other federal and state employment-related laws. As such, health centers should use caution when classifying workers, reviewing and utilizing various worker classification tests and seeking professional guidance when necessary. Taking appropriate precautions will substantially reduce the legal and financial risks, both to the health center and to the individual worker(s) involved.

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