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# NORTH CAROLINA STATE UNIVERSITY

## EMPLOYEE VS. INDEPENDENT CONTRACTOR REFERENCE GUIDE

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# EMPLOYEE VS. INDEPENDENT CONTRACTOR REFERENCE GUIDE

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## INTRODUCTION TO GUIDE

North Carolina State University (NCSU), in accordance with Federal and State laws, requires that an accurate classification be made with regards to the University engaging an independent contractor to perform services of a professional, technical, or administrative manner that cannot be readily performed by employees because of existing staffing constraints or the nature of the work. A determination must be made as to whether an employee-employer relationship will result before an individual may be engaged as an independent contractor. This guide includes the criteria used in determining a worker's status as an independent contractor or an employee based on the Internal Revenue Service (IRS).

## PURPOSE OF GUIDELINE

This guide covers the use of independent contractors to provide professional, technical, administrative, or unique services generally performed by individuals and sole proprietors. The use of an independent contractor is expected to address the performance of a specific task or job that will be accomplished within a specified period of time. An independent contractor should not be used to direct a University program or retained on an indefinite basis to perform tasks that would normally be assigned to an employee.

Services provided by employees of employment agencies shall not be treated as independent contractor arrangements covered under this guide. In addition, an honorarium paid to a non-University faculty member as an expression of gratitude for performing a short-term service (e.g., a speaking engagement, reading a manuscript, etc.) generally would not be treated as an independent contractor payment covered by this guide.

This guide establishes the standards for hiring workers to perform independent contractor services for the University. The guide conforms to the Internal Revenue Code (IRC) and applicable Treasury Regulations governing the classification of independent contractors for tax purposes.

## RESPONSIBILITIES

**The Tax Compliance Office** is a unit within the University's Controller's office responsible for issuing required tax forms to independent contractors at the end of the calendar year.

**Accounts Payable** is a unit within the University's Controller's office responsible for reviewing and issuing payments to independent contractors throughout the year.

**Purchasing** is a unit within Materials Management responsible for reviewing contract agreements and is the approved signature authority for the University in regards to independent contracts. All contract agreements need to be signed by Purchasing.

**Human Resources** is responsible for the University's employment guidelines, policies and payroll. If it is deemed that a prospective independent contractor should be classified as an employee, HR should be contacted immediately and provided with all necessary information.

**Departments** are responsible for determining a vendor's correct status as an independent contractor or an employee before any services are performed. Departments proposing to engage a contractor must complete the Independent Contractor Checklist (attached).

#### PRIMARY GUIDANCE

- [Independent Contractor Agreements](#)
- Human Resources Guideline to [Independent Contractors and the IRS](#)
- [IRS Employee Training Manual on Employee vs. Independent Contractors](#)
- [IRS Website: Independent Contractor or Employee](#)

#### WHO IS GOVERNED BY THIS GUIDELINE

Any employee who is responsible for engaging the services of an independent contractor as well as supervisors and Business Officers who supervise an employee with such responsibilities.

## 1.0 EMPLOYEE vs. INDEPENDENT CONTRACTOR

### 1.1 GENERAL DEFINITIONS

An **employee** is an individual who performs a service for North Carolina State University (NCSU) and is working under the direction and control of NCSU or its employees. Direction and control can be implied to exist when NCSU has the right to control *both the results as well as the means and methods of the worker*. ([IRS Treasury Regulation 31.3121\(d\)-1\(c\)](#)). When someone is an employee, they are paid through the payroll system and required Federal and State taxes are withheld and/or paid on the employee's behalf.

An **independent contractor** is an individual engaged by the University to perform a specific function or task and who is free to perform this function or task completely *at the individual's own discretion with regard to means and methods*. No taxes are required to be withheld or paid on compensation disbursed. ([IRS Treasury Regulation 31.3401\(c\)-1\(b\)](#)). The existence of an agreement or contract helps support the independent contractor position. This document should be fairly specific in what is to be provided and amount or lack of control the University has over the individual. When someone is an independent contractor, they are not on the payroll system, taxes are not withheld from their payments and their income is reported as nonemployee compensation on form 1099-Misc (if payments exceed \$600).

### 1.2 FACTORS TO DETERMINE EMPLOYEE STATUS FROM INDEPENDENT CONTRACTOR STATUS

An employee/employer relationship generally exists under the common law when the worker is subject to the right of control by the business as to what work shall be done and how it shall be done. The IRS has developed a **20-factor** test presented below to aid in determining whether a business has the right to control and direct a worker. Although the general importance of each factor varies, the IRS has identified three primary categories of evidence to assess in determining worker classification. These categories are **behavioral control, financial control and the relationship of the parties**. Each category is more fully described in the Independent Contractor or Employee IRS Training Manual, which can be obtained in the link below. To make this determination we must examine the relationship of the worker and the business. The main focus of this examination is control and independence. This usually falls into three categories:

- 1) Behavioral Control-Does the University have the right to control how the job is done?
  - a) Type of instructions given
  - b) Degree of instruction
  - c) Evaluation systems
  - d) Training
- 2) Financial Control-Does the University have the right to control the economic aspects of the job?
  - a) Significant investment
  - b) Unreimbursed expenses
  - c) Opportunity for profit or loss

- d) Services available to market
  - e) Method of payment
- 3) Type of Relationship-How do the University and the worker see their relationship with one another?
- a) Written contract
  - b) Employee benefits
  - c) Permanency of the relationship
  - d) Regular activity of the business, i.e. University

### 1.2.1 BEHAVIORAL CONTROL

Behavioral control derives from facts that illustrate a right to direct or control how the worker performs their tasks. What is the level of instruction that the business gives the worker? The more defined these instructions are, the more likely the worker is an employee. These instructions could include, but are not limited to:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or assist with work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

Even if no instruction is given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. The key is whether or not the business has retained the right to control the details of a worker's performance.

Examples of behavioral facts from the IRS twenty factors are as follows:

- Instructions (IRS factor 1) - A worker who is required to comply with another person's instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the RIGHT to require compliance with instructions.
- Training (IRS factor 2) - Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.

Highly trained professionals such as physicians, accountants, lawyers, engineers, or computer specialists may require very little, if any, training and/or instruction on how to perform their services. Therefore, such professional workers who are engaged in the pursuit of an independent trade, business, or profession in which they offer their services to the public are generally independent contractors and not employees ([Treasury Regulation 31.3121\(d\)-1\(c\)\(2\)](#)). See excerpt from IRS Revenue Ruling 66-274 presented below for criteria to assess when determining worker classification of a physician (a useful example).

### 1.2.2 FINANCIAL CONTROL

Financial control derives from facts that illustrate an employer's right to direct or control how the business aspects of the worker's activities (employment) are conducted. Questions that you may ask to determine if there is financial control:

- Does the worker have unreimbursed expenses? Independent contractors are more likely to have unreimbursed expenses than employees.
- Does the worker incur fixed ongoing costs regardless of whether the work is currently being done? Yes to this question may indicate the worker is an independent contractor.
- Does the worker have a significant investment in the facilities he or she uses in performing services for someone else? If yes, then the worker is normally an independent contractor. However, the lack of a significant investment in facilities does not automatically mean the worker is an employee.
- Does the worker make his or her services available to other businesses? This is a clear indication of independent contractor status. Often times an independent contractor will advertise, maintain a viable business location and make themselves available to other businesses.
- Is the worker paid a regular wage? An employee is generally guaranteed a regular wage amount for a set period of time - hourly, weekly, monthly, etc. An independent contractor may be paid based on a per job basis, or can also be paid by the hour.
- Can the worker incur a profit or loss? An independent contractor can make a profit or loss on the work/job.

Examples of financial factors from the IRS twenty factors are as follows:

- Realization of profit or loss (IRS factor 16) - A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is generally an employee. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.
- Significant investment (IRS factor 15) - If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices.

### 1.2.3 RELATIONSHIP OF THE PARTIES

Types of relationships refer to facts that show how a worker and business perceive each other's relationship to one another. Several facts that illustrate how the parties perceive their relationship with the other are listed below:

- Is there a written contract between the business and the worker that describes the relationship intended between the two parties?
- Does the business provide the worker with employee-type benefits, such as insurance, a pension plan, vacation and/or sick pay? If so, the worker has the characteristic of an employee.
- What is the permanency of the relationship? If the worker is given the expectation that the relationship will continue indefinitely, rather than for a specific project or period, then it is more likely that the intent was to establish an employer/employee relationship.
- Are the services performed by the worker a key aspect of the regular business of the company? If the services provided by the worker are considered a key aspect of the business' regular activities, it is more likely that the business will have the right to direct and control his or her activities. The ability to direct and control the activity is a characteristic of an employer/employee relationship.

Examples of relationship factors from the IRS twenty factors are as follows:

- Continuing relationship (IRS factor 6) - A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.
- Working for more than one firm at a time (IRS factor 17) - If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

### 1.3 IRS TWENTY FACTOR TEST (As pulled from Revenue Ruling 87-41)

Generally there is an employer/employee relationship 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 to be accomplished but also as to the details and means by which the result is accomplished. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so. The Internal Revenue Service developed 20 factors to assist the taxpayer in determining if a worker is an employee or Independent Contractor.

#### 1.3.1 A "Yes" answer for the following questions indicates that the worker is an employee:

- 1) **Does the business provide instructions to the worker about when, where and how he or she is to perform the work?** A worker who is required to comply with another person's instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if



the person or persons for whom the services are performed have the RIGHT to require compliance with instructions.

- 2) **Does the business provide training to the worker?** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner
- 3) **Are the services provided by the worker integrated into the business' operations?** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.
- 4) **Must the services be rendered personally by the worker?** If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.
- 5) **Does the business hire, supervise and pay assistants to the worker?** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
- 6) **Is there a continuing relationship between the business and the worker?** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring, although irregular, intervals.
- 7) **Does the business set the work hours and schedule?** The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control
- 8) **Does the worker devote substantially full time to the work of the business?** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor on the other hand, is free to work when and for whom he or she chooses.
- 9) **Is the work performed on the business' premises?** If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.

- 10) **Is the worker required to perform the services in an order or sequence set by the business?** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently.
- 11) **Is the worker required to submit oral or written reports to the business?** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.
- 12) **Is the worker paid by the hour, week or month?** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on straight commission generally indicates that the worker is an independent contractor.
- 13) **Does the business have the right to discharge the worker at will?** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.
- 14) **Can the worker terminate his or her relationship with the business any time he or she wishes without incurring liability to the business?** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.
- 15) **Does the business pay the traveling expenses of the worker?** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.

1.3.2 A "Yes" answer for the following questions indicates that the worker is an Independent Contractor:

- 16) **Does the worker furnish significant tools, materials and equipment?** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.
- 17) **Does the worker have a significant investment in the facilities?** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices.
- 18) **Can the worker realize a profit or loss as a result of his or her services?** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily

realized by employees) is generally an independent contractor, but the worker who cannot is an employee. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

- 19) **Does the worker provide services for more than one firm at a time?** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
- 20) **Does the worker make his or her services available to the general public?** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

#### 1.4 ADDITIONAL FACTORS (Taken from the Employee IRS Training Manual)

In its Independent Contractor or Employee Training Manual, the IRS identified certain other facts that were relevant in court decisions regarding worker classification. The other facts presented in the training manual primarily relate to how the worker and employer perceive their relationship. We have presented a few examples below of the other factors for informational purposes.

**Intent of parties/written contract** - A written agreement describing the worker's classification is evidence of the intent regarding the working relationship. However, the contract itself is not sufficient evidence regarding worker classification. Therefore, the substance of the written agreement should be assessed in combination with all other relevant facts and circumstances.

**Forms W-2** - Filing a Form W-2 for a worker generally indicates employee status.

**Incorporation** - Workers who create a corporation and provide services to a business are generally considered independent contractors of the business.

**Employee benefits** - If a worker receives employee benefits, such as paid vacation days, paid sick days, health insurance, life or disability insurance, or a pension, the worker generally would have employee status. Employee benefit facts lending towards employee status are generally strongest if the worker is provided with a tax-qualified retirement plan, IRC section 403(b) annuity, or cafeteria plan.

**Discharge/termination** - The circumstances under which a business or worker can terminate their relationship with the other party are generally considered useful evidence regarding worker classification. However, due to the complexity regarding the right to discharge or terminate, this type of evidence should be used with caution.

The IRS's training manual (link below) can be used for training purposes but should not be used as a final authority. The IRS website also has a good overview of classification of employee vs. independent contractor (link below).

[IRS Independent Contractor or Employee Training Materials](#)

[IRS Independent Contractor \(Self-Employed\) or Employee?](#)

## 1.5 ISSUES IN HIGHER EDUCATION AUDITS (in relation to Employee vs. Independent Contractor)

IRS auditors have examined enough abuses of the existing employment tax rules occurring in tax exempt organizations to have become sensitized to situations that are unique to higher education. Specifically, the IRS will be scrutinizing payments that are made to the following individuals:

- "Adjunct" faculty and part-time instructors; *TAM 9105007 concluded that part-time professors were employees of the college because of the elements of control existing in the relationship between the college and the professors.*
- Outside contract payments to coaches;
- Agricultural laborers performing temporary work;
- Instructors in non-degree professional development programs;
- "Consultants" or other "independent contractors" who perform management or supervisory functions for the institution;
- Graduate research assistants and fellows; *Teaching/research assistants and graduate assistants (non-teaching) are defined as being assigned to specific duties by a principal investigator or project leader. The employer's legal right to control both the method and the result of the service causes these individuals to be considered employees by definition.*
- Individuals with excessively low withholding;
- Independent contractors paid more than \$5,000 in a calendar year;
- Nonresident aliens paid as employees, independent contractors, or who receive fellowship or scholarship grants;
- Early retirement options and *payments to induce professors to give up tenure and retire early are wages subject to FICA and federal income tax withholding purposes. (IRS Letter Ruling 9711001). Tenure, and the rights associated with this status, are awarded to probationary appointees as a consequence of their past service to the university. Since these payments are made to cancel tenure rights that relate to past services, rather than to cancel a contract right, they are includable in taxable wages.*
- "Dual-status" workers (those considered both an employee and a contractor). *In some circumstances, an employee may have an outside professional corporation that performs the contracted service and payment is being requested from the corporation. A basic question needs to be asked at this point - who is being hired? The individual through their corporation or the corporation itself? If the individual is simply requesting that payment be made to his or her personal service corporation, the amount should be considered wages. If, on the other hand, the personal service corporation contracts with the university, and the corporation has a bona fide employer-employee relationship with the faculty/staff member, there may be enough substance to the*

*relationship that it would be respected by the IRS. Remember, the IRS generally takes the position that if an employee performs any service for his/her employer, all payments to that employee should be treated as wages. In IRS Letter Ruling 9219020, the IRS determined that an employee who performed 95% of his/her services for the corporation to the employer, and only 5% to other entities was truly acting as an employee rather than an independent contractor through the corporation. Thus if the principal client of the personal service corporation is the university, then the contracted service should be considered wages to the employee. A common area where this situation occurs is with those faculty members who teach continuing education courses.*

## 1.6 DETERMINABILITY OF EMPLOYEE vs. INDEPENDENT CONTRACTOR

The determination of whether or not the worker is an employee or independent contractor is the responsibility of the University. If the Internal Revenue Service challenges the classification made by the business, the burden of proof is on the taxpayer (University).

If requested, the IRS will make a determination of whether a worker is an employee or independent contractor. This request is done by filing Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

To help with determining whether a worker is classified as an employee or an independent contractor a checklist has been provided with this guide. The checklist should be filled out by department. If the vendor is determined to be an independent contractor, then an agreement should be signed by the University's Purchasing Department and the Independent contractor before payments are made and kept on file in the University Purchasing office.

Links to these forms can be found here:

[http://www.ncsu.edu/general\\_counsel/contracts\\_library/ContractsLibrary.php#Independent](http://www.ncsu.edu/general_counsel/contracts_library/ContractsLibrary.php#Independent)

[http://www.ncsu.edu/human\\_resources/employment/contractor.php](http://www.ncsu.edu/human_resources/employment/contractor.php)

[http://www.ncsu.edu/human\\_resources/employment/docs/Independent\\_Contractor\\_Checklist.doc](http://www.ncsu.edu/human_resources/employment/docs/Independent_Contractor_Checklist.doc)

## 1.7 IRS RECLASSIFICATION OF INDEPENDENT CONTRACTORS TO EMPLOYEE STATUS

If the IRS reclassifies a significant number of independent contractors to employee status, the result could be a substantial financial impact on the University and the departments that are making these payments. In situations where intentional violations of employment tax rules and regulations are detected (i.e., changing a long-standing employee to an independent contractor in order to "save" payroll taxes and benefit costs), the IRS will assess taxes as follows:

- Federal income tax at the applicable rate; and
- Federal social security and Medicare tax assessment of 15.3%.

In some cases, the IRS can levy penalties and interest charges. Even if the taxes have already been paid by the individuals in question, the IRS will still make the tax assessment against the university/agency. It then becomes the responsibility of the university/agency to obtain repayment from the individuals in question (assuming the university/agency paid the tax assessment).

Additionally, reclassification to employee status may require that the employee be included in pension plans and other fringe benefit programs. The pension plan could be subject to penalty violations or even disqualification.