

Independent Contractor and Employee Status: What Every Employer in Sport and Recreation Should Know

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INTRODUCTION

In sport and recreation the use of "contingent workers" (Lenz, 2001, p. 1), which include independent contractors, is critical for the attainment of the organization's goals and objectives. The flexibility that contingency workers bring to organizations is critical for the fiscal and technical survival of many sport and recreation programs. Independent contractors in sport and recreation allow for seasonal work, such as coaches and officials, as well as those that have the technical knowledge and skills to raise funds and provide consulting services in the areas of facility development and management development and improvement (Human Resources, n.d.).

The classification of workers has many implications in terms of tax liability and tort liability, yet the reality of how workers are classified can present problems for employers due to the complexity and vagueness of the process. The Supreme Court of the United States addressed this issue of classification almost 60 years ago when it stated, "Few problems in the law have given greater variety of application and conflict in results than the cases arising in the borderland between what is clearly an employee-employer relationship and what is clearly one of independent, entrepreneurial dealing" (*NLRB v. Hearst Publ'ns, Inc.*, 1944, p.121).

The employment relationships that an employer may utilize fall into four primary categories. Hollrah (2002) has identified these categories as:

- (1) Company engages a worker directly as its own employee;
- (2) Company engages a worker directly as an independent contractor;

(3) Company engages a worker through a third party as an employee of the third party and as an independent contractor relative to the Company; or

(4) Company engages a worker through a third party as an independent contractor relative to both the third party and the Company (Introduction section, para. 5).

For the most part, employers in the sport and recreation industry will utilize the first two categories when hiring workers.

With the potential confusion and possible ramifications of classifying or misclassifying a worker, an examination of the literature and governmental regulations is in order to prevent the occurrence of a misclassification. Therefore, the purposes of this paper are to present the pros and cons of classifying workers as either an employee or an independent contractor, delineate the process of classification of workers, discuss the ramifications and legal implications of treating workers as independent contractors, and the process of protecting your organization from outside legal and governmental scrutiny if you choose to classify a worker as an independent contractor.

PROS AND CONS OF USING INDEPENDENT CONTRACTORS

Several authors have discussed the advantages and disadvantages of using independent contractor instead of hiring an employee. It is up to the employer to weigh the benefits over the liabilities of using independent contractors, but when they come to the conclusion that the independent contractor is best suited for their organization, the employer is always cautioned to make sure that the classification process is diligently followed to maintain the benefits of their decision. A list of advantages and disadvantages discussed by other authors follows:

ADVANTAGES OF HIRING INDEPENDENT CONTRACTORS

- (1) Saves money in benefits and tax contributions (Human Resources, n.d.)
- (2) Limits statutory requirements (Davidov, 2002, p. 363)
- (3) Employer can dictate terms and scope of the contract (Davidov, p. 363)
- (4) Allows women with children, as well as others to enter the job market (Dnea, 1995, p. 902)

(5) Allows an employer to fill temporary or specialized needs (Ducea, p. 902)

(6) Allows an employer to implement new technologies or ideas quicker and cheaper (Ib.)

(7) Allows for easy reduction of staff in the off-season (Fried & Miller, 1998, p.7)

DISADVANTAGES OF HIRING INDEPENDENT CONTRACTORS

(1) Danger of misclassification

(2) Less control of the worker and process

(3) Lack of loyalty

(4) Need to negotiate and re-negotiate the contract when it expires (Human Resources, n.d.)

As the above list demonstrates, an employer must weigh the advantages and disadvantages of hiring an independent contractor over an employee based on the goals and needs of his or her organization. If the worker is only needed for a temporary or transient period of time, then an independent contractor would be preferable over an employee. But if the employer needs a worker that develops loyalty and a work commitment to the employer, an employee would be the preferred worker classification.

DEFINITIONS

There is a great deal of difference between an employee and an independent contractor. The two classifications of workers have very different rights, responsibilities, and liabilities for the employer. The employer should consider which classification of a worker is to the employer's benefit before choosing to employ a worker as either an employee or an independent contractor. For the purposes of this paper, the term "employee" will be defined as:

Under the common law test, a worker is an employee if the person for whom he works has the right to direct and control him in the way he works both as to the final results and as to the details of when, where and how the work is to be done. The employee need not actually exercise control. It is sufficient that he has the right to do so. (Gates, pp. 4.23 – 65-66).

An employer can typically rely on IRS regulations and rulings, since guidelines such as the 20 Common Law Factors (discussed later) were developed using common law and case law (*In re Rasbury*, 1994, p. 162). Under the IRS rules and regulations there are three primary areas that determine a worker's status. These areas include behavioral control, financial control, and the relationship of the parties (Internal Revenue Service (a), n.d. ("IRS(a)").). When a worker is determined to be an employee, the employer becomes liable for the withholding responsibilities of income tax, social security tax, Medicare and unemployment taxes (IRS(a)).

On the other side of the coin is the worker who can be classified as an independent contractor. The general legal definition of an independent contractor is:

An independent contractor is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of the undertaking. He may or may not be an agent (American Law Institute ("ALI"), 1958, p. 12).

In essence, the employer hires the independent contractor to do something, and the independent contractor does it with little or no input on how the work is completed, just so the work is completed to the satisfaction of the employer according to the conditions of the contract (H.R. Rep. No. 95-1748, 1978, p.3). If an employer hires and pays an independent contractor an amount over \$600 per year, the employer must complete an IRS Form 1099-MISC for the independent contractor (Internal Revenue Service (b), n.d. ("IRS(b)").).

This is an obvious contrast to the *Restatement's* treatment of an employee, who serves as a "servant" to a "master" (ALI, 1958, p. 13). The IRS defines what an independent contractor is in a matter-of-fact manner by stating that if, "the person for whom the services are performed, have the right to control or direct only the results of the work and not the means and method of accomplishing the results (Internal Revenue Service (e), 2003, p.3 ("IRS(e))).

With an understanding of the difference between an employee and an independent contractor, the next question is what process should an employer use in order to properly classify its workers. The proceeding section discusses the classification process, allowing the employer to classify workers correctly – hopefully. The importance of proper classification from the beginning of the employment relationship was exemplified by Alden (2003, pp. 22-23), when he stated that, "Because the liabilities can be large when the government comes along later to collect what you should have withheld or paid in the first

place, whether the people you hire are employees or independent contractors may mean virtually the world to you" (p. 21).

THE CLASSIFICATION PROCESS

While the above definitions seem fairly clear to most people, the reality of classifying employees can turn into a very costly nightmare. As Davidov (2002) stated, there are two problems that arise in the classification process, "First is the inability of current definitions and tests to prevent deliberate misclassification by employers trying to avoid employment responsibilities. Second is their inability to identify employees in atypical relationships" (p. 363).

To make things even more complicated for an employer attempting to classify his or her workers as either employees or independent contractors, is the fact that, as Hollrah (2002) explains, "A worker's status must be determined separately for purposes of three different federal employment taxes, namely Federal Insurance Contributions Act ("FICA") taxes, Federal Unemployment Tax Act ("FUTA") taxes, and federal income tax withholding. 'Employee' status is defined slightly different for purposes of each tax" (p.6).

The IRS has established 20 factors, called Common Law Factors, which, "assess whether a service provider is classified for tax purposes as an employee or an independent contractor" (Apostolou, Beehler & Hassell, 1993, p. 1389). These common law factors are:

(1) *Instructions* [Deals with the requirement to comply with instructions of when, where and how to complete the work. If the employer has the right to control compliance with instructions then the worker is most likely an employee. If the employer can only control the completion date and the resultant completion of the work, the worker is most likely an independent contractor.]

(2) *Training* [Is determined based on the amount of training required by the employer, and how much the worker needs to complete the job. If the employer requires the worker to be trained by an employee, correspond with the employer, or attend meetings, the worker may be determined to be an employee. An independent contractor should have the skills to complete the work assigned prior to the assignment and should be able to complete the work independent of the employer.]

(3) *Integration* [Two concepts dictate integration, first being that the services of the worker is integral to the completion of the success of the business. That integration tends to indicate a high level of control

and supervision of the worker by the employer. Therefore, the worker would probably be considered an employee if the task they perform is critical to the business enterprise.]

(4) *Services Rendered Personally* [Is there a requirement that the worker must perform the services contracted for personally. If the worker is required to perform the work themselves, this requirement may indicate that the worker is an employee. If the worker can subcontract or assign someone else to perform the work, this independence may indicate the worker is an independent contractor.]

(5) *Hiring, Supervising, and Paying Assistants* [When assistant workers must be hired, paid and supervised, the control of these assistants is critical. If the employer hires, pays or supervises the assistants, the worker is most likely considered an employee. If the worker is allowed to hire, pay and supervise the assistants, the worker is probably going to be considered an independent contractor.]

(6) *Continuing Relationship* [Does a continual business relationship exist between the worker and the employer? If the worker is contracted on essentially a continual basis, an employee-employer relationship probably exists. The worker may be hired frequently over a period of time, but it must be at irregular intervals.]

(7) *Set Hours of Work* [One factor that indicates a higher level of control by the employer is the establishment of work hours for the worker. If the employer requires specific work hours of the worker, the worker would most likely be considered an employee.]

(8) *Full Time Required* [If a worker is required or expected to work at or substantially at a full-time basis, the employer is considered in control of the ability of the worker to contract with other employers. An independent contractor is typically seen as a worker that can establish their own working hours, allowing them to work for several employers at the same time.]

(9) *Doing Work on Employer's Premises* [For the most part, if an employer requires the work to be performed either on the employer's premises or directs a specific location in which the work must be performed, the employer is considered exerting a high level of control on the worker, which may indicate that the worker is indeed an employee. The nature of the service itself may require that the worker perform the work at the employer's premises simply due to the nature of the work (e.g. an independent personal trainer working at an

employer's gym), but does not indicate a level of control required for the worker to be considered an employee.]

(10) *Order or Sequence Set* [When the employer requires that the worker perform the work in a specific sequential manner, not normally associated with that type of work or service, the employer is seen as controlling the worker as an employee. Some forms of service by their nature must be performed sequentially and is not dictated by the employer, and would most likely not be seen as a control issue.]

(11) *Oral or Written Reports* [If the employer requires oral or written reports by the worker, it may indicate that there is a higher level of control by the employer, and therefore, the worker might be considered an employee.]

(12) *Payment by Hour, Week, Month* [When a worker is paid in a lump sum or on commission, it will usually indicate that the worker is an independent contractor. Payment of workers by the hour, week or monthly usually will indicate that the worker is an employee, but may be agreed upon by an employer and an independent contractor if it is more convenient for either party.]

(13) *Payment of Business and/or Traveling Expenses* [If business and/or travel expenses are paid by the employer, the employer is seen in a position of controlling the business activities of the worker, and therefore, an employer-employee relationship probably exists. Independent contractors are usually responsible for paying their own expenses.]

(14) *Furnishing of Tools or Materials* [When an employer provides the tools and materials to the worker for completion of the service, the worker is usually considered an employee.]

(15) *Significant Investment* [Independent contractors will typically be responsible for personal investment in facilities such as office space and work space in order to complete the service contracted by the employer. If there is no indication of such an investment, it will usually indicate an employer-employee relationship. This investment may be very minimal in the sport and recreation fields, especially when it involves workers such as game officials.]

(16) *Realization of Profit or Loss* [If the worker has the opportunity to profit or lose money based on the services rendered, then the worker is an independent contractor. The caveat to this is that both independent

contractors and employees run the risk of not being paid by the employer, and this type of loss issue is not considered an indication of this rule.]

(17) *Working for More Than One Firm at a Time* [Independent contractors have the ability to work for more than one employer at any one time without control or permission from any of the employers. This rule only holds up as long as they are not considered an employee of those employers.]

(18) *Making Services Available to General Public* [Making one's services open to the general public on a regular and consistent basis indicates that the worker is an independent contractor.]

(19) *Right to Discharge* [Due to the fact that an independent contractor's work is based on a contractual relationship, they cannot be fired or discharged by the employer. The ability to fire or discharge a worker is an indication of control over the worker by the employer, and therefore, the worker is an employee.]

(20) *Right to Terminate* [The converse relationship based on contract law is that if the worker has the ability to terminate the relationship with the employer, they are to be considered an employee. Independent contractors are bound to the contract for their services and cannot unilaterally –without cause– terminate their relationship with the employer.] (Internal Revenue Service (c), pp. 298-299, ("IRS(c)").

While the IRS has attempted to assist employers in classifying their workers with the 20 common law factors, many authors and the courts have stated that, as Duea (1995) pointed out, "the IRS retains the power to determine the weight to give each of the twenty factors" (p. 917).

In an attempt to clarify those 20 factors and identify the factors "more relevant" to the classification of a worker, Apostolou et al. (1993) conducted a study with Certified Public Accountants who served as tax professionals. The study identified five of the twenty factors that seemed to be significant factors in determining if a worker should be classified as an employee or an independent contractor. These five factors, identified in order, were: 1) Realization of profit or loss; 2) Significant investment; 3) Full-time requirement; 4) Making services available to the general public; and 5) Working for more than one firm at a time (p. 1395). Apostolou et al. identified these five factors as a possible "safe harbor" for classifying workers (pps. 1393 & 1395). Narrowing the 20 common law factors down to the five most

relevant factors in determining worker status allows employers the ability to make a more precise decision in classifying their workers.

If you are an employer and make a mistake in identifying an employee as an independent contractor, there is relief from a very unlikely source—the United States Congress. In the Revenue Act of 1978, Congress passed Section 530. Section 530, "provides an eligible business with perpetual and absolute protection against the IRS reclassifying covered workers as employees for purposes of federal employment taxes" (Revenue Act of 1978, §530). This absolute inoculation from IRS intervention provides a great deal of coverage for employers if they indeed qualify.

Section 530 presents a problem in some respects for the researcher, since it has never really been specifically codified into law. But that does not mean that § 530 does not have the force of law. As the court stated in *McClellan v. U.S.A.* (1995),

Congress' failure to codify §530 does not indicate that it must assume less importance than other tax provisions. Indeed, Congress enacted the statute in order to curb over-zealous IRS enforcement of the established tax code. . . . Thus, Congress has instructed the IRS to accept presumptively the taxpayer's classification of the individual as a non-employee unless there is no reasonable basis for doing so (p. 106).

Section 530 has specific areas of relief that an employer can use to protect themselves from IRS fines and back tax assessments (Revenue Act of 1978, §530). In general, the employer must meet several criteria in order to have a safe harbor under Section 530. For the most part, an employer must begin any work classification with Section 530 (Internal Revenue Service (d), p. 1-1, 1996 ("IRS(d)"). The employer must then meet requirements in two areas of compliance:

CONSISTENCY TEST (must meet both tests)

- (1) Filing all required Forms 1099 (reporting consistency)
- (2) Treating all workers in a similar position the same (substantive consistency)

REASONABLE BASIS TEST (must reasonably rely on at least one of the following)

- (1) Prior audit safe haven (IRS audit for employment tax purposes)
- (2) Judicial precedence safe haven (including court rulings, published rulings, technical advice memos, private letters, etc.)

(3) Industry practice safe haven (long-standing and involve a significant segment of the industry)

(4) Other reasonable basis (IRS(d), pp. 1-2 – 1-36).

When Section 530 was promulgated, Congress, in a House Ways and Means Committee Report, stated that, "[t]he committee intends that this reasonable basis requirement be construed liberally in favor of the taxpayer" (H.R. Rep. No. 95-1748, 1978, p.5). This statement by Congress does help provide employers a significant level of protection when they attempt to classify workers, or if the IRS questions their previous classifications since it indicates Congressional intent that the tax payer be given the benefit of the doubt in worker classification controversies.

While the 20 common law factors and Section 530 are methods in which employers can explore and determine what classification they will assign to a particular individual or class of workers, the IRS does provide its own service of determination. When unsure of how to classify a worker, employers have the option to request that the IRS determine the status of the worker's classification. An employer-or worker for that matter-can submit IRS Form SS-8 and the IRS itself will conduct the classification (Internal Revenue Service (f), 2003, p. 4, ("IRS(f)"). If the employer disagrees with the IRS determination they may appeal the decision with the determining officer (IRS(f), p. 4). The IRS's basis for determination of a worker's classification using Form SS-8 is Section 530 regulations (p. 5). Using IRS Form SS-8 gives employers a definitive method of classifying its workers since the IRS is making the determination, but as stated earlier, the IRS will make the determination based on Section 530, therefore, it is probably advisable that the employer or their representative be familiar with this tax law.

LEGAL ISSUES

In sport and recreation, many times workers are hired for short-term work or as workers for niche companies that are independent contractors themselves. These employers may or may not know the legal issues involved with worker classification, and through this ignorance, misclassify workers.

Sometimes employers see an opportunity to save money by classifying a class of employees or an individual employee as an independent contractor (Davidov, 2002, p. 363). This saves the employer the need to provide retirement, medical and other benefits, as well as the tax burdens discussed earlier. Employers could do this with new workers, and in extreme cases, one could see a greedy or desperate employer attempting to reclassify a group of current employees in order to save money. Typically the later example could

easily be determined as a violation of IRS rules, since it would violate the "classification consistency" test described earlier.

A problem arises with independent contractors who voluntarily sign contracts with employers as freelancers for a specific project. If the independent contractor is integrated into the employment culture of the employer, either at the beginning of the work or during the work contracted for, a problem develops as to the correct classification of the worker. This was the case in *Vizcaino v. Microsoft Corp.* (1997), in which Microsoft contracted with freelance workers. The workers agreed to the notion that they were indeed independent contractors, and therefore were not entitled to the typical employee benefits and tax status. In exchange for agreeing to be classified as independent contractors, the workers received a higher level of compensation in upfront money than a typical Microsoft employee would receive for the same type of work.

The problem with this employment arrangement was that the independent contractors were immediately integrated as "employees" of the company. When these freelancers asked Microsoft for benefits, especially the stock options available to regular employees, Microsoft denied them their request and the freelancers filed suit against the company (*Vizcaino*, 1997, p. 1009). In the end, the workers were reclassified as employees by Microsoft (*Vizcaino*, p. 1301). This misclassification cost Microsoft over \$198 million, due to the fact that the court found that even though the workers signed contracts that stated they were independent contractors, the workers' positions quickly fit the descriptions of an employee (p. 1008-1009).

The lesson from the Microsoft case is that if you have workers that initially are willing to forego benefits and the tax status of an employee, it may come back to bite you. If you hire independent contractors with the intent of circumventing the tax and benefits laws of the federal and state governments you run a great risk of getting caught and being penalized for it. If you hire independent contractors without the evil intent of cheating the workers and the government out of their dues, it is best to consult an outside source, or at last resort, the IRS itself. In the end, legal scrutiny and financial liability can be avoided.

A classic case of misclassification is the *American Consulting Corp. v. United States* (1971). In this case, the employer had treated its workers - a group of consultants - as employees for a number of years in which it paid FICA taxes for those employees. In 1959, the company hired a new accountant that reclassified the employees as independent contractors and ceased paying the FICA tax. The government was not happy with to the fact that American Consulting stopped paying taxes on these employees and pursued the company

for misclassification. The court could not find any evidence of an employee-employer relationship between American and its consultants, and called American nothing more than a "specialized employment agency", and hence, it was not liable for the FICA tax contributions (p. 484).

Another area that has the potential to cost an organization a substantial amount of money is in the area of tort liability. Based on the classification of a worker, the level or existence of liability of an employer may change. Although this issue could be the subject of an entire treatise, it will only be addressed briefly.

According to the *Restatement of the Law* (Second) (1958) the employer may or may not be liable for the actions of an independent contractor in their employ. In most cases, an employee is responsible for negligent acts conducted or caused by the employer's employees if the employee caused the tort while acting within the scope of their work, however, there are exceptions to this (ALI, §214, pp. 463-465). If an independent contractor is considered an "agent" of the employer, their actions may also hold the employer liable (§251, pp. 551-552). But for the most part, when an independent contractor is not acting as an agent of the employer, and the independent contractor causes a tort, the employer will not be held liable (§250, pp. 549-550).

CONCLUSIONS

Sport and recreation have long been the beneficiaries of independent contractors. Without the use of independent contractors most sports teams could not operate and most recreational leagues could not exist in part as a result of the classification of officials as independent contractors due to their independence from the school districts in accepting or rejecting employment as an official (Halcomb Lewis, 1998, p.252). At the collegiate and professional levels on the other hand, there is much more of an employer-employee type relationship with the collegiate conference who hires the officials, and at the professional leagues, who make substantial amounts of money from sports, and typically give the official their work schedule for the season (Halcomb Lewis, pp. 253 & 284). In fact, several states, including Alaska, California, Missouri, Montana, Oregon and Virginia have legislated that amateur officials are not "employees," and therefore, not liable for taxes and other employee issues (p. 16).

Other areas in which independent contractors are advantageous in the sport and recreational context include personal trainers in fitness and recreational organizations, as well as situations in which "highly specialized, non-supervised work that is needed only once or sporadically" must be

contracted out such as, advertising, gala and fund raising event planning, commissioned art (Human Resources, n.d.). It would not make good business sense nor would it be financially feasible for fitness clubs or public recreation departments to hire as employees, individuals with these skills as full-time or even part-time employees. They are truly used on a sporadic and temporary basis.

Classification of workers is a critical step in determining a workers tax and tort liability status. Classifying a worker or group of workers can be costly on both sides of the equation as seen in the *Microsoft* case where the workers were classified as independent contractors and were later found to indeed be employees, while the *American Consulting* case demonstrated how workers incorrectly classified as employees cost the company money in the form of overpaid taxes, and subsequent legal fees to defend the company's decision to reclassify the workers as independent contractors.

Using independent contractors can be very beneficial to an organization as long as steps are taken to ensure full compliance with the law. There are several steps employers can take to ensure proper classification of workers. One step is to draft a specific contract with the independent contractor that describes the work to be done, the time frame and responsibilities of the contractor to complete the work to be done, and states explicitly in the contract that the contractor is free to hire out their services to others (Human Resources, n.d.). Alden (2003) gives several other steps an employer can take to ensure proper classification of workers. These steps include making the proper classification in the first place by doing your homework, watching what your competition or others in your industry are doing in terms of classification, and once workers are classified you should not change the worker's classification, and in the contract, explicitly state that the worker is an independent contractor (pp. 22-23).

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