

INDEPENDENT CONTRACTOR OR EMPLOYEE?

It is critical that nonprofit organizations correctly determine whether the individuals providing them services are employees or independent contractors. As you know, organizations must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. If an organization misclassifies an employee as an independent contractor and it has no reasonable basis for doing so, the owner may be held liable for employment taxes for that worker. This means, among other things, that the relief provisions discussed below may not be available.

For organizations with a reasonable basis for classifying its workers, an opportunity to properly reclassify workers or employees under the Voluntary Classification Settlement Program (VCSP) is available. VCSP allows reclassification of employees in future tax periods for employment tax purposes. Essentially, the taxpayer is required to pay a reduced percentage of the employment tax liability that would have been due on compensation paid in prior years. Additionally, taxpayers participating in the voluntary program will not be liable for any interest or penalties on the liability. The program is open to eligible taxpayers that agree to prospectively treat their workers (or a class or group of workers) as employees. Participation in the program requires that the taxpayer meet a number of eligibility requirements including consistently treating the workers as non-employees and having filed all required Forms 1099 for each of the three preceding calendar years.

EMPLOYEE CLASSIFICATIONS When determining how to treat payments made for services, the organization owner must understand the relationship that exists with the person performing the services. The person performing the services may be one of the following:

- An **independent contractor** includes people such as doctors, dentists, lawyers, accountants, contractors and subcontractors who are in an independent trade, business or profession in which they offer their services to the general public. However, whether these people are independent contractors or employees depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done.
- An **employee** (common-law employee) includes anyone who performs services *if the organization owner can control what will be done and how it will be done*. This is so even when the employee is given freedom of action. What matters is that the organization has the right to control the details of how the services are performed.
- A **statutory employee** is a worker who is an independent contractor under the common law rules, but is treated as employees by statute for certain employment tax purposes. These include drivers paid on commission and individuals who work at home on supplied materials or goods to furnished specifications that must be returned.

- A **statutory nonemployee** falls into one of three categories: direct sellers, licensed real estate agents and certain companion sitters.

In order to determine how a payment for services would be classified within the preceding categories, all information that provides evidence of the degree of control and independence must be considered. The IRS will apply common law control rules when examining these facts which will fall into three categories:

1. **Behavioral:** Does the organization control or have the right to control how the worker performs the specific task for which he or she is engaged?
2. **Financial:** Are the employment aspects of the worker's activities controlled by the worker? (These include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. **Type of Relationship:** Are there written contracts or employee-type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the organization's function?

Organizations must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no "magic" or set number of factors that "make" the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

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Susan Jones joined Miller Cooper from a national accounting firm in which she had more than 20 years experience serving a broad range of nonprofit, private and public audit clients. In addition to handling the accounting and audit needs of her nonprofit clients, she consults with them regarding planning and various organizational matters, and shares best practices from working with a variety of organizations.

Ms. Jones received a Bachelor of Science in Accounting from the University of Illinois-Champaign/Urbana. She also received a Master of Business Administration from DePaul University: Kellstadt Graduate School of Business. Ms. Jones is a member of the Illinois CPA Society and its Not For Profit Committee and the Association Forum.