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Board Taking Points: Use of Independent Contractors

In an effort to contain payroll expenses employers turn to "consultants" and independent contractors. Employers believe that the use of independent contractors saves them money on payroll taxes, benefits and gives them a more flexible workplace. Unfortunately, employers do not accurately classify workers as independent contractors and expose the organization to potential liabilities.

Questions:

1. What is the difference between an employee and an independent contractor?
2. How do we know if a worker is properly classified as an independent contractor?
3. Does having a written agreement that states the worker is an independent contractor end the analysis?
4. What is the risk if we misclassify a worker as an independent contractor rather than an employee?
5. If we decide that we need to classify a worker as an employee, does that mean we have to offer them benefits?

Answers:

1. What is the difference between an employee and an independent contractor?

An employee is a worker that the organization "controls" and for whom the organization withholds income taxes and pays unemployment, Social Security, and Medicare taxes. Control in this context means establishing what work will be done and how it is done. An employee will receive a W-2 statement each January that reports the worker's annual earnings. Generally speaking, an independent contractor controls the "when, where and how" of his or her work and employers do not have to withhold or pay any taxes on payments to the contractor. See IRS Publication 15-A. The organization must issue a 1099 to an independent contractor that receives $600 or more in payments annually.

2. How do we know if a worker is properly classified as an independent contractor?

The determination of whether a worker is properly classified as an independent contractor or an employee will depend heavily on the facts and circumstances surrounding his or her work. The Internal Revenue Service (IRS) has developed a three-prong test (with several subcategories) to guide this analysis. The three prime factors are: (1) behavioral control; (2) financial control; and (3) type of relationship. The factors indicating the degree of control and the degree of independence will be weighed most heavily. If the organization requires the worker to be onsite in their offices at specific times, provides the equipment or materials needed to complete the work and provides instruction, the worker is likely to be considered an employee. It is important to remember that the mere fact that the individual works part time or on a temporary

basis does not automatically mean that the individual is an independent contractor. See page 6 of Publication 15-A. New York State uses a similar analysis for determining a worker's status under New York State Law.

Example: Do Right retains Sally to work as a grant writer for $20 per hour. Do Right requires Sally to be in the office Monday, Wednesday, Friday from 9-12 and provides Sally with a computer, telephone. Each week, Do Right's Executive Director reviews Sally's work plan with her and helps to prioritize her work. ***Sally is properly classified as an employee****.*

Do Right retains Sally to work as a grant writer and pays her $5,000 for each completed report or proposal. Do Right's Executive Director contacts Sally when she has an appropriate project, describes the project and sets a due date for a draft. Sally works offsite and is free to decline the work if she cannot meet the deadline. ***Sally is properly classified as an independent contractor.***

3. Does having a written agreement that states the worker is an independent contractor end the analysis?

Unfortunately, a written contract stating that the worker is an independent contractor is only one of the factors that the IRS or New York State considers when examining the type of relationship. The other factors examined as part of this analysis are: (i) whether the worker receives any benefits; (ii) the permanency of the relationship and (iii) whether the worker's role is integral to the organization.

4. What is the risk if we misclassify worker as an independent contractor rather than an employee?

If an employer misclassifies a worker as an independent contractor rather than an employee without a "reasonable basis" the employer will be liable for back Federal and State withholding taxes as well as penalties and interest, and penalties for failure to provide statutory benefits such as workers compensation coverage. This misclassification is most often discovered when the worker is terminated and applies for unemployment. The Department of Labor will determine that unemployment insurance had not been paid for that worker and has the option of then auditing the entire organization to determine if they are correctly classifying employees.

5. If we decide that we need to classify a worker as an employee does that mean we have to offer the worker benefits?

No, not all workers within the same organization need to be offered the same employee benefits. Under some circumstances, it is legal to provide benefits for some categories of employees but not for others. It is common for many employers to exclude part-time employees (for instance, those working fewer than 20 hours per week) from their benefits plans. You should seek advice on this subject from both a qualified benefits advisor and an attorney who specializes in benefits law.

This alert is meant to provide general information only, not legal advice. Please contact Legal Director Linda Manley at 212-219-1800 ext. 239, lmanley@lawyersalliance.org, or visit our website www.lawyersalliance.org for further information.