Contractor or Employee? Time to Get it Right

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It's nice to know that you've answered correctly, particularly on matters over which the Internal Revenue Service has authority. But when it comes to classifying workers as either employees or independent contractors, many nonprofit leaders select the more convenient option. Instead of holding your breath and hoping that the IRS will agree, it's time to take stock of helpful guidance available from the IRS and the simple tips in this article. There is no time like the present to classify properly the workers who bring your nonprofit's mission to life.

Out with the Old, In with the New

For as long as many nonprofit leaders remember, the standard tool for classifying workers was the "20-factor checklist." This approach has now been replaced with a three-factor test. The new test focuses heavily on the issue of control.

As you revisit the classification of the workers at your nonprofit, focus your attention on:

- Who has behavioral control?
- Who has financial control?
- What is the relationship between the parties?

While some of the questions posed in the old 20-factor test are still helpful to tease out factual scenarios that may point towards either employee or contractor status, key questions to ask include:

(1) Does the nonprofit have the right to control the behavior of the worker?

- A worker is likely to be an employee if the nonprofit controls when and where the services are performed, who receives services and how the services are delivered.

(2) Does the nonprofit have financial control over the business activities of the worker?

- One factor that would weigh towards employee status is if the nonprofit controls the frequency of compensation, as opposed to the worker sending an invoice after services are performed. Other factors include whether or not the worker makes his or her services available in the broader market place and whether or not the worker incurs business expenses that are reimbursed by the nonprofit. The more independently the person operates, including being responsible for his or her own expenses, the more

likely it is that the IRS will see the person as an independent contractor.

(3) What is the nature of the relationship between the parties?

- This catch-all category includes whether or not there is an arms' length contract between the parties; whether the nonprofit provides the worker with traditional employee benefits; how long the relationship has been going on; and whether the services performed by the worker are integral to the nonprofit's activities.

The three factors are explained in greater detail on the following IRS Web page: www.irs.gov/taxtopics/tc762.html

Don't Plug a Round Hole with a Square Peg

Classifying an employee as an independent contractor is like putting a square peg in a round hole. If there isn't a neat fit, the nonprofit faces the risk of penalties for back withholding taxes, plus penalties and interest. A number of new federal laws on this topic are circulating around the halls of Congress, including the "Employee Misclassification Prevention Act." Each of the legislative proposals increases penalties for misclassification. Moreover, the IRS has announced that it will specifically be on the look-out for instances of misclassification in the nonprofit sector.

Here are some tips to support your nonprofit's classification of workers as independent contractors or consultants:

- Review all contractor/consultant relationships with the IRS three-factors in mind.
- Always issue IRS Form 1099s to contractors/consultants and W-2s to employees.
- Don't label workers who perform identical duties, or those who perform substantially similar duties, differently. If one is labeled an employee and another an independent contractor, you are calling into question the accuracy of your classification system.
- Adopt and standardize language in a written agreement that is used with all contractors/consultants, spelling out that, "the [Name of Contractor] reserves the right to control the manner in which services are performed and the scheduling of performance."
- Contractors and consultants should not have any access to employee-only benefits and generally they should not be provided with the nonprofit's business card or listed in a document titled "staff directory."
- If contractors or consultants are given an email address for the time period when they are working on a project for the nonprofit, require them to include a footer in their emails that clarifies that they are not employees of the nonprofit.
- Don't take personnel actions with contractors and consultants that are consistent with employee status (such as performance reviews).
- Watch out for the 1,000 hour rule: For purposes of participation in qualified retirement plans, eligibility is generally defined as working 1,000 hours of service performed during the plan year. Unless workers are clearly and properly classified as independent contractors, workers could claim eligibility for retirement plans if they work 1,000+ hours in a plan year.

The IRS has posted a very helpful article on its web site that addresses worker classification issues and provides links to forms used to report compensation to contractors, a description of possible penalties for misclassification, and the relief provisions that may be available when a taxpayer can show that there is a reasonable basis for treating a worker as an independent contractor rather than an employee.

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