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Legal Alert: General Overview and FAQ Independent Contractor/Employee Relationships

Non-profits and small businesses are often faced with an important question when seeking good help: is the person I'm hiring an employee or an independent contractor? This can be a confusing issue and it involves high stakes.

Indeed, misclassifying employees as independent contractors can have serious financial and legal implications. Penalties for misclassifying a worker as an independent contractor can include taxes, penalties, and interest. Further, the IRS may assess payroll taxes for three years after the date the employer files a tax return and the U.S. Department of Labor can recover minimum wages and unpaid overtime, interest, and statutory penalties of \$100 per employee per pay period for the first violation, and \$250 per employee per pay period for subsequent violations, plus penalties of 25% of the unpaid wages, and attorneys' fees.

So, all things considered, it is extremely important that employers properly classify their workers, to ensure compliance with the law and avoid potentially stiff penalties. Fortunately, there is a way to determine the right answer, and that's the purpose of this memorandum.

1. Why Would I Want to Classify as Independent Contractors Instead of Employees?

There are good reasons why organizations--small ones especially--would prefer to take the independent contractor route. Here are just a handful of advantages to independent contractors versus employees:

- Does not have to pay the usual employer contributions for state disability or unemployment tax, social security contributions, or federal unemployment tax. This is because independent contractors are not "employees" and therefore do not need to pay employee-related taxes. Independent contractor compensation is reported on an IRS Form 1099, as opposed to an IRS Form W-2.
- Does not have to provide health, vacation, sick leave or retirement benefits.
- Can choose whether to provide workers' compensation coverage.
- Does not have to comply with state or federal labor and wage/hour laws.
- Is relieved of most anti-discrimination legislation (*e.g.*, Title VII, ADEA).
- Enjoys minimal risk of being sued for wrongful termination or unemployment benefits.

2. Why Would I Want to Classify as Employees, Instead of An Independent Contractor?

The downside, however, is that properly classified independent contractors are not beholden to the same level of control that employees are, and that might make it more difficult or risky to run your organization. Here are the key risks/disadvantages of independent contractors:

- Loss of control over how the work is performed.
- Generally, loss of ability to terminate at will without risk of breach of contract.
- Need to monitor the relationship to ensure the worker is properly classified.
- Bearing the risk of misclassification.

How Do I Evaluate If My Independent Contractors Are Employees?

The big question is this: how do employers evaluate whether they are properly classifying their independent contractors? Unfortunately, the government does not look at titles when making this determination -- labeling an employee a "contractor" will not cut it. The government is instead concerned about what the true *realities of the relationship* are. In other words, it's not what you call it, it's what the relationship actually is that counts.

There are several related and similar tests for evaluating whether or not an independent contractor is improperly classified and should be classified as an employee. The following list provides the key factors an organization should consider in deciding.

- 1) **Who has the right to control the manner and means of accomplishing the results desired from the service?** If your organization has the *right* to exercise complete control over how the service was provided (*i.e.*, hours worked, manner of performance, tools used), whether or not such control was actually exercised, the relationship will be one of employer/employee.
- 2) **Right to terminate at will?** If your organization has the right to terminate the relationship with the person at will, this is a strong indicator of employment.
- 3) **Is the person providing the service holding himself/herself out to the general public to provide the same services to others?** In other words, is the individual rendering similar services for other organizations? If so, this is evidence of an independent contractor relationship.
- 4) **Is the person engaged in a separately established occupation or business?** If so, this is an indication of independent contractor status.
- 5) **Is the service skilled or unskilled?** The less skill required, the more likely the person was subject to supervision and control, and thus more likely an employee.

6) **Does the person providing the service provide the tools, instrumentalities and place of work?** If the company provides the place of work, tools, equipment, supplies, support staff, etc., this indicates employment.

7) **Does the person providing the service have the right to hire and fire others to assist him/her in performing the service?** If so, this is an indicator of control and hence of an independent contractor.

8) **Is the relationship of long or short duration?** If short and discrete work, it is more likely to be an independent contractor relationship.

9) **What is the method of payment?** If by the job, more likely an independent contractor. If by the hour, more likely an employee.

10) **Were the services part of the regular business of the employer?** If so, more likely an employee. If not, less likely an employee.

11) **What was the parties' belief about the relationship?** This factor is not determinative but will be construed in view of the circumstances of the performance of the job.

While evaluating the above factors may seem daunting, the bottom line is that employers should evaluate the nature of the relationship with the person doing the work and evaluate what the relationship truly is. Are you hiring someone for a discrete project for a set period of time, in which that person is completely free to render similar services outside of your organization? Then that person will often be appropriately classified as an independent contractor. Alternatively, are you hiring someone to work at your offices as an office assistant for 20 hours per week with set daily hours? If so that person is an employee.

FAQs

1. Can our Executive Director be an independent contractor so we don't have to pay taxes, etc.?

The answer to this question is that classifying your Executive Director as an independent contractor is likely not appropriate and the answer would not change if the ED is categorized as part-time or full-time. Anyone who is responsible for running the day to day activities of the organization should be classified as an employee. In all likelihood the ED will be reporting directly to the Board, and will hold themselves out as a representative or officer of the organization. This makes the ED quite clearly an employee and the ED should be treated as such.

2. We have a full-time employee who we can no longer pay for full time work, can we treat her/him as an independent contractor?

The answer to this question depends entirely on the nature of the work and how they are being treated by the organization, but it is likely that this employee should remain an employee and not be reclassified as an independent contractor. Key questions to consider are:

- Whether or not the individual is being held out as someone with a job title within the organization. If so, that person is more likely to be considered an employee, not an independent contractor.
- Whether or not the individual is performing a discrete service for the organization for a set time period, or the individual is in fact a long-term member of the organization who is performing the same tasks through his/her part-time work as he/she did in his/her previous full-time work. If the latter is true, the individual is more likely to be considered an employee rather than an independent contractor.
- Whether or not the organization retains the right to terminate the individual at will or to discipline or demote him. If the organization retains the right to terminate at will and/or to discipline/demote, the individual is likely to be considered an employee rather than an independent contractor.

Ultimately, if the organization intends on retaining the same amount of control over the individual as it did when the individual was a full-time employee and performing his/her work, then the individual should continue to be classified as an employee.

3. We have a short-term grant and need to hire someone to implement the grant. Can that person work for us full time during the grant period and be an independent contractor?

Although possible, this sounds like an employment relationship, even if for a definite duration, as opposed to an independent contractor relationship. This implementer is working full-time on behalf of the organization, holding himself/herself out as a member of the organization, taking the lead on a matter integral to the organization, and presumably subject to standard organizational performance standards. All in all, this appears to be an employment relationship.

4. Are paid interns independent contractors?

Paid interns are generally properly classified as *employees* and *not* independent contractors and they should therefore be categorized as such.

5. We employ teaching artists who work for us part-time and have other jobs. Are they independent contractors?

As noted above, this depends on many factors. These teachers are likely employees, not independent contractors, because they perform services directly for and on behalf of the organization, likely pursuant to standards or protocol set forth by the organization, and are presumably subject to the same performance standards and at-will relationship that a

typical employee would be subject to. It sounds as though these teaching artists are treated in a manner akin to adjunct professors. If so, they are almost certainly employees and not independent contractors. Again however, this is a fact-specific inquiry and it is difficult to generalize based on such a broad description of the work and position in this question.

Thank you to Colton Long and the law firm of Seyfarth Shaw LLP for preparing this Legal Alert.

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