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Worker Employment Status for Tax and Other Purposes: Employee Versus Independent Contractor

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Worker Employment Status for Tax and Other Purposes: Employees Versus Independent Contractors

Most nonprofit organizations hire workers for various purposes and under diverse circumstances. Whether these workers should be treated as “employees” or “independent contractors” can be confusing and can lead to unintended liability and other consequences. Depending on the nature of the work involved and the way in which an employer structures its relationships with these workers, an employer may face significant liability for employment taxes, tort claims, other employment-related matters such as wage-hour obligations and workers’ compensation benefits. While legal advice tailored to specific clients’ circumstances may be necessary, the following information provides general guidelines regarding the legal implications of employment status.

I. General Considerations

All paid workers are classified as either employees or independent contractors. Different legal tests exist depending on the legal issues at stake, such as federal income taxes, workers’ compensation, or tort liability. These tests have several overlapping factors, most notably that of the “right to control” as the primary determinant. In addition, regardless of how an employer may label a worker, the IRS, a court, or other government official may disregard such designation and impose liability as well as penalties (for employment taxes) in the event of a differing conclusion.

The following legal areas are affected by the employee versus independent contractor distinction:

- A. Federal and state tax withholding and Form W-2 reporting for employees (or Form 1099 reporting for independent contractors, with no withholding);
- B. Unemployment insurance coverage;
- C. Workers’ compensation coverage for employees and other potential liability based on harm suffered by the workers under negligence and related legal theories;
- D. Liability to others based on employees’ negligence, intentional misconduct, or other civil wrongs under the *respondeat superior* doctrine, which does not apply to acts of independent contractors;
- E. Wage and hour laws such as overtime pay provisions that apply only to employees;
- F. Other employment-related liability such as provided under Title VII, the Age Discrimination in Employment Act, and the Americans with Disabilities Act (unlawful employment discrimination);

- G. Collective bargaining rights for employees under the Labor Relations Act;
- H. Immigration reporting requirements for employees (I-9 forms);
- I. New hire reporting requirements for child support enforcement; and
- J. Personnel records requirements for employees.

An incorrect classification can cause a myriad of problems including liability for payment of back taxes, liability in tort for injured workers, absence of sufficient insurance coverage, and expensive legal fees to dispute these issues. Basic risk management considerations thus warrant addressing these issues before problems arise.

To make things more complicated, workers may be considered “employees” for one legal purpose while simultaneously qualifying as an “independent contractor” in another area of law. Generally, a person is more likely to be considered an employee for certain legal areas such as workers’ compensation than for other purposes, because of an underlying policy to provide an economic safety net. Similar policy considerations affect the other legal areas listed above. As a practical matter, the government and courts will classify workers as employees whenever possible. In addition, an injured worker who considers himself or herself to be an employee likely will not hesitate to sue an employer and claim that an employment relationship exists. Whether an employer wins, after incurring significant legal expenses, depends on a very fact-specific inquiry. The burden to accurately and effectively classify a worker as an independent contractor in all these legal contexts thus may be heavy.

II. Application of Legal Tests to an Employer’s Workers

A. The IRS’ Eleven-Factor Test

For federal income tax purposes, the IRS’s primary inquiry is whether an employer has the right to control its workers. The IRS recently has identified three groups totaling eleven factors to aid in this determination. Overall, the less control the employer has over its workers, the more likely the workers will be classified as independent contractors. The weight accorded to each factor varies depending on the nature of the work and the facts of each case. A careful analysis of an employer’s current and intended workers is thus well warranted. Although the IRS does not automatically require all factors in support of independent contractor status to exist, it will require most to be present as well as adequate justification for those factors that are missing.¹ For more information regarding proper classification of employees under the IRS’

¹ If an employer desires explicit direction from the IRS, it may seek a written determination of employment status from the IRS by completing IRS Form SS-8. Most likely, however, such an inquiry will result in an answer that the worker in question is an employee, since the IRS generally favors employee status. An employer may also find solace in the “safe harbor” afforded employers who follow established judicial precedent or otherwise have a “reasonable basis” for its position, if it is willing to incur the attendant extra legal expenses to justify its position.

test, please contact an attorney in our office or see IRS Publication 1770, available at www.irs.gov.

B. Negligence and Related Tort Liability

As with the IRS' employment classification test, the test under tort law principles (i.e., civil wrongs including negligence) focuses on whether an employer has a "right to control" the worker at issue, as well as other factors. An employer may thus need to balance any interest it has in avoiding liability for workers' misconduct with its need to control the workers' day-to-day activities. For example, an employer's need to have certain safety measures and task timetables in place and closely monitored may outweigh any benefit from structuring a particular job as an independent contractor arrangement. In addition, an employer should be aware that liability may otherwise be imposed even for an independent contractor's wrongdoing based on agency principles.

C. Workers' Compensation

Workers' compensation laws were developed to provide employees with recovery from their employers when hurt on the job, regardless of fault. As a result, workers' compensation laws are interpreted very broadly to include as many workers as possible. The practical result is that it is more difficult to classify workers as independent contractors, and employers are held more accountable for their injuries.

Careful consideration should be given as to whether an employer even wants its workers to be independent contractors for workers' compensation purposes. Having workers classified as "employees" will increase an employer's workers' compensation insurance costs, but then these workers will not have any independent right to sue an employer for work-related injuries. In addition, an employer's insurance carriers will be obligated to provide legal defense and handle any resulting workers' compensation litigation. Having workers classified as independent contractors will result in cheaper insurance for an employer, but the workers will retain the right to sue an employer for their injuries caused by an employer's negligence.

The issue of right to control is again paramount. Significantly, more workers likely will be classified as "employees" for purposes of workers' compensation coverage under its broad definition than for IRS purposes, tort liability, or other purposes. Even if workers plainly fit into the definition of an independent contractor, one may reasonably assume that they will file for workers' compensation benefits anyways. An employer will have the burden, risk, and expense of establishing the workers' independent contractor status.