



4151 Okemos Road  
Okemos, MI 48864 USA

## Township Law *E-Letter*

# W-2 or 1099? How to Utilize Independent Contractors Without Putting Your Township at Risk

*Many townships rely heavily on independent contractors for township services. Whether the township uses independent contractors to manage and maintain its cemetery, mow its parks, or clean the township hall, independent contractors are important service providers for many townships.*

*Independent contractors are individuals who operate their own business and offer their services to the general public for a fee. Unlike employees, independent contractors do not collect wages and are free to work for whomever they choose and with significantly greater control of the work.*

*Trouble can sometimes arise because merely calling someone an independent contract or sending them a Form 1099 instead of a W-2 does not end the debate whether that person is truly an independent contractor. And this issue is not a distinction without a difference; misclassifying someone as an independent contractor when they are instead an employee can have serious and sometimes costly implications for townships who get it wrong.*

### **WHY THE EMPLOYEE VS. INDEPENDENT CONTRACTOR DISTINCTION MATTERS**

Many statutes require “employers” to undertake obligations on behalf of their “employees,” such as:

- Workers' Disability Compensation Act requires employers to provide workers' compensation insurance for employees.
- Michigan Employment Security Act requires employers to make tax contributions to a trust fund from which employees receive benefits when they are involuntarily unemployed.
- Fair Labor Standards Act requires employers to pay nonexempt employees the minimum wage and overtime compensation.
- Anti-discrimination in employment statutes apply to employees and their protected-class status (although the Michigan Court of Appeals has applied state anti-discrimination law to an independent contractor in at least one instance).
- Internal Revenue Code requires employers to withhold a portion of an employee's wages as taxes and also to make tax contributions on behalf of an employee.

If you use independent contractors, however, these obligations are the responsibility of the independent contractor.

## **BENEFITS TO UTILIZING INDEPENDENT CONTRACTORS**

Because federal and state law have those additional requirements for employees and not for independent contractors, townships often prefer to utilize independent contractors to avoid costly obligations related to the requirements listed above. Townships may also avoid providing employee benefits that might otherwise be due to township employees but not to independent contractors. Because employees must be paid overtime and contractors need not be, utilizing contractors is also generally a more predictable cost to townships as the fees will be set forth in advance and will be unlikely to vary from week to week or month to month. Independent contractors also require less direct supervision to get work done. In total, the diminished costs and reduced hassle of using independent contractors are undeniably enticing.

## **THE RISKS IF YOU ARE WRONG**

With those benefits to using independent contractors, why not designate all (or nearly all) township workers as independent contractors? Simply put, there are legal rules in place to prevent misclassifying employees as independent contractors. Further, misclassifying someone as an independent contractor can be a costly mistake. Misclassification generally results in paying back whatever would have been owed in taxes or compensation and in many cases also results in extra penalties, especially if the misclassification is deemed intentional.

### ***General Risks***

- Employers must provide workers' compensation coverage to employees, but not to independent contractors. In return, employees cannot sue for on-the-job injuries where workers' compensation covers the issue. Where a worker is misclassified as an independent contractor and suffers an on-the-job injury, Michigan's workers' compensation statute provides that the injured worker can sue the employer, and the employer can be fined up to \$1,000 per day of violations.
- Misclassification can also pose problems where a worker is sued while performing work for your township. In many instances, employers can be sued for injuries caused by their employees who negligently cause harm. The same is not true for independent contractors. If your township misclassifies someone as an independent contractor and later finds out that person was an employee, your township may unexpectedly be on the hook for harm (and resulting money damages) caused by that worker.
- Sometimes an agreement with an independent contractor results in a set fee for services that turns out to be below the minimum wage or the employee works in excess of forty hours per week without overtime pay. If those situations arise and the worker is properly

classified as an employee, the township may find itself in violation of the Fair Labor Standards Act. If a worker was not paid the minimum wage or overtime because of a misclassification, the Fair Labor Standards Act allows for penalties including payment of the wages or overtime owed to the employee, plus an equal amount in damages, with the possibility of additional fines for willful violation.

- If your township takes action against a worker who bands together with others to discuss or raise concerns about wages, benefits, or working conditions, the township may be violating labor laws that prohibit adverse employment action for those who engage in protected concerted activity or union organizing if that worker turns out to be misclassified as an independent contractor.
- Misclassification might also mean that you suddenly owe certain employee benefits (pension and other retirement benefits, healthcare, etc.) to individuals who the township believed were not entitled to benefits as independent contractors.
- Aggrieved workers who were misclassified as independent contractors might also retroactively sue under anti-discrimination statutes if they believe they were discriminated against on the basis of a protected-class status. Independent contractors would not have the same ability to sue in most cases.

### ***Tax Concerns***

Employers owe certain tax obligations when dealing with employees that are not present when working with independent contractors. Tax implications of misclassification include payment of:

- Taxes Not Withheld (contributed by employer), including Employer FICA, State unemployment tax, and Federal unemployment tax (FUTA).
- Additions to Tax include interest and penalties.
- Exposure for Failure to Withhold and Deposit Federal Employment taxes.
- If an employer “unintentionally” fails to deduct and withhold the correct amount from an employee’s wages because the employee was not treated as an employee, the employer is liable for 1.5 percent of the wages paid to the employee and 20 percent of FICA taxes. In cases where the employer “willfully attempts in any manner to evade or defeat any such tax or the payment thereof,” the amount of tax liability shall be, “in addition to other penalties provided by law, . . . a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.”

- In “unintentional” cases, the “employer” is liable for the penalty while in “intentional” cases, this liability is extended to “any person required to collect, truthfully account for, and pay over any tax imposed . . .” A “responsible” person can be an individual that signs payroll accounts, signs payroll returns, or holds an officer position.

## **HOW DO I KNOW IF I AM USING AN “INDEPENDENT CONTRACTOR”?**

With all the risks associated with misclassification, how do you know whether your township is properly classifying employees and independent contractors? There is no simple answer, but it goes well beyond simply calling a worker an employee or an independent contractor and well beyond merely having a contract with that worker. It also goes beyond the job title (in other words, the building inspector in one township may be an employee, while the building inspector in the neighboring township may be properly classified as an independent contractor). Keeping in mind that no single factor is decisive, courts in Michigan look to the following factors and tests:

- I. **The Economic Realities Test.** The economic realities test looks at the totality of the circumstances surrounding the relationship between the parties. Under the economic realities test, the following factors are balanced to determine if an individual is an employee or an independent contractor:
  - What liability, if any, does the employer incur if the individual is terminated at will? Employees are much more likely to be terminable at will.
  - Is the work being performed an integral part of the employer's business that contributes to the accomplishment of a common objective? If the work is central to the operation, it is more likely to be done by employees.
  - Is the position or job of such a nature that the individual primarily depends upon the income from the employer for payment of living expenses? An employee is more likely to depend solely (or in large part) on the employer.
  - Does the individual furnish his/her own equipment and materials? Independent contractors bring their own equipment and materials.
  - Does the individual hold himself/herself out to the public as one ready and able to perform tasks of a given nature? Independent contractors often hold themselves out as available for hire. Employees do not.
  - Is the work or undertaking in question customarily performed by an independent contractor?
  - Does the employer have the right to control the means by which the individual achieves the end result? Greater control exists in employee-employer relationships.

## 2. Rules to Live By (and Factors to Consider) to Ensure You Can Safely Utilize Independent Contractors

- Behavioral Control
  - Hours of work. Do not regulate the hours of the independent contractor. Someone in their own business sets their own hours.
  - Hiring of assistants. It would be ideal if the independent contractor had his or her own employees. This is not practical in most real-world situations and is not mandatory.
  - Tools and equipment. The independent contractor should supply their own work instrumentalities. If you have the equipment, consider leasing to the independent contractor.
  - Training. If the work requires independent or professional training or experience, then the chances of making the independent contractor label stick are much greater. If you do not provide that training, the label is ever more likely to stick.
  - Instructions. You may control the ends but not the details of the work.
- Financial Control
  - Significant Investment. Independent contractors have significant investment in their own tools and equipment.
  - Payment of expenses. Do not pay the expenses of your independent contractors. If someone is in their own business, they should pay their own business expenses.
  - Opportunity for profit or loss. Independent contractors have an opportunity to make a profit or to suffer monetary loss. Employees simply collect wages.
  - Making services available to the public. This gets right to the core of the matter. True independent contractors are in their own business. One would expect them, therefore, to make their services available to the public.
  - Method of payment. Payment should be by the job rather than by unit of time (i.e., an hourly wage).
- Type of Relationship
  - Liability insurance and employee benefits. Don't supply this kind of insurance to your independent contractors. They will look like employees if you do.
  - Permanency of the Relationship. Independent contractors are hired for specific projects while employees are hired indefinitely.
  - Services are Key Activity of the Operation. If someone does the work central to the operation of the employer, it is more likely that person is an employee.

- Right to fire at will. If you have the right to fire at will, you have an employee.
- Ending the relationship. It should not be with written notice at least two weeks in advance.

## **CONCLUSION**

Despite the risks if someone is misclassified as an independent contractor, we strongly encourage townships to use independent contractors whenever that classification is proper. Independent contractors are a great way to do provide excellent service to township residents while keeping costs under control and steering clear of many of the headaches that come with being a public employer. If your township is looking to bring in new personnel or is simply reviewing existing arrangements, feel free to contact the municipal and employment law experts at Fahey Schultz Burzych Rhodes, PLC to ensure that your workers are properly classified.

- Chad Karsten and Christopher Patterson