



Stay Exempt

Course 3 Summary: Employment Issues

Worker Classification

Because the IRS treats various workers differently for tax purposes, understanding your 501(c)(3)'s tax responsibilities means figuring out what types of workers it has—employees, independent contractors (IC), or volunteers.

Employee or IC?

The key distinctions between employees and ICs are:

- Employers have the right to direct and control the way their employees do their jobs.
- ICs are self-employed and carry on independent trades or businesses; they also bear a genuine possibility of profit or loss.

To assist in making these distinctions, the IRS has developed three categories of evidence:

Behavioral control: If your 501(c)(3) imposes instructions on the worker that sets the time, place, and manner of accomplishing the job, and provides specific procedures to follow, the worker is probably an employee.

Financial control: If the worker directs or controls the financial aspects of his or her work, the worker is probably an IC.

Relationship between the parties: If your 501(c)(3) can terminate the worker and provides typical employee benefits, the worker is probably an employee.

Statutory Workers

The Internal Revenue Code (the Code) classifies some types of workers automatically:

- Officers of an 501(c)(3) are employees.
- Directors are nonemployees.

Volunteers

Volunteers normally present no employment tax issues, but the 501(c)(3) must be careful about the way it thanks them: If your 501(c)(3) gives volunteers **cash** items, such as gift certificates or any other taxable fringe benefit, it must include these items in the volunteers' taxable wages.

Withholding, Paying, and Reporting Employee Taxes

501(c)(3)s must pay Federal employment taxes on employees' wages (but not IC fees).

Federal Income Tax and FICA (Federal Insurance Contribution Act) Taxes

Withhold and pay Federal income tax and FICA (Social Security and Medicare) taxes together.

Employees should figure out how much Federal income tax they will withhold using Form W-4, *Employee's Withholding Allowance Certificate*.

For FICA taxes, the employer matches the tax withheld from the employee's pay.

Payment occurs upon depositing the taxes into an authorized depository.

For deposit purposes, earned income credit (EIC) advance payments reduce withheld Federal income and FICA taxes. Employees should complete Form W-5, *Earned Income Credit Advance Payment Certificate*, to apply for EIC advance payments.

501(C)(3)s must also report Federal income and FICA taxes together—on Form W-2, *Wage and Tax Statement* (which goes to the employee, the IRS, and the Social Security Administration), and on Form 941, *Employer's Quarterly Federal Tax Return* (which goes to the IRS).

Transmit the W-2 to the IRS using Form W-3, *Transmittal of Wage and Tax Statements*. Employees must receive the W-2 by January 31 and the IRS by the last day of February for the preceding calendar year.

FUTA (Federal Unemployment Tax Act) Tax

FUTA tax provides unemployment insurance to those who have lost their jobs. Organizations exempt under Code section 501(c)(3) are not required to pay FUTA taxes.

Employment Eligibility Verification

Ensure that your 501(c)(3) and its employees complete Form I-9, *Employment Eligibility Verification*, to determine worker status and verify work eligibility. The 501(c)(3) should keep the form in its records for three years after the date of hire or one year after the date employment ends, whichever is later.

Withholding and Paying IC Employment Taxes

501(c)(3)s do not withhold or pay Federal income taxes for ICs, unless they:

- Incorrectly classify an employee as an IC, or
- Have to backup withhold.

If the 501(c)(3) has to backup withhold, it must withhold 28 percent of the IC's pay (or the applicable rate established by legislation amending Code section 3406).

Reporting IC Tax Payments

Your 501(c)(3) may need to report payments it has made to the IC.

If the IC:

- is not a corporation,

- was paid \$600 or more in a calendar year, and
- was paid in the course of the 501(c)(3)'s business,

then the 501(c)(3) probably will have to report payments to the IC.

To find out whether the IC is a corporation, have the IC complete a W-9, *Request for Taxpayer Identification Number and Certification*, on which ICs provide their business status (corporation, sole proprietor, or partnership), as well as their Employer Identification Number (EIN) or Social Security number (SSN) and address.

Form 1099-MISC, Miscellaneous Income

If your organization does have a reporting requirement for an IC, report payments made to the IC as "nonemployee compensation" on Form 1099-MISC, *Miscellaneous Income*.

Furnish a completed 1099-MISC to the IC by January 31 and a copy to the IRS by February 28 for payments made in the preceding calendar year. Transmit the completed form to the IRS using Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*.

Recordkeeping

It is important to keep accurate records of Federal income tax, FICA taxes, and FUTA tax withheld and/or paid for each employee. Keep these records for at least four years.