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Classifying Employees Correctly

Misclassifying workers is a common mistake made by employers of all kinds – nonprofits included. Doing so can result in serious consequences, including back wages and taxes owed, as well as violations of federal and state employment laws with associated penalties. These mistakes can also result in dissatisfied employees, risking a negative effect on the nonprofit’s mission.

In recent years the IRS has been stepping up its enforcement of employee classification, creating one more compelling reason for nonprofits to reexamine whether workers are properly classified as employees or independent contractors, and as exempt or non-exempt employees.

Why does it matter?

Misclassifying a worker can result in the nonprofit owing significant penalties, back taxes, and back pay. Nonprofit employers need to know first whether each worker is an independent contractor or an employee. If determined to be an employee, the nonprofit must then determine whether the employee is “exempt” or “non-exempt” from overtime.

The correct classification is determined by two layers of definitions: federal and state. Therefore, both state and federal Department of Labor (DOL) regulations may

apply. Many states follow the federal Fair Labor Standards Act (FLSA) definitions, but in others, different definitions and wage/hour rules may apply, just as different states have different minimum wage rules.

Independent contractor or employee?

A typical misclassification scenario is that a nonprofit classifies a worker as an [independent contractor](#) when in fact the federal DOL, federal IRS, or state wage and hour laws would define that worker as an [employee](#).

U.S. Department of Labor (DOL) Classification

The U.S. DOL updated the law on independent contractors by publishing a final rule, effective Mar. 11, 2024: [Employee or Independent Contractor Classification Under the Fair Labor Standards Act](#) and releasing [Department of Labor FAQs](#).

- The Rule requires consideration of six factors to determine whether an individual is an employee, none of which is weighed more or less than the others:
 1. The nature and degree of the worker's control over the work;
 2. The worker's opportunity for profit or loss;
 3. Investments by the worker and the potential employer;
 4. The degree of permanence of the work relationship;
 5. The extent to which the work performed is an integral part of the potential employer's business; and
 6. The worker's skill and initiative.
- If the individual is considered an independent contractor, they are not entitled to the wage and hour protections as employees.

Internal Revenue Service (IRS) Classification

- The IRS has its own rules governing classifying workers as employees or independent contractors, distinct from the U.S. DOL and state rules.
- A good overview of the IRS rules can be found in this [IRS "tax tip" from August, 2022](#).

- More help on the differences between [independent contractors and employees](#) (IRS Publication 1779)
- If the state or federal DOL finds that the nonprofit has misclassified the worker, the nonprofit can be responsible not only for unpaid wages, including [overtime](#), but also state/federal withholding taxes, as well as potential penalties.

Practice Pointers

- Position descriptions should be prepared for employees, but not for independent contractors.
- Instead of a position description, independent contractors should sign a written contract with the nonprofit describing the scope of work. These agreements are also a good way to document that independent contractors/consultants understand that they are responsible for their own income taxes and insurance coverage.
- IRS [guidance](#) can help distinguish between employees and independent contractors; state law definitions should be checked also.
- [Reporting payments to independent contractors](#). (IRS)

Exempt or Non-Exempt?

Another common misclassification scenario occurs when a nonprofit considers a worker to be exempt from payment of overtime, when in fact federal or state wage and hour laws would classify the worker as [non-exempt](#). This misclassification could result in the employer owing the worker compensation for overtime, and potentially also owing penalties to the state or IRS.

Practice Pointers

- Even if workers are "salaried" they could still be entitled to overtime for hours worked over 40 in a single work week under the [federal rules](#).
- Each state has its own wage and hour rules that govern which workers are entitled to overtime in that state and what makes an employee exempt from overtime, so be sure to review the applicable wage and hour regulations/guidelines in your state. Quite a few states automatically follow federal wage and hour (and overtime) regulations.

- NOTE: The U.S. Department of Labor has published proposed regulations that would raise the minimum salary level that employees must be paid to qualify as exempt employees. A final rule is expected by April 2024. [Learn more](#).
- Manage employees' expectations about their compensation and make sure they know whether they are, or are not, entitled to overtime pay. One way to do this is by including a category of "worker classification" on position descriptions, for example: "Regular, full-time, exempt" or "Temporary, part-time, non-exempt."
- Most employment lawyers advise employers to have a policy that workers may only work overtime with advance authorization from their supervisor - which limits surprises and budget overruns.
- When preparing budgets for grant proposals, consider whether to anticipate overtime in the budget.

Additional Resources

- [Breaking down your nonprofit's obligation to pay overtime](#) (National Council of Nonprofits, updated Feb. 29, 2024)
- [Important updates on classifying employees correctly](#) (National Council of Nonprofits, July 20, 2022)
- [Fact Sheet on Nonprofit Organizations and the Fair Labor Standards Act](#) (U.S. DOL)
- [Worker Classification 101: employee or independent contractor](#) (IRS tax tip, August 2022)
- [Contractor or employee? Time to get it right](#) (Nonprofit Risk Management Center)

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