

The Tax Adviser

# Distinguishing Between Independent Contractors and Employees

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Before a business entity pays for services rendered, it should consider this: Is it paying a contractor or has it hired an employee? This question arises every time a business pays a person for services rendered. At times the answer is clear, but often the minute details will present a challenge to the small business owner when classifying the service provider.

When expanding its workforce, a business will either hire an employee or retain an independent contractor. To categorize the "new addition," consider the relationship between the business (payer) and the individual (payee): Who holds the "right to control"?

The worker's classification is determined by analyzing three factors:

1. *Behavioral control* is ascertained by determining which party retains the rights to control where, when, and how a job should be done.
2. *Financial control* considers the business aspects of the relationship, including which party bears the financial risk, how the payment is structured, and whether or not the worker can realize gain or loss.
3. *The type of relationship between the parties* is defined by written agreements, contracts, benefit structure, expected time line and recurrence of such agreements, and the relationship of the services rendered to the nature of the business.

The IRS developed a 20-point guide that describes the ideal circumstances under which a worker is an independent contractor (see Rev. Rul. 87-41). The Service also provides a safe harbor to exempt a worker or business from the "20 questions." To qualify for the safe harbor, the business (1) must have consistently treated others on the workforce (of similar type) as independent contractors, (2) must have filed all necessary forms, and (3) must have reasonable basis in historical rulings, case law, or common practice in the specific industry (Rev. Proc. 85-18).

It is important that each worker is classified correctly so that the business complies with its income and employment tax obligations. The business must withhold employees' income, Social Security, and Medicare taxes (Secs. 3402(a) and 3102(a)). The business usually does not have these obligations to independent contractors.

The following example illustrates some of the issues surrounding the determination of independent contractor status.

**Example:** C is a certification company that attests whether companies comply with required industry guidelines. C employs approximately 100 administrative and permanent employees and contracts hundreds of individuals worldwide to inspect certification-seeking companies. C trains these inspectors to examine production and processing plants using a set of guidelines and procedures. An inspector must be present for each certified batch that a manufacturer produces in order to confirm compliance. C pays these inspectors on an hourly basis; they are paid a higher rate for days longer than 10 hours. C treats these inspectors as independent contractors.

Under these circumstances, the inspectors might be viewed as employees for tax purposes, because they follow guidelines and schedules provided by C (behavioral control), receive extra payment for working overtime (financial control), and perform the primary function of C's business (relationship of the services rendered to the nature of the business).

C contracts with the inspectors and treats them as independent contractors just as a homeowner might contract with an electrician. The customer (C or the homeowner) defines the desired end result but does not dictate how it should be achieved. The contractor (inspector or electrician) then follows industry guidelines to perform the necessary procedures to accomplish the task. C allows inspectors to implement the guidelines however they wish and does not dictate their work schedule. The inspectors are drawn from a pool of qualified professionals, and the manufacturers must coordinate with an individual inspector for each certified batch. The inspector then has the right to determine his or her working hours and may refuse any request. C is not involved in this process until the end, when the inspector submits the post-examination report (behavioral control).

C acts as a middleman for all payments in order to maintain the inspectors' independence so that reports are not biased (due to direct payment from manufacturers). Because every inspection has different requirements, the inspector can charge a variable rate, based on the complexity of the work required. Even though the monies go through C, the inspector bears the ultimate financial risk; if the manufacturer does not pay C, the inspector does not get paid. Ultimately, the inspector is contracted by the manufacturer, and C is simply the certifying parent (financial control).

C's line of business is certification, not inspection. Inspectors visit manufacturing plants and send in factual reports. Much like court stenographers, who record courtroom proceedings but do not explain them, inspectors report facts about manufacturing plants and production to C but do not render an opinion as to the compliance of the manufacturer. C's administrators then analyze the inspectors' reports and use them to furnish an opinion. Since certification-seeking manufacturers are globally dispersed and their schedules can be sporadic, C uses freelance inspectors. For each inspection, there is a separate contract. C does not control the inspectors' vacation schedules, cannot prevent them from working for C's competitors, and cannot force an inspector to take a job. Inspectors maintain control of their own schedules and choose their own contracts (type of relationship between the parties).

In this case, the inspectors control the methods through which they implement industry standard guidelines for their inspections, compensation, and work schedule. They retain behavioral and financial control while they perform a service that facilitates C's business purpose but does not explicitly perform it. These inspectors are actually independent of C and so are considered independent contractors.



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