

Independent Contractor vs. Employee Status

Five key steps to ensure that your documents are in order in case the IRS comes after you.

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by Mary Bernard, CPA

As part of the National Research Program, the Internal Revenue Service will be focusing audit attention on employment tax issues. One area of concern is expected to be worker classification as independent contractor or employee. Businesses hoping to reduce payroll taxes and fringe benefits may think that using independent contractors is the answer. However, the Internal Revenue Service (IRS) is looking for ways to increase revenue and compliance in this area as there is tremendous opportunity for abuse through misclassification resulting in employment tax understatement.

Since 1987, the IRS has used the “20-factor test” in Revenue Ruling 87-41 in determining worker classification. It recently combined the factors into three general groups: behavioral control, financial control and relationship of the worker to the firm. The determination of status is made based on the degree of control the employer can exercise over the worker in terms of how, when and where the job is completed. An indefinite relationship would indicate an employee relationship, whereas a project-based relationship over a specific time period indicates an independent contractor relationship. Industry practice, the intent of the parties and the presence of a written agreement or benefits provided are also considered. The use of independent contractors for work that is part of the employer’s regular business is especially susceptible to challenge. If an accounting firm uses an independent contractor for janitorial services in the office at night, the IRS is not likely to question the position upon audit, with proper documentation. If the firm treated some of their part time accounting staff as an independent contractor, however, a challenge should be expected. It is difficult to justify two people performing the same job under the same business enterprise with one treated as an employee and one treated as an independent contractor.

Be Prepared

There are steps to document your taken positions, in the event that an independent contractor status is challenged. Conduct your own audit of your files before the IRS descends upon you.

- 1. Review all current independent contractor agreements.** With the above control and relationship factors in mind, review the terms of the agreements for red flags. Have any questionable agreements re-drafted to comply with the guidelines of the Revenue Ruling. Renegotiate terms of existing contractors to eliminate or revise problem issues. Specific mention of the treatment of the individual as an independent contractor, not an employee, should be included in the agreement. Words like manager and contract should be used in place of supervisor and hire. Payments for services should be referred to as contract or service fees, not in terms of wages, rates, or benefits.
- 2. Establish contemporaneous documentation.** By having an executed agreement in place at the start of a business relationship, the intent of the parties is established at the outset, not at the time of an IRS audit of the classification documentation. This should be standard procedure for establishing all independent business relationships.
- 3. Maintain appropriate documentation.** Once executed, the agreement should be retained as documentation among the vendor files, not the employee files. In addition to purchase orders and invoices, this file should include support for the position of independence, such as bids, contracts, public advertisements, business cards and stationary, licenses, permits and any proof of reimbursements.

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4. **Review standard practices in your industry.** It is possible to use the safe harbor provisions of standard industry practices, as long as a reasonable basis exists for classification as an independent contractor. Some industries, like court reporters, have established precedence positioning them as independent contractors as a standard industry practice, due to the nature of their duties and services provided.
5. **Use arm's-length business terms.** Take extra precaution to maintain independence when providing additional resources or benefits to independent contractors. Use a fair market value approach to all transactions with the contractor. Require competitive bids from other vendors on projects to establish the intent of an independent relationship. Any payments from the contractor should be by check rather than deducted from their invoice to keep transactions separated.

Conclusion

The detailed employment tax audits are planned to begin in November 2009, will last for three years and include at least 2,000 examinations per year. There's still time to complete the review of the status of your independent contractor files.