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NEW IRS TESTS TO DETERMINE INDEPENDENT CONTRACTOR STATUS

By Victor Sy, CPA, MBA

Whereas the IRS historically relied on a list of 20 common law factors to classify workers, the Service now looks at three factors to determine if your worker should be classified as employee or independent contractor:

1. Behavioral Control - Whether the business has a right to direct and control how the work is done through instructions or training.

A. Instruction to worker:

- 1) When and where to do the work.
- 2) What tools or equipment to use
- 3) What workers to hire or assist with work
- 4) Where to purchase supplies, materials, or services
- 5) What order sequence to follow

B. Training to the worker.

2. Financial Control - Whether the business has the right to control the financial and business aspects of the job. Independent contractors are more likely to have unreimbursed expenses, be able to work for others, and to make a profit or loss.

A. Extent to which the worker has unreimbursed expenses

B. Extent of the worker's investment in the business

C. Extent to which the worker makes services available to other customers (marketing, business location, etc.).

D. Method by which worker is paid (guaranteed wage or set price at the outset of the project?)

E. Extent to which the worker can realize a profit or incur a loss.

3. Relationship of the Parties - Whether there are written contracts describing the relationship the parties intended to create. An employee's relationship is more likely to be permanent and is more likely to provide services that are key aspects of the business.

A. Is there a contract describing the relationship between business and worker?

B. Is the worker provided with any fringe benefit (insurance, pension, sick leave)?

C. Permanency of relationship (indefinite continuing relationship is a sign of employee status)

D. Extent to which services performed by the worker is a key aspect of the business.

You may want to conduct a self-audit by filling out form SS-8. Fill this out for your internal use only (do not submit to the IRS which will most probably rule against you). If your self-assessment points toward independent contractors, you need a planning session with your tax adviser, accountant, or lawyer to strategize how to proceed. The stakes are high: the very survival of your business, and worse, the potential assessment of trust funds to you personally as director, officer, or check signer.

Development: The IRS and the Employment Development Department (EDD) have been quite active in the area of worker classification audits. They also exchange information - a deadly combination for companies trying to survive competition - or just trying to survive.