

# Bookkeeping Tips

## Employee or independent contractor?

High employment taxes have led employers to look for every possible way to classify workers as independent contractors (ICs) rather than as employees. The problem is that a worker cannot be classified as an IC just to avoid these taxes.

The following guidelines were published in *The General Ledger*, the monthly technical newsletter for AIPB members ([www.aipb.org/general\\_ledger.html](http://www.aipb.org/general_ledger.html)).

### The common-law test

The 20-question test that the IRS uses to determine whether a worker is an employee can be summarized in one question: Do the workers *have the freedom to be employers*? In other words, can the workers hire others to perform services for you and can the workers provide similar services for other customers? If not, they are almost surely employees under the common-law test.

### Workers are *employees* if. . .

- The services they provide are integral to the product/service provided to the employer's customers.
- You instruct them on when, where and how to do the work.
- They do not have the freedom to hire, supervise and pay others to do the work.
- The employer sets their hours.
- The employer furnishes their tools and supplies.
- They do not have the freedom to offer similar services to other firms.
- The employer made a significant financial investment in the facilities, furniture or equipment they need to perform the job.
- They must represent themselves as employees while performing services for you.

### Common misconceptions

Many employers mistakenly (and dangerously) assume that if workers are retirees, come in part-time or sign an agreement with the right wording, *voilà*, they are ICs. and there are no employment taxes. Here are the most common—and dangerous—misconceptions:

- If workers sign a contract agreeing that they will be classified as ICs, they are ICs.
- If they are hired for temporary job assignments, they can be classified as ICs.
- Part-timers can be classified as ICs.
- Workers can be ICs during their probationary period.
- Retirees who return to perform the services provided prior to retirement may be classified as ICs.
- Payments to workers for "after-hours" services such as taking inventory or moving file cabinets may be treated as self-employment income and reported on a 1099-MISC.
- Bonuses, overtime pay and other special wage payments may be treated as self-employment income and reported on a 1099-MISC.

### The exception: "industry practice"

You can classify workers as ICs if a significant segment of your industry has had a long-standing practice of paying similar workers as ICs and you can show that this was the basis of your classification (rather than an afterthought for the audit).

(continued)

## Two "industry practice" court cases

The following decision, from 1995, has been supported by more recent decisions.

**Case #1.** A used car dealer provided evidence that most independent dealerships in his area treated their salespeople as ICs. The IRS claimed that the workers were employees, took him to court and won. But, on appeal, the decision was reversed because, the court said, industry practice qualified as a "reasonable basis." The IRS argued unsuccessfully that *franchised* dealerships in the area generally treated their used car salespeople as employees. But the judge said that the owner had to show only that a *significant* segment of the industry followed a similar practice—not that *all* segments followed the practice. [*Martin L. Springfield v. U.S.* 78 AFTR2d Par 96-5050 No. 95-55270]

A 2004 decision follows this precedent:

**Case #2:** An installation firm contracted with cable t.v. system companies to install the cables in subscribers' homes. The firm had treated its installers as ICs since its founding in 1987 but when the IRS audited the firm, it deemed the installers to be employees because the employer controlled how and when the work was done. The case ended up in court.

**The issue:** Even employers who control how and when the work is done can treat workers as ICs if they can cite an IRC §530 safe harbor, one of which is demonstrating that treating workers as ICs was industry practice when the payments were made.

**The decision:** The court found for the employer because it offered proof that paying installers as ICs was widespread industry practice. Both of the founders had worked at numerous cable installation firms where they were always treated as ICs, and they named a number of firms they knew from personal experience and conversations that treated installers as ICs. Then the firm's installers testified that all the firms that they knew treated installers as ICs. The IRS provided no evidence that other installation firms in that geographic area treated installers as employees. [*KM Systems v. U.S.*, D.C.N.J., No. 02-4567, May 10, 2004]

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- To provide bookkeepers with low-cost continuing professional education.
- To return the membership fees of any bookkeeper who is dissatisfied with the benefits of membership