A & B Office

Income Tax Training School

Independent Contractors

Taxation Mini-Course

This Mini-Course contains a comprehensive example of Schedule C and questions and answers that will strengthen your knowledge.

Learn How To:

- Differentiate Employee From Independent Contractors
- Classify Workers Correctly
- Choose The Correct IRS Forms To File A Return
- Prevent Run-Ins With The IRS
- Preparer Solid Tax Returns
- Identify Correctly Who Is Self-Employed
- Identify The Misclassification of An Employee
- Use Schedule C (Common Expenses)
- Identify a Statutory Employee
- Identify Passive Activities Affecting Your Tax Return
- Claim Home Office Expenses
- Use “Optional Method” When Paying Taxes
- Programmers, Writers, Designers, Marketing Consultants, Nurses, Janitors, Telemarketers, Drivers Etc. Should Be Hire As...
- And Much More...

Issued: Sept 2013

Interactive Self-Study Course

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Introduction

The IRS defines the Independent Contractor as a people such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, or auctioneers who are in an independent trade, business, or profession in which they offer their services to the general public are generally independent contractors. However, whether these people are independent contractors or employees depend on the facts in each case.

The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done. The earnings of a person who is working as an independent contractor are subject to Self-Employment Tax.

You are not an independent contractor if you perform services that can be controlled by an employer (what will be done and how it will be done). This applies even if you are given freedom of action. What matters is that the employer has the legal right to control the details of how the services are performed.

If an employer-employee relationship exists (regardless of what the relationship is called), you are not an independent contractor, and your earnings are generally not subject to Self-Employment Tax. However, your earnings as an employee may be subject to FICA (Social Security tax and Medicare) and income tax withholding.

Self-Employed or Employee?

It is critical that business owners correctly determine whether the individuals providing services are employees or independent contractors. Generally, you must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. You do not generally have to withhold or pay any taxes on payments to independent contractors.

Determine Your Classification

1**. I am an independent contractor or in business for myself.** If you are a business owner or contractor who provides services to other businesses, then you are generally considered self-employed. For more information on your tax obligations if you are self-employed (an independent contractor), see page 4.

2. **I hire or contract with individuals to provide services to my business.** If you are a business owner hiring or contracting with other individuals to provide services, you must determine whether the individuals providing services are employees or independent contractors.

Determining Whether the Individuals Providing Services are Employees or Independent Contractors (IC)

Before you can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be:

In a relationship of this kind where Jay is clearly running his own business, it's virtually certain that H-burgers does not have the right to control the way Jay performs his plumbing services. Its control is limited to accepting or rejecting the final result. If H-burgers doesn't like the work Jay has done, it can refuse to pay him.

The difficulty in applying the right of control test is that control isn't always easy to determine. Government auditors can't look into your mind to see if you are controlling a worker. They rely instead on indirect or circumstantial evidence indicating control or lack of it - for example, whether you provide a worker with tools and equipment, where the work is performed, how the worker is paid, and whether you can fire the worker.

The following chart shows the primary factors used by the IRS and most other goverment agencies to determine if you have the right to control a worker.

IRS Test For Worker Status

	Worker Will More Likely Be Considered IC If:	**Worker Will More Likely Be Considered An Employee If:**
Behavioral Control	• You do not give them instructions • You do not provide them with training	• You give them instructions, they must follow about how to do the work. • You give them detailed training.
Financial Control	• They have significant investment in equipment and facilities. • They pay business on travel expenses themselves. • They make their services available to the public. • They are paid by the job done. • They have opportunity for profit or loss.	• You provide them with equipment and facilities free of charge. • You reimburse their business or travel expenses. • They make no effort to market their service to the public. • Your pay them by the hour or other unit of time. • They have no opportunity for profit or loss - for example, because they're paid by the hour and have all expenses reimbursed.
Relationship Between You And The Worker	• They do not receive employee benefits such as health insurance. • They sign a client agreement with the payer. • They can quit or be fired at will. • They perform services that are not part of your regular business activities.	• They receive employee benefits. • They have no written client agreement. • They can quit at any time without incurring any liability to the payer. • They can be fire at any time • They perform services that are part of your core business.

Sole Proprietorship

As the name states, a sole proprietor is someone who owns a business by himself (not incorporated). However, if the taxpayer is the sole member of a domestic limited liability company (LLC), he is not a sole proprietor if he elects to treat the LLC as a corporation and a corporate tax return must be filed. A sole proprietor reports the income and expenses from his business on a Schedule C, *Profit or Loss from a Business*. One is self-employed if he/she:

- Conducts a trade or business as a sole proprietor
- Is an independence contractor
- Is in business for him/herself many other ways

When to Use Schedule C

Use Schedule C (Form 1040) to report income or loss from a business you operated or a profession you practiced as a sole proprietor. An activity qualifies as a business if your primary purpose for engaging in the activity is for income or profit, and you are involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a business. To report income from a nonbusiness activity, see the instructions for Form 1040, line 21, or Form 1040NR, line 21.

One who owns a business is an independent contractor. This status entitles him to certain favorable tax benefits (and full responsibility for employment taxes). The independent contractor can itemize all his business expenses, even if he does not itemize his personal expenses (Schedule A). He does this on a Schedule C. His expenses are not subject to the 2% floor that employee business expenses must exceed to be eligible for a deduction. In order to be considered an independent contractor, the taxpayer should set his own hours and work schedule. Probably be responsible for having his own tools or equipment, and usually work for more than one individual or company.

If a taxpayer is an Independent contractor, he will not fill out a Form W-4. Employee's Withholding Allowance Certificate, for individuals for whom he works, nor will anything be withheld from his paychecks. He is responsible for paying self-employment tax (Social Security and Medicare) and making estimated tax payments to cover both his self-employment tax and his income tax.

It is often hard to determine whether someone is self-employed or an employee. The IRS has issued guidelines for determining the category into which a taxpayer falls and if the employer cannot make a determination, the IRS will determine it for him if so requested.

<u>The Following Factors Generally Make Workers Employees</u>

1. He must comply with the employer's work instructions
2. Receives training from the employer or the employer's designee
3. Provides services which are integral to the employer's business
4. Provides services which are personally rendered
5. Hires pays and supervises workers for the employer
6. Has an on-going working relationship with the employer
7. Must follow set hours of work
8. Works full-time for the employer
9. Does his work on the employer's premises

a qualifying small business taxpayer (see the Part III instructions of Schedule C), you must use the accrual method for sales and purchases of inventory items. Special rules apply to long-term contracts (see section 460 for details).

If you use the cash method, show all items of taxable income actually or constructively received during the year (in cash, property, or services). Income is constructively received when it is credited to your account or set aside for you to use. Also, show amounts actually paid during the year for deductible expenses. However, if the payment of an expenditure creates an asset having a useful life that extends substantially beyond the close of the year, it may not be deductible or may be deductible only in part for the year of the payment. See chapter 1 of Pub. 535.

Accrual accounting is considered to be the standard accounting practice for most big and small companies, with the exception of very small operations (self-employed). This method provides a more accurate picture of the company's current condition, but its relative complexity makes it more expensive to implement. This is the opposite of cash accounting, which recognizes transactions only when there is an exchange of cash. See Pub. 538.

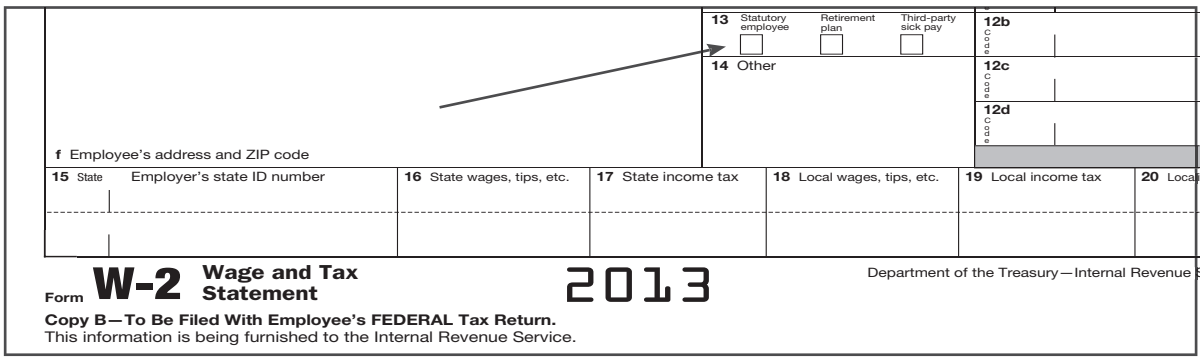
To change your accounting method, you generally must file Form 3115. You also may have to make an adjustment to prevent amounts of income or expense from being duplicated or omitted. This is called a section 481(a) adjustment. A change to an accrued method involves much more booking tasks.

Example: You change to the cash method of accounting and choose to account for inventorial items in the same manner as materials and supplies that are not incidental. You accrued sales in 2011 for which you received payment in 2012. You must report those sales in both years as a result of changing your accounting method and must make a section 481(a) adjustment to prevent duplication of income.

A net negative section 481(a) adjustment is taken into account entirely in the year of the change. A net positive section 481(a) adjustment is generally taken into account over a period of 4 years. Include any net positive section 481(a) adjustments on line 6. If the net section 481(a) adjustment is negative, report it in Part V. This topic is out of the scope of this mini-course.

What Is A Statutory Employee?

If one qualifies as a statutory employee for income tax purposes, the box entitled "Statutory Employee" on Form W-2, *Wage and Tax Statement*, will be checked. Income and expenses should be reported on Schedule C. Business deductions will not be subject to the 2% floor.


13 Statutory employee Retirement plan Third-party sick pay
14 Other
12b
12c
12d
f Employee's address and ZIP code
15 State Employer's state ID number
16 State wages, tips, etc.
17 State income tax
18 Local wages, tips, etc.
19 Local income tax
20 Local
Form W-2 Wage and Tax Statement 2013 Department of the Treasury—Internal Revenue S
Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

The following occupation groups qualify as statutory employees:

1. Agent drivers or commission drivers - limited to those who distribute meat, vegetables, fruit, baked goods, beverages (other than milk) products, laundry or dry cleaning services.