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WEALTH PLANNING > **HIGH NET WORTH**

Employee vs. Independent Contractor

It's an important distinction for wealth advisors to be able to make. Here's why.

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What's the distinction between characterizing someone as an employee or independent contractor? Perhaps more importantly, do you as a wealth advisor or estate planner care? Isn't this an issue that's solely within the purview of CPAs? No. It can affect a wide range of planning considerations, and even if the more technical tax nuances are primarily addressed by CPAs and corporate attorneys, wealth advisors and estate planners need to be conversant with the issues as it can touch on many common planning areas.

Effect on Planning

Consider:

Asset protection is an important component of many estate plans. Proper characterization of individuals providing services may be integral to claimants respecting the integrity of entities. When business interests are transferred in whole or part to an irrevocable trust as part of a plan, payment of reasonable compensation by those businesses to family members, especially the grantor, should be at arm's length. If the payments are insufficient, the Internal Revenue Service may argue that the businesses made additional gifts to the trust. If the payments are excessive, the IRS may argue that the grantor retained the right to receive payments from the trust so that it should be included in the grantor's estate for estate tax purposes.

- The family partnership rules under Internal Revenue Code Section 704(e) require payment of reasonable compensation for a gift of a family partnership to be respected. Proper characterization and compensation of those providing services may be integral to having the partnership respected.
- Improper characterization of employees resulting in improper treatment for pension and other benefit purposes might call into question the integrity of the entity.

Liability Issues

Many clients are concerned about asset protection and look to trusts and other structures. However, clients might start with basics, such as operating their businesses defensively. **Example**: If a company employee goes and picks up someone at the airport and there's an accident, the company is responsible. But if Uber is hired to pick that person up, there's an independent contractor relationship instead.

General Consequences

Often, people are unaware of the differences between an independent contractor versus an employee. These distinctions can significantly impact taxation, liability and insurance. A common important issue is health care coverage. In many states, an employer must provide health coverage, workers' compensation and unemployment insurance, or the insurance carrier must write policies that cover employees. Independent contractors don't always enjoy these benefits. If a person working as an employee is treated as a independent contractor, failure to provide these coverages can have catastrophic consequences. Creditor protection and liability coverage are additional considerations.

Distinguishing Characteristics

A clear distinction between an employee versus independent contractor is how beholden that individual is to the person who's paying him and whether he's paid a wage or salary. If your client is asking someone to be regularly present in hisoffice, and he's paying him an hourly rate and expressly giving him specific tasks under his oversight, then an employer/employee relationship most commonly exists. Another factor is if there's a separate business that's getting paid to render a specific service. If the individual has a separate business and charges a set fee for a task to be accomplished and your client don't control what he does, he'll typically be an independent contractor

If the person your client hires has a portfolio of other clients, separate billing and his own business (for example, a limited liability company to operate out of), as well as control over how he does his work (control as to time, tools, location), he's usually an independent contractor.

IRS Guidance

Because of the importance of proper characterization, it's better to be safe. If your client has a question about how someone performing work for him should be categorized, he can fill out a form SS8 and send it to the IRS. The IRS will tell you whether the person should be listed as an employee or a contractor for income and employment tax purposes. The IRS will almost always err on the side of employer/employee status because it wants its employment taxes and withholding.

Inconsistent Treatment for Tax and Legal Purposes

On the other hand, state law can be very generous and allow somebody who's working on your clinet'sproperty even 40 hours a week for a few weeks doing your painting and trimming trees may be the best strategy to avoid responsibility if he hurts somebody. Your client might fall in the cracks between a tax and liability standpoint. Your client might follow the IRS guidelines for tax compliance and even workers compensation purposes but treat the person as an independent contractor for liability purposes.

Get it in Writing

Written agreements can present a lot of gray area, but are essential to have.

Trying to override the fact that a person really should be classified as an employee by asking him to sign a waiver agreement won't necessarily protect your client, but getting the status confirmed in writing is nonetheless recommended as a protective mechanism. A writing helps prove that the relationship is as reflected in the agreement. The agreement needs to outline the insurances your client requires himto have as an independent contractor. This may still protect your client to some extent, even if the person is classified as an employee, and reduces your client's exposure. Your client needs to consider risk and reward for his business, for those doing work for him and for customers alike.

20 Percent QBI Deduction

Under IRC Section 199A, a person with a business may qualify to receive a 20 percent deduction on trade and business income, whereas employees (with a W-2) don't. However, a high earner's company must often pay a certain amount of wages to get the deduction. It's critical to speak with a certified public accountant who can best advise your client as to what approach works best based on the circumstances and on a the wide range of issues and what does and doesn't define a worker as an employee or an independent contractor through all possible lenses.

Be Proactive

Getting ahead of this issue will help you navigate an array of tax implications, insurance issues and hopefully keep your client out of hot water with the Labor Department. In addition to your referring your client to his CPA, you may want to consult with an attorney with specialized expertise in employment and labor law who's astute regarding liability and insurance related to the workforce. Be proactive and preemptive in this arena before making any decisions that could bear a negative set of consequences.

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