

## A Taxing Question: Are CFI's employees or independent contractors?

The question of proper classification of workers as either employees or independent contractors is a continuing source of controversy between the IRS and employers. This question is of particular importance to FBOs who have elected to classify their flight instructors as independent contractors. It could become a crucial question when the FBO is forced to defend an independent contractor classification during an IRS audit. Because substantial amounts of money could be at stake (including penalties and interest), it is imperative that the FBO be prepared to defend and justify a reasonable decision to classify flight instructors (CFIs) as independent contractors. This preparation is made more important in light of the current IRS emphasis of reclassifying a worker's status from independent contractor to employee.

### Definitions

In any discussion regarding the differences between "employers," "employees," and "independent contractors," it is first necessary to define these terms.

An "Employer," is the person or organization for whom a worker performs a service as an employee. (Circular E-Employer's Tax Guide, p. 3)

An "Employee," is a worker who performs a service for an employer under the Common Law (i.e. case law) rules used to determine an employer-employee relationship. Under Common Law Rules (unless certain statutory rules apply), the relationship of employer and employee exists when the "employer" has the right to control and direct the worker not only as to the result to be accomplished but also as to the details and means used to achieve the desired result. In other words, an employee is subject to the will and control of the employer not only as to what work has to be done but also as to how the work must be accomplished. The IRS interprets this to say that is not necessary for the employer to actually direct or exercise this control as long as the employer retains the right to do so.

An "Independent Contractor," is a worker who is subject to the control and direction of another only as to the result of his work and not as to the means.

### Benefits of Independent Contractor Status

FBOs may realize several benefits from the classification of a CFI as an independent contractor. Some of these benefits include the following:

1. The business is not responsible for wage withholding, FICA, and FUTA contributions on payments made to independent contractors.
2. It is often easier to cancel or not renew an agreement with an independent contractor than it is to fire an employee-especially in light of recent anti-discrimination laws.
3. Agreements with independent contractors can be terminated without subjecting the business to higher state unemployment insurance premiums.
4. Independent contractors are not covered under federal wage and hour laws (although most CFIs working as independent contractors are compensated at levels well above the limits mandated by wage and hour laws).
5. Independent contractors are not typically included in benefit programs such as pension plans and health insurance programs.

A worker (CFI) may also realize benefits from classification as an independent contractor. Benefits enjoyed by CFIs working as independent contractors include the following:

1. An independent contractor is generally allowed to work more autonomously than an employee.

2. An independent contractor is allowed more flexibility in his/her schedule and methods of operation.

3. An independent contractor may be able to deduct expenses for continued training, education, tools, and equipment as ordinary and necessary business expenses on schedule C (Form 1040).

### **Twenty Factors**

The IRS has established a twenty-factor control test to help determine whether a worker is an employee or an independent contractor under the Common Law for wage withholding, FICA, and FUTA tax purposes. The twenty factors attempt to indicate what degree of control exercised by the business over the worker is sufficient to establish an employer-employee relationship. These factors are a guideline only, and the degree of importance of each factor varies with each specific occupation and employment situation. The twenty factors and their relevance to the FBO-CFI relationship are as follows:

**Instructions** – A worker who is required to comply with instructions about when, where, and how the work is to be done is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions (Rev. Rule 68-598, 1968, C.B. 464, and Rev. Rule 66-381, 1966, C.B. 449). CFIs classified as independent contractors should be allowed to set their own schedule with students. Also, CFIs should be allowed to employ their own teaching techniques. If instructions must be given, they should be minimal and general. This factor should not preclude an FBO from requiring compliance with a minimum level of FAA-prescribed standardization necessary to meet practical test standards.

**Training** – Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by other means, indicates that the business wanted the services performed in a specific manner which reflects an employer-employee relationship (Rev Rule 70-630, 1970-2, C.B. 229). FBOs that utilize the independent contractor classification should be careful about giving CFIs further instruction. CFIs wishing to upgrade their certificates (i.e. CFII or MEI) should pay for their training and be treated similar to other students. This factor should not preclude FBOs operating under FAR Part 141 from providing initial and recurrent CFI training as required by FAA regulations. FBOs should avoid requiring CFIs to attend mandatory company meetings. A good practice is to schedule aviation safety meetings to discuss training and safety topics where CFI attendance is strongly encouraged but not mandatory.

**Integration** – Integration of a worker's services into a business's operations indicates an employer-employee relationship. When the success or failure of a business depends to an appreciable degree upon the performance of certain services, the workers who perform these services must necessarily be subject to a certain amount of control by the business. This factor is very difficult to defend against an independent contractor classification. Presumably all contractors, to some extent, add to the business's operations. For example, an outside accountant or CPA hired as an independent contractor would no doubt be considered an integral part of most business operations. For FBOs choosing to classify CFIs as independent contractors, it is advantageous to show that the FBO is made up of many departments (i.e. fuel sales, maintenance, charter, sales) and that the business is not totally dependent on independent contractors (CFIs) for its business operation. An FBO should be able to point out its many employees including mechanics, line service technicians, secretaries, receptionists, salespeople, managers, etc.

**Services Rendered Personally** – If the services of the worker must be rendered personally, presumably the business is interested in the method used to accomplish the work as well as the results, which indicates an employer-employee relationship. FBOs that choose to hire CFIs as independent contractors do so for their professional skills and training. Because the CFI must render his/her contracted services personally, this factor should not be used for or against an FBO in determining whether a CFI is an employee or an independent contractor.

**Hiring, Supervising, and Paying Assistants** – If a business hires, supervises, and pays assistants for a worker, this generally shows control over the worker and indicates an employer-employee

relationship. On the other hand, if the worker is responsible for hiring, supervising, and paying his own assistants under a contract which provides that worker will provide all labor and materials to achieve a desired result, this factor indicates that the worker is an independent contractor. This factor is generally not applicable to the FBO-CFI relationship.

**Continuing Relationship** – A continuing relationship between a business and worker indicates that an employer–employee relationship exists. A continuing relationship could exist where work is performed at frequently recurring, though irregular, intervals. An FBO that chooses to hire CFIs as independent contractors should consider using a written contract that spells out either a set period of time to perform the training or specify a given amount of training to be performed.

**Hours of Work** – When a business sets the hours of work for a worker, this shows control over the worker and indicates an employer–employee relationship. FBOs should allow an independent contractor flexibility in arranging his/her schedule with students. FBOs should avoid requiring a CFI working as an independent contractor to be present at the business during a set period of time, particularly at times when no training is needed.

**Full- Time Required** – An employer–employee relationship is indicated when a worker must work full time for a business. Full time work implies that the worker is restricted from performing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he/she chooses. CFIs working as independent contractors should not be required to work a certain number of hours per day, but should be allowed flexibility in setting their own schedule to accomplish the training contracted. The work schedule of an independent contractor should vary according to the amount of training to be performed, aircraft availability, and the student schedule.

**Working on Employer Premises** – If the business requires that the work be performed on the business's premises, this suggests control over the work typical of an employer–employee relationship, especially if the work could be done elsewhere. Common sense dictates that this factor applies only if the work could be done elsewhere. Obviously, the nature of flight training requires the services to be performed at the airport on the FBO premises.

**Order or Sequence Set** – If a worker must perform services in the order of sequence set by the business, this shows control over the worker and indicates an employer–employee relationship. Under these circumstances, the worker is not free to follow his/her own pattern of work but must follow the established routines and schedules of the business. Often, because of the nature of the flight training occupation, the business does not set the order of the services or sets it infrequently. Independent contractors conducting flight training for an FBO under FAR Part 61 should be given the latitude to set the order and sequence of training to comply with Part 61 regulations. Training conducted under FAR Part 141, however, must conform to the school's approved syllabus and training course outline. CFIs must follow this sequence of training to comply with Federal Aviation Regulations. An FBO should be allowed to require and reasonably expect that the CFI (whether classified as an employee or an independent contractor) will comply with all applicable laws, ordinances, and regulations.

**Oral or Written Reports** – A business that requires the worker to submit regular oral or written reports suggests a degree of control indicative of an employer–employee relationship. An FBO should exercise care in requiring CFIs working as independent contractors to submit oral or written reports (i.e. training or aircraft activity summaries) as part of their duties. This factor should not preclude the FBO from requiring compliance with regulations concerning training records, logbook entries, and other paperwork requirements of FAR Part 61 and 141.

**Payment by Hour, Week, Month** – Payment made by the hour, week, or month generally indicates an employer–employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. FBOs that classify CFIs as independent contractors generally pay them a set fee for each hour of training performed. This method of payment could be considered a fee sharing relationship in which the FBO (through its normally billing procedure) collects the fees and in turn pays the CFI his/her portion of the fee. FBOs should also avoid paying contractors different fees for comparable work performed. A difference in pay scales based upon the longevity or "seniority"

of a contractor is indicative of an employer–employee relationship.

**Payment of Business and/or Traveling Expenses** – If a business ordinarily pays a worker's business and/or traveling expenses, the worker is typically an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities. FBOs should not pay an independent contractor's business or traveling expenses. This is normally not a problem since CFIs performing local flight instruction do not incur many business or travel expenses. It should be understood by the CFI that allowance for miscellaneous expenses is incorporated into the agreed upon fee.

**Furnishing Tools and Materials** – Businesses that furnish sufficient tools, materials, and other equipment necessary to perform a service tend to show the existence of an employer–employee relationship. FBOs should require independent contractors to furnish their own tools and equipment. For example, a CFI should provide his/her own headsets, intercom, IFR hood, etc., to indicate independent contractor status. Most CFIs do not provide or own their own aircraft. The furnishing of an aircraft is inherent in the services typically provided by the FBO.

**Significant Investment** – If a worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an outside office rented at fair value from an unrelated party), this tends to indicate that the worker is an independent contractor. On the other hand, a worker's lack of investment in facilities indicates dependence on the business for the facilities and, accordingly, indicates an employer–employee relationship. This factor tends to work against an FBO utilizing independent contractors since the CFIs normally utilize the facilities of the FBO to perform their work. This factor can be minimized, however, by pointing out that the FBO also makes these facilities (planning areas, lounge, office areas, etc.) available to the general public and that the utilization of these facilities is a normal function of the services provided by the FBO. An independent contractor should also be able to show a significant investment in tools and equipment as discussed above. A CFI can also point to a significant investment in training and education required for certification as a flight instructor.

**Realization of Profit or Loss** – A worker who can realize a profit or suffer a loss as a result of his/her services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but a worker who cannot realize a profit or loss is an employee. Because CFIs are performing an instructional service that is rendered personally (their main investment is their time), it is difficult to show a direct risk of capital investment in the performance of their services. It is possible, however, to point out a CFI's significant investment and expense in training, tools, and materials that affects the CFI's "profit or loss" from instructional activities. It is also in the FBO's best interest to have student fees paid in advance or as services are rendered. This minimizes questions that might arise regarding CFI compensation given for instruction to students who default on their accounts.

**Working for More Than One Business at a Time** – If a worker performs more than minimal services for a number of unrelated businesses at the same time, this factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one business may be an employee of each of the businesses, especially when the businesses are part of the same service arrangement. FBOs classifying CFIs as independent contractors should consider explicitly allowing them to perform services for others during the term of the contract. FBOs may still reasonably expect its contractors to conform with ethical standards and refrain from contracting with direct competitors.

**Making Services Available to the General Public** – The fact that a worker makes his/her services available to the general public on a regular and consistent basis is indicative of an independent contractor. Independent contractors can hold themselves out to the public as certified flight instructors by advertising in local newspapers and distributing flyers that advertise their services. This advertising sets the CFI somewhat apart from the FBO with a separate identity; however, the FBO should realize the benefits of additional advertising without the cost.

**Firm's Right to Discharge** – The right to discharge a worker is a factor indicating that the worker is an employee and a business that possesses that right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the

independent contractor produces a result that meets contractual specifications. FBOs that classify CFIs as independent contractors should retain the right to terminate a CFI if the results of his/her work do not meet the standards of performance as contracted for. Examples of unsatisfactory performance should include training to unsatisfactory performance levels, abuse of aircraft or equipment, and failure to adhere to applicable laws and regulations.

**Worker's Right to Terminate** – If the worker has the right to end his/her relationship with a business at any time he/she wishes without incurring liability, this factor indicates an employer–employee relationship. An independent contractor is legally obligated to make good for a failure to complete the work contracted for. Technically, a CFI could be legally liable to the FBO for contracted work left uncompleted. As a practical matter, most FBOs would incur minimal damages, if any, from the default of a CFI contractor.

### **Section 530 Relief**

An FBO that finds its classification of CFIs as independent contractors rejected by the IRS under the Twenty Factor Guidelines could find a "safe haven" for its classification under section 530 of the Revenue Act of 1978. This act could provide relief even if the employer has erred in classifying an employee as an independent contractor. To qualify for relief under section 530, a business must meet three criteria:

1. The business must have treated all workers in similar positions as independent contractors.
2. The business must have consistently filed Form 1099 for its independent contractors.
3. The business must have a reasonable basis for treating the workers as independent contractors. A "reasonable basis" can be established by demonstrating reliance on one or more of the following conditions:
  - a. Judicial precedent, published rulings, IRS Technical Advice provided to the employer, or a letter ruling to the employer.
  - b. A past IRS audit of the employer in which there was no assessment attributable to the treatment of workers holding positions substantially similar to the position in question.
  - c. A long–standing recognized practice of a significant segment of the industry to treat the workers as independent contractors. (It is generally recognized that a significant segment of the FBO industry has classified CFIs as independent contractors).

Section 530 relief provides an employer protection from compliance with wage withholding, FICA, and FUTA requirements. Be aware, however, that the IRS takes the position that arguing for "safe haven" relief under Section 530 as an admission by an employer that a worker is an employee under the Common Law tests.

### **Summary**

In spite of numerous IRS advisories, court rulings, and "guidelines," the distinction between employee and independent contractor status is often not clear. The IRS has determined that employer status exists when the FBO has the right to control and direct the CFI, not only on the result of the work, but also on the details and means for rendering the service.

Many FBOs elect to classify their CFIs as employees in order to exercise a greater degree of control over their activities than is allowed under an independent contractor's classification. However, for FBOs deciding to classify their CFIs as independent contractors, the Twenty Factors are designed as indicators to demonstrate the degree of control that the FBO exercised over the CFI. The degree of importance of each factor varies depending on the unique circumstances of each FBO. While it might not be possible to completely satisfy the technical requirements of each and every factor, it is possible, using the Twenty Factors as a guide, to structure an FBO–CFI relationship to properly classify the CFI as an independent contractor.