



Independent contractor or employee?

Whichever side of the equation you're on, make sure that the distinction is clear

By Karine Benzacar, CMA

Saving money is usually top of mind for business executives, and one popular way to keep costs down is to hire independent contractors instead of permanent employees. But the line separating contractors and employees must be very clear to prevent potentially significant financial consequences.

The benefits of an independent contractor

The independent contractor arrangement, if handled correctly, can be a win-win situation for both the contractor and the hiring company.

The contractor can deduct many expenses — travel, cellular phone use, Internet — that an employee can't deduct. "The out-of-pocket (after tax) expense to the individual is much lower, and depending on income levels and the province of residence, it's almost half of the actual expense," says James Myers, partner and tax accountant at Myers Tsiofas Norheim accounting firm.

By hiring an independent contractor, the hiring company avoids a long-term employment commitment, which could result in an expensive severance package should an employee be dismissed. The hiring company doesn't need to offer employment benefits, nor does it need to pay payroll taxes such



as Employment Insurance (EI) and Canada/Quebec Pension Plan (CPP) contributions.

Contractor tests

If the benefits of independent contractor relationships are so high, why aren't companies rushing to structure all work arrangements in this way? The answer is simple — they can't. Regardless of how the parties define the relationship, the Canada Revenue Agency (CRA) and labour law have several subjective tests to determine the type of relationship between an individual and a hiring company. The main tests are the following:



Control

The CRA looks at who controls the individual's time and work processes. If the hiring company sets the hours, insists that the work be done at a certain location, determines how the work gets done, and prohibits the individual from working for others, then the CRA will likely decide that the individual is an employee rather than an independent contractor.

Ownership of tools

The CRA looks at whether the individual or the hiring company owns the "tools" the individual uses in the course of fulfilling his or her duties. For example, the CRA will look at who owns the computer equipment, phone, and other items, and in whose facilities work is taking place. The definition of "tools" is quite broad and can even extend to the use of certain company employees, such as secretaries.

Chance of profit or risk of loss

The CRA will look at the business arrangement to see if the individual in question is truly incurring a business risk. For example, if a hiring company pays an individual a fixed annual rate, then the individual doesn't incur any business risk and might be deemed to be an employee rather than an independent contractor. A better arrangement is to have the contractor undertake a job for a fixed price, regardless of the length of time it takes to complete it. An arrangement whereby the company pays an hourly rate is also acceptable, provided that there isn't a guaranteed number of hours per week, per month, per year, or over the life of the contract.

More recently, additional tests have been developed to deal with individuals whom these traditional tests would not catch in the employment net. The most significant of these tests is the Integration Test. Under the Integration Test, if the individual's work is an integral part of the business, then the individual will be considered an employee.

"For example, a salesperson whose sales are the financial lifeblood of a company will be considered to be an employee, regardless of how the working arrangement is structured," said Jeffrey Goodman, a partner spe-



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cializing in employment law at Heenan Blaikie Barristers and Solicitors and co-author of *A Guide to Alternative Work Relationships*, speaking at a recent conference organized by the Human Resource Professionals Association of Ontario. “However, the test must always be looked at from the individual’s perspective and not the employer’s, otherwise every contractor who provides important services to the employer would be found to be an employee.

“This area of the law is confusing and often contradictory,” he continues. “This is because there is no one test used to determine the true nature of the working relationship and, in fact, different courts and statutory tribunals often apply different tests. Consequently, an individual can easily be found to be an independent contractor by one court and an employee before a different tribunal.

“For example, employment tribunals tend to have a much broader definition of employment than the CRA. Part of the role of these employment tribunals is to protect the rights of employees who are deemed to be a vulnerable class within our society and to ensure they are not improperly classified as contractors. Whereas, recent decisions of the Federal court make it clear that they are prepared to interpret the *Income Tax Act* in a way that respects the contractor relationship the parties have created as long as there is some evidence to support that designation.”

Misclassified?

The consequences of misclassifying a working relationship can be significant.

“The employer will be responsible for payroll taxes owed to the CRA, both the employer’s share and the employee’s share, plus interest and penalties,” says Emilia Kotris, communications manager for the CRA.

But the payroll tax liability might end up being the least of the employer’s problems. Being deemed to be an employee gives the individual the entitlement, in arrears, to standard company benefits such as medical benefits, pension plan membership, and severance package. As a result, “often the request to be classified as an employee comes from the individual, usually after they apply for EI benefits at the end of a contract and are denied,” says Kotris.

In the U.S., when the Internal Revenue Service ruled that certain contractors hired by Microsoft Corp. during the mid-1980s were employees, the individuals launched a class action lawsuit against the company,

suing for the value of the stock options they would have received had they been employees. Given that the value of Microsoft’s stock exploded in the 1990s, Microsoft ended up paying out a \$97 million (US) settlement in early 2001.

“Individuals are now challenging the nature of the work relationship more than ever,” says Goodman.

More information

If you’re not sure whether or not a relationship is an employment relationship, submit the form *Request for a Ruling as to the Status of a Worker under the Canada Pension Plan and/or the Employment Insurance Act* found on the CRA’s website, www.cra.gc.ca. For more detailed information, you can also read the *Guide on Employment (RC4110)* on the same website. However, if ever in doubt, the safest thing to do before starting an independent contractor relationship is to obtain advice from an HR advisor, lawyer, or tax professional to make sure your arrangement meets all the proper criteria. ■

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Do’s and don’ts when hiring independent contractors

Develop a written contract which clearly states the terms of the relationship between the parties, including as many of the points below as possible:

1. Identify in the contract that the individual is responsible for remitting income taxes to the CRA.
2. Ensure that the contract is for a specific and limited time period and/or for a specific project.
3. Require the contractor to invoice the company for services rendered.
4. Permit the contractor to subcontract all or part of the work, at the contractor’s discretion.
5. Ensure that the contract does not restrict the individual from offering his or her services to other companies.
6. Exempt the individual from adhering to company policies and disciplinary procedures.
7. Insist that the contractor supply his or her own computer, pay for his or her own cell phone and internet services, if required, and work from an offsite location.
8. Make sure the contractor is treated differently than employees, with no cafeteria discounts, no access to the corporate fitness facilities, and no health or pension benefits.