

Financial Services Institute¹ - Independent Contractor Issue Briefing

Background on FSI and the Independent Broker-Dealer Community

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

Registered Representatives of Independent Broker-Dealers are Properly Classified as Independent Contractors

The independent broker-dealer (IBD) business model focuses on offering financial solutions to the "main street" clients that form the backbone of America's investor class. Financial advisors associated with IBDs provide those families with the critical financial advice they need to prepare for the future and maximize their ability to achieve their financial goals. The IBD industry is a network of financial advisors who own their own business, provide their own start-up capital, experience profits and loss based on their own business success, service their clients beyond mere securities transactions, dictate their own business practices, pay their own operating expenses, have complete flexibility on personnel issues, and report their compensation on Internal Revenue Service (IRS) Form 1099. Taken together, the aforementioned indices of independence clearly illustrate that these financial advisors are independent of their IBDs. Further, the idea that financial advisors affiliated with IBDs are properly classified as independent contractors has been vindicated both through Congressional and judicial action.

Representative Dave Camp's Tax Reform Proposal Does Not Offer Certainty for the IBD Model

In February 2014, Representative Dave Camp (R-MI) released his long-awaited comprehensive tax reform proposal. Included within the proposal is a second safe harbor that allows employers to classify a worker as an independent contractor if certain specified conditions are met. In order to qualify for independent contractor status under the proposal, a registered representative of a broker-dealer must meet the requirements under three discrete tests. First, a RR must be compensated primarily on a commission basis and

¹ FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. Our mission is to insure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. We also provide our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

“substantially all” of that compensation must be based on sales of goods or services instead of hours worked. Second, a registered representative of a broker-dealer must meet at least one of the following four criteria: (1) Have a principal place of business; (2) Not primarily provide goods or services in the IBD’s place of business; (3) Pay fair market rent for use of the IBD’s space; or (4) Provide any good or service primarily using the registered representative’s own equipment. Finally, the written contract between the BD and RR must contain certain identifying data for the RR, contain a statement that the RR will not be treated as an employee, contain a statement that the IBD will withhold income as directed by the Internal Revenue Code (IRC), contain a statement specifying that the RR is responsible for applicable taxes, and contain a statement that the contract is intended to meet the safe harbor provisions as laid out in the proposal. The withholding obligation would require the IBD to withhold five percent of up to the first \$10,000 of payments made to a RR in a given year. The purpose of this withholding likely serves a tracking function for the benefit of the IRS and would require a maximum withholding of no more than \$500. Although the amount of the withholding is relatively small, the administrative burden to the IBD could be potentially great.

Although Rep. Camp’s proposal does not contain language that would outright reclassify legitimate independent contractors on its face, it leaves many important questions unanswered and fails to provide legal certainty on the issue. The proposal does not explain what will become of the current safe harbor provision contained in Section 530 of the IRC, does not define does not indicate if the IRS will continue to use the existing 20-factor worker classification test, and authorizes the IRS to promulgate additional rules in the future, which adds an additional layer of uncertainty going forward.

Conclusion

If IBDs were forced to reclassify their financial advisors as employees, the additional costs and compliance burdens would cripple their ability to remain profitable while also providing the services needed by their advisors and clients. IBDs could be subject to substantial back taxes, penalties, and interest payments. As a result, the health of this successful and necessary business model would have been significantly threatened. Any move to eliminate the independent contractor status without carving out IBDs and financial advisors would undermine the entrepreneurial spirit and the independence that is so vital to the advice, products, and services provided by independent financial advisors to their clients. Additionally, repeal of the safe harbor provision would wipe out the “sweat equity” independent financial advisors have built in their own small businesses and eliminate their ability to determine how to best serve their clients. This would be a tragedy for Main Street investors who have come to rely upon the professional financial services they receive from their local independent financial advisor.

For these reasons, FSI urges Congress and the Administration to exempt IBDs and their financial advisors from any future worker classification legislation that may be considered in the 113th Congress.