



Making Sure Subs Aren't Employees

by Jonathan Levine

Contractors have heard and read much lately about the current Internal Revenue Service (IRS) crack-down on relationships between independent contractors and their subcontractors. The IRS is examining these relationships closely to make sure that contractors' subs really are independent subcontractors, rather than employees who look primarily to the contractor for their livelihoods, and for whom the contractors should be paying income and social security taxes.

Often such questions are clear-cut. But sometimes the distinction between sub and employee is fuzzy. As a result, the IRS might declare someone you honestly consider a sub to be an employee. Suddenly you owe the IRS a lot of money for back taxes and penalties.

The IRS rulings in this area so far don't provide much comfort. Revenue Ruling 56-155, for instance, determined that employer-employee relationships existed between certain contractors and the subs they used, even though those relationships fit what trades recognize as traditional contractor-subcontractor arrangements.

These decisions may not be reassuring, but they do provide some guidance as to how a contractor wishing to subcontract parts of a job can proceed with as little risk as possible. Taking these steps can make the difference between a favorable and an unfavorable IRS ruling if you are audited.

Choosing Subs

Your first step is to determine whether your subs can show that they are operating truly independent businesses. The IRS is more inclined to see them this way if:

- the subcontractor is incorporated or at least has a "dba" ("doing business as") name by which he or she is known;
- the subcontractor has a separate place of business or separate office in his or her home;
- the subcontractor maintains a separate business telephone listing; and
- the subcontractor advertises in local telephone directories, trade journals, or other public means.

The IRS considers these to be signs of a truly independent operation that explicitly offers its services to the public, rather than only to you. The more of these conditions your subs meet, the better.

Written Contracts

You should also have written agreements with all subs, and for every job. Such formal agreements, if they are correctly written, will differentiate between a job-by-job contractor-subcontractor relationship and a continuing employer-employee relationship. Contract characteristics that help establish the subcontractor as an independent business include:

- *Having a definite term* for the contract, tied to a specific project,

with beginning and end dates.

The contract should not be for an indefinite duration, which the IRS invariably views as evidence of an employer-employee relationship.

- *Omitting any instructions* to the sub regarding the details of how to perform the services.
- *Making the subcontractor responsible* for his or her own tools, equipment, and materials.
- *Compensating the subcontractor with a flat fee* on a given project, even if partial payments for that fee are based on hourly rates.
- *Emphasizing the subcontractor's right to perform services for others*, consistent with the completion of its services under the contract in question.
- *Limiting the right of either party to terminate the relationship* before the contract's termination date. Of course, some right to sever the relationship based on dissatisfaction with performance may be necessary.

Conclusion

There is no guarantee that even if all possible steps are taken, the IRS or some other agency won't reclassify a subcontractor as an employee. But a careful approach like the one outlined above should help you minimize this risk. ■

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