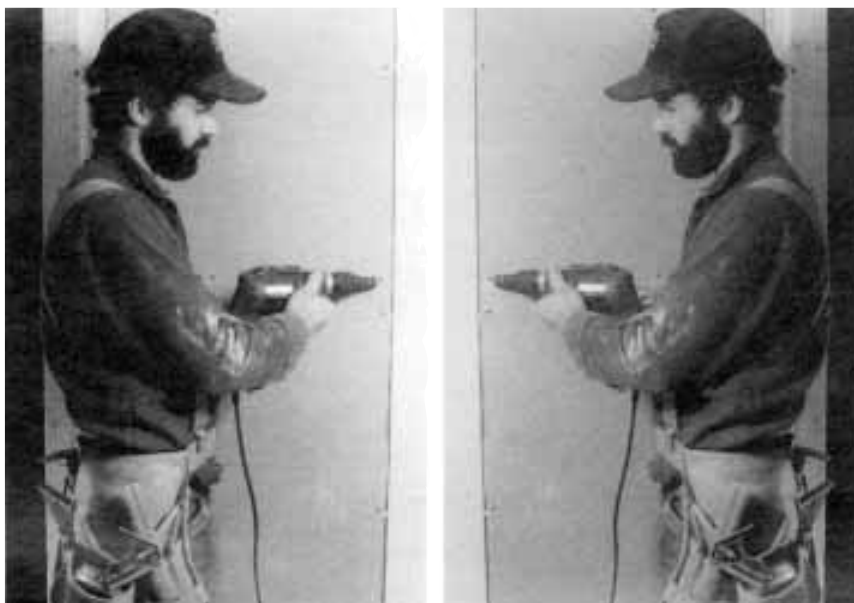


SUB OR EMPLOYEE?



The law is vague, but the risks are clear if you hire “subs” who are really employees

JLC Staff Report

Most people think of small builders and remodelers as general contractors who maintain crews of carpenters and only sub out special trades. Many firms, however, now subcontract major portions of their work. Often this includes tasks traditionally performed by employees, such as framing and finish carpentry. Some firms sub out even the job management to a construction management firm, which in turn manages the other subs. With the persistent and growing shortage of skilled labor, this reliance on “non-traditional” subs has spread from sophisticated companies to more conventional firms that also maintain a core crew. But in many cases, the legal and tax status of such subcontractor relationships is vague.

Are Your Subs Legitimate?

Consider a journeyman-level carpenter who first becomes a sub before going out on his own. He stays with his old crew. Few things change. He takes home a better paycheck (one without withholdings) and he feels more independent. And you, the hiring contractor, go along willingly. Why shouldn't you? You hang on to your skilled labor without the burden of payroll taxes and workers compensation insurance.

But if you maintain the subcon-

tractor relationship in name only, you face considerable risks. The courts, in the event of a lawsuit, or the IRS, in an audit, will always investigate this working relationship. If they reclassify a worker, you could be liable for third-party claims — claims made against you by someone injured by the subcontractor's actions — or claims made by a sub who injures himself. Moreover, you can be assessed for back payroll taxes including *both halves* of social security, unemployment taxes, federal income tax withholding, and penalties. Finally, your workers compensation insurance carrier may “reclassify” the sub as an employee and bill you for premiums to cover him.

There are ways to legally change the status of a worker from employee to sub. But you have to actually change the way you do business with the person.

Insurance Matters

Since insurance companies routinely audit their clients, the insurance risks of hiring subcontractors are the most apparent. Most business liability coverage designates only the owner and employees as “insured.” Such a policy probably will not cover third-party claims unless you have additional coverage, such as *contingent liability*, to cover your subs.

Thus, in its annual audit, your insurance company will request a certificate of insurance to show that each subcontractor you hire carries his own liability insurance. Without this piece of paper, your insurance costs will be raised to cover the risk.

Workers compensation insurance works similarly. Though workers comp regulations vary by state, most consider anyone not clearly a sub to be an employee who is entitled to workers comp coverage by the contractor. Thus, if you lack documentation that a sub is independent (such as proof that the sub carries his own insurance), your workers comp carrier will likely bill you for premiums based on any wages paid to that sub. You will then bear the burden of proving the sub actually works independently.

Proving Who Works for Whom

A subcontract agreement helps only so much in proving a contractor-subcontractor relationship. Standard forms specify that the subcontractor is responsible for workers compensation, public liability insurance, and all income taxes and unemployment compensation. This establishes a record of your mutual intention. But a court of law often looks at a contract as just another piece of paper. It is not definitive

evidence that a contractor and sub have an independent business relationship. The court may rule that a contractor actually functions as an employer and the “agreement” is but empty words.

In the event of an insurance claim, an insurance audit, or a lawsuit, a subcontractor's status will be determined based on the following common-law guidelines:

- The extent of control, which, by the agreement, the contractor may exercise over the details of the sub's work
- Whether the sub is engaged in a distinct occupation or business
- The sub's occupation and whether it is traditionally done without supervision or direction by the contractor
- The skills required for the work
- Whether the contractor or sub supplies the tools needed to perform the job
- The length of time the person is employed
- The method of payment (whether by time or by the job)
- Whether the work performed is part of the contractor's regular business
- The intent of the parties in entering the relationship
- Whether the contractor is an established entity

The first determinate — commonly called “the right to control” — is the most important. In a 1976 appellate court decision, the judge wrote (concerning liability for a construction site accident), “All of these factors are of varying importance in determining the type of relationship involved, and, with the exception of the element of control, not all elements need be present.” This is a clear affirmation that you can legally work with nontraditional subs, even though some factors seem to exclude this.

This ruling has given rise to a common-law definition of employee and subcontractor. An employee is someone you direct step-by-step through the job; you are an employer if you have control over the specific task you are hiring a worker for. An independent sub is someone you turn loose on the job after showing him what needs to be done. When you subcontract out work in this way, you hand the right to control the job over to the sub. A sub must be free to negotiate when he performs the job and to choose the tools and techniques he deems best. And since the definitions are based on a worker’s approach to a specific job, it requires paying and billing a worker out by the job.

Tax Concerns

In years past, the IRS had a strong incentive to classify a worker as an employee, simply because an employee used to earn more money for the Treasury than a subcontractor. Perhaps because the IRS felt it has not been able to adequately track down all the subcontractor earnings and has been losing money because of this, it has increased the self-employment tax contribution. An independent subcontractor now is required to pay 15.3% of his wages to Social Security, as required by SECA (Self Employed Contributions Act). This equals the total tax contribution acquired from an employee, which includes both the employee’s withholding and an employer’s contribution, as required by FICA (Federal Insurance Contribution Act).

General contractors are required to file Form 1099-MISC for all non-incorporated subcontractors who are paid \$600 or more each year. This enables the IRS to track the earnings of self-employed workers.

According to John Wyckoff, a business consultant in South Burlington, Vt., who specializes in counseling building professionals, a contractor should require two things of every subcontractor who walks onto the job site. First, you need verification that a subcontractor is incorporated. If the subcontractor is not incorporated, he should supply an employer identification number to facilitate filing Form 1099. In

IRS Subcontractor Guidelines

1. Is the individual providing services (the sub) required to comply with instruction on when, where, and how the work is to be done?
2. Is the individual provided with training to enable him or her to perform the job in a particular manner?
3. Are the services performed by the individual a part of the contractor’s business operations?
4. Must the services be rendered personally?
5. Does the contractor hire, supervise, or pay assistants to help the individual performing under the contract?
6. Is the relationship between the parties a continuing one?
7. Who sets the hours of work?
8. Is the individual required to devote full time to the party for whom the services are performed?
9. Does the individual perform work on another’s business premises?
10. Who directs the sequence in which the work must be done?
11. Are regular oral or written reports required?
12. What is the method of payment — hourly, weekly, commission, or by the job?
13. Are business or traveling expenses reimbursed?
14. Who furnishes the tools and materials necessary for the provision of services?
15. Does the individual have significant investment in the tools or facilities used to perform his services?
16. Can the individual providing services realize a profit or loss?
17. Can the individual providing services work for a number of firms at the same time?
18. Does the individual make his or her services available to the general public?
19. Can the individual be dismissed for reasons other than nonperformance of contract specifications?
20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job?

some cases, this may be a social security number. In addition, a certificate of insurance is needed to verify that the sub has liability insurance.

This will provide the basic documentation for establishing a true contractor-sub relationship. But if you are audited, you may be required to prove that you actually work as contractor and sub rather than as employer and employee.

The IRS Training Manuals 8463 and 3142-01 list 20 factors used to determine whether an individual is an independent contractor or an employee (see list above). These questions have been compiled to cover all industries. Some of the questions, such as #4, #11, and #13, are often not relevant to the building trades. Others, like #7, #9, and part of #14, are gray areas. Setting the hours of work is often a mutual agreement based on a project’s schedule. The business premises — a job site — are common to the principal and his subs. And often a contractor will supply all the materials, from the concrete to the shingles, even though jobbers will install them.

Factor #6 looks gray, too, because general contractors often have “continuing” relationships with their subcontractors. But, according to Wyckoff, the IRS rule is specific. A “continuing relationship” is defined by the IRS as a steady, rather than a repeated, relationship. For example, a contractor might always hire the same plumber. But the plumber also

works for other contractors. Similarly, a finish carpenter can work repeatedly for the same contractor. If he works for only one, however, he is, without dispute, that contractor’s employee.

Wyckoff asserts that a few other factors are key to establishing a true contractor-sub relationship with nontraditional subs in the building trades:

- *Skills and independence.* Above all else, a subcontractor should have the necessary skills to perform the work on his own. If a worker receives training or supervision from the contractor, he is considered an employee. Similarly, a subcontractor must hire his own helpers. He cannot use a contractor’s helper on a routine basis.
- *Risk of profit or loss.* Often this factor can validate a subcontract agreement. It confirms that a sub operates a distinct business.
- *Furnishing tools.* The larger a worker’s investment in tools, the more likely he is considered to operate an independent business.
- *The method of payment.* An independent subcontractor should be paid by the job.

There are no rules as to how many factors a worker must conform with to be classified as an independent contractor. A contractor should set things up to conform with as many conditions as possible. He then has a fighting chance in the world of lawsuits and tax and insurance audits. ■