Subs, Employees & the Safe Harbor Rule

by Quenda Behler Story

Construction companies rely on subcontractors because they provide workers with specialized skills, such as electrical wiring, plumbing, drywalling, excavating, and so on, to employers who could not afford to keep these workers on a regular payroll. There are other advantages, too. When you hire an independent contractor, you don't have to pay payroll taxes, such as FICA, or include that sub in your company's pension plan or health plan. Nor do you have to file federal withholding or prepare income taxes for the subcontractor.

In fact, these advantages are so attractive that some employers succumb to the temptation to class workers who are really employees as independent contractors. When the IRS catches someone doing that, there are big-time penalties. But many employers have been totally surprised to discover that the "independent contractor" who worked off and on for them for years was actually, in the cold light of an IRS audit, a "part-time employee."

Three Tests

While the light is still not especially bright concerning who is or is not an independent contractor, IRS Section 530 — the so-called "safe harbor" rule — does bring some relief from back taxes and penalties to employers who acted in good faith when they classed a worker as an independent contractor.

Threshold test. How much relief depends on the employer meeting three tests. The first, called a "threshold" test, is crucial: The employer must file a 1099 for every independent contractor who earned more than $600 during the year. If an employer files the required 1099s, the IRS will grant some relief from back taxes and penalties even if that employer fails the other two tests. But if an employer fails the threshold test, all bets are off. Under Section 530, an employer who did not file the required 1099s is entitled to zippo, as we say in the legal trade, and must pay *all* back taxes and penalties for *all* of the years he failed to pay withholding and FICA for the sub — whom the IRS now considers to have been an employee.

Consistency. The second test is for consistency. The employer must be able to show that all workers who were in basically the same situation were treated in the same way. For example, if Joe does the drywalling and is treated as an employee, then Jack, who comes in once in a while to help with drywall and who works under basically the same conditions as Joe, should be treated the same way. That could mean that Joe gets to be an independent contractor, or that Jack becomes an employee; unfortunately, I'm not prepared to declare which here. Whatever the answer is, however, it had better be the same for both of them.

Reasonable belief. Test number three is for reasonable belief. The employer must have had some real reason for believing that Jack could be classified as an independent contractor. That reason must be more substantial than the fact that it made doing business easier and cheaper.

There are several ways to meet the test of reasonable belief. For example, if you treat your electrician as an independent, and you can show that electricians are typically treated that way in the industry, that's a good start. It also helps if you can point to an opinion letter from somebody knowledgeable about worker classification, or if you can demonstrate in some other way that you were relying on somebody who should have known what he was talking about. Better yet are published rulings or court cases, and best of all is a prior audit where the IRS did not reclassify your electrician.

Pass-Fail

Remember, an employer who clearly fails these last two tests — the ones for consistency and reasonable belief — but who passed the threshold test by filing 1099s will still only be held liable for the taxes in the latest audit year. That's much better than having to pay all of the taxes and penalties for all of the years the employer had classed employees as independent contractors. People have been put out of business by those back taxes and penalties.

The employer who passes all three tests but who makes the wrong classification according to IRS rules will get an even better deal. That employer would only have to pay 25% of the taxes due, and only for the latest audit year. In other words, you may file all required 1099s and consistently treat workers as subs and have a good reason to do so, but the IRS may still rule that the subs should have been classified as employees. But because you passed all three tests of the safe harbor rule, your penalties will be much smaller.

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