



# Is Your Subcontractor Really Your Employee?

by Quenda Behler Story

My husband and I own a small remodeling company. We're not young anymore, so we don't want to work as hard as we would need to work to generate the additional overhead money we would need for employees. We particularly don't want to cope with the forms and the payments for workers compensation, the IRS, unemployment insurance, state safety regulations, and all that other good stuff that goes with employees. So we rely heavily on subcontractors.

We always make sure, however, that our subs are truly independent contractors, rather than phantom employees. Our subs are all licensed, run their own companies, and own their own tools. They give us estimates in advance of the work, and they must submit bids to get the job. And we sometimes have to wait for the subs because they're tied up on somebody else's job. It's very clear they are independent business-persons, so we don't worry too much about getting nailed by the IRS or insurance auditors for disguising employees as subs.

## Trouble in Gray Areas

Some contractors, however, *do* try to disguise employees as subs, courting big trouble. We know an interior decorator who also relied on subcontractors. She estimated her jobs, lined up the customers, then contracted out all the painting, wallpapering, and trim work. She had a list of people she called on; if someone wasn't available, she went to the next person on the list. The people on her list averaged about 200 hours of work a year from her. They were housewives, semiretired people, or people with full-time jobs elsewhere looking for extra income. Although they owned the tools themselves, she told them what kind of tools they needed to work on her jobs. She also supplied the materials and the job specifications, paid them according to how many hours they worked, and filed W-4s every year for them.

The IRS said, in effect, "These people are not subs; they're part-time or tempo-

rary employees." Then they handed the decorator a staggering bill for unpaid withholding, back FICA contributions, and a big fat back-breaking penalty. She went to court, but the court ruled that her subcontractors were not actually in business for themselves and that she controlled their behavior in the way that employees are controlled.

The question of who is an employee and who is not is important for insurance issues, unemployment obligations, job-site injury claims, and a whole range of employee problems. But right now, it's a particular problem with the IRS, which is cracking down on small contractors.

It doesn't matter to the IRS that the employer honestly believes a particular worker to be an independent contractor. It does not even matter if the worker actually requested to be treated as an independent contractor. The regulatory agency will look for the real nature of the relationship. The IRS even uses the term "captive subcontractors" to describe the relationship; the term means that the worker you may have been treating as a sub is really your employee.

Remember that it is up to the employer to prove the subs are not employees. When dealing with the IRS, there's none of this "innocent until proven guilty" business. If a contractor were arrested for car theft, a prosecutor would have to prove guilt, but if the IRS were to assess a penalty against that same contractor, the contractor would have to prove his or her innocence.

## Tilting the Weight of Evidence

So how do you prove that a worker on your job site is a sub and not an employee? Both the IRS and insurance regulators tend to look at a number of factors, rather than any one factor, in determining whether subs are legitimate. They evaluate these factors by asking questions about the relationship, and then weighing the various answers to determine whether a sub is truly independent.

While some of these questions are more important than others (the issue of who decides when and how a job gets done, for instance, is weighed heavily, as is the question of whether the sub is paid by the job or by the hour), the IRS determination is usually decided by which way the weight of the evidence falls.

Ask yourself the following questions. The more the answers to these questions indicate an independent relationship, in which the sub both enjoys the freedoms and runs the risks of an independent business operation, the more likely the IRS is to agree with you that your sub is a sub, and not an employee. (You can write or call the IRS for a copy of these guidelines.)

**Does this person work for other contractors?** If a worker works on other job sites for other contractors, that goes a long way towards proving that he or she is a sub. However, it does not automatically establish that the worker is not your employee. The worker could be an employee with two jobs — lots of employees work for someone else on weekends and after hours. So ask yourself, “How is that other work treated?” If your jobs always come first, or if the worker always schedules his or her other work around your jobs, that worker begins to look more like your employee who accepts jobs on the side.

**Does the sub run his or her work like a business?** Ideally, your subs will run their operations like independent businesses that consider each job they do for you separately, and that must win each job separately, in competition (either direct or implied) from other subs. The IRS uses several criteria to evaluate this. Does the sub do estimates for your job before starting? Do they ever face competition in those bids? Do they bill for the job? Are they paid by the job rather than by the hour? Is it possible for them to take a loss on the job? Do they supply their own tools and materials? Do they have a federal ID number? Are they insured? A “yes” answer to these questions indicates a subcontractor relationship.

**How does the sub get other work?** This is another key criteria. Does he or she advertise? If your subs bid for other

jobs, do they bid and charge in a manner similar to the way they bid and charge for your jobs? Do they have a business name? A business phone number? A business card? Letterhead? A worker who actively pursues other business is behaving like a person in business for him or herself.

**Does the sub have a license?** Lots of employees have licenses, so that alone does not mean they aren’t employees. However, a lack of a required license strongly suggests they are not independent businesspeople.

**How much control does the sub have over the way the job is done?** The IRS looks at how closely the actual work of the sub is controlled, both in terms of when the sub does the work and how he or she goes about the work. Ideally, a sub determines when he or she does a given contracted job, and also decides how he or she will go about the job, or even who (among the sub’s own employees, if there are any) does the work. In construction, of course, this is a fuzzy area, since job specifications and construction schedules often determine not only when a job needs to be done, but how. However, the more a contractor directly dictates the time in which the sub must do the work, or supervises the work itself, the less the IRS will be inclined to consider that sub a sub.

Don’t panic if you’re working with a sub and you can’t answer every single one of these questions in the way the IRS wants you to. These questions are intended as a guide to let you know when the IRS might hesitate to classify the workers on your job site as subcontractors. If your answers to these questions suggest that you might have a problem, you should consider changing how you deal with your subs. Seek advice from your accountant or attorney about the best way to make this change. You can even ask the IRS for a ruling about whether or not those workers are subcontractors. ■

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