

PUBLICATION

20 Ways Your Subcontractor Might Be an Employee

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Quite often, companies in the construction industry hire “subcontractors” and classify them as independent contractors. However, these companies should take caution in proceeding with such classification. In February, the IRS began its first comprehensive audit of employment tax issues in over 25 years. The main issues to be examined in these audits are worker classification, executive compensation and taxable fringe benefits. (For a broad discussion of all of these issues, please see our Firm's November 2009 Tax alert *IRS Will Audit 6,000 Companies – Make Sure Your Employment Taxes Are in Order.*) Because worker classification is an issue that arises often for construction companies, this article focuses solely on worker classification and the factors involved in making an accurate determination.

Generally, the IRS favors classifying workers as employees. When workers are classified as independent contractors, the company does not pay employment taxes or withhold income taxes. Instead, the workers pay the full amount of employment taxes and pay income taxes, usually through estimated payments. Moreover, as independent contractors, workers are not entitled to unemployment, retirement and health benefits offered through the hiring company or many of the protections afforded to employees through the various federal acts which protect employees. As such, misclassification has a profound effect on the ability of the IRS to collect all taxes that should have been paid, and it denies workers the ability to participate in employee benefit plans and receive legal protections to which they may otherwise be entitled.

The IRS will only allow independent contractor classifications when the company hiring the contractors can show it lacks the necessary control over the workers that would indicate an employer-employee relationship. However, before analyzing control, any worker classification analysis should begin with these two threshold questions:

- Does the hiring company pay its regular employees to perform essentially the same duties as the subject worker who is treated as an independent contractor?
- Has that worker previously been paid by the company as an employee to perform essentially the same task?

If the answer to either of these questions is yes, the worker in question very probably is an employee for classification purposes.

Beyond these threshold questions, the IRS considers the following 20 factors to determine whether the company hiring the worker actually has control over the worker:

1. **Instructions.** A worker who is required to comply with another person's instructions regarding when, where, and how to perform the work is ordinarily an employee.
2. **Training.** Training a worker indicates that the company wants the services performed in a particular method or manner, which also indicates control.
3. **Integration.** Integration of the worker's services into the company's core business operations generally shows that the worker is subject to direction and control.

4. **Services Rendered Personally.** If the worker must personally perform services for the company, this will indicate control by the company. Alternatively, if the worker is free to engage others to perform the service for the company (i.e., subcontractors), a lack of control by the company is indicated.
5. **Hiring, Supervising and Paying Assistants.** Similar to #4 above, if the worker is unable to hire, supervise, and pay assistants to perform services for the company, control by the company is indicated. However, a lack of control is indicated when the worker is able to hire his or her own assistants and pay them from the worker's own funds.
6. **Continuing Relationship.** A lengthy and continuing relationship between the worker and the company indicates that an employment relationship exists.
7. **Set Hours of Work.** If the worker works certain hours set by the company, employment status is indicated. If the company does not control the hours of the worker, independent contractor status is indicated.
8. **Full Time Required.** If the worker must devote substantially full time to the company's business, control is indicated.
9. **Work Performed on Employer's Premises.** If the work is performed on the company's premises, the company is considered to have control over the worker, especially if the work could be done elsewhere. Control is also indicated when the company has the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.
10. **Order or Sequence Set.** If a worker must perform services in the order or sequence as determined by the company, the worker is generally subject to an employer's control. However, if the worker chooses his or her own method for completing a job, a lack of control exists.
11. **Oral or Written Reports.** A requirement that a worker submit regular or written reports is an indicator of control.
12. **Payment by Hour, Week, Month.** Hourly, weekly or monthly payments generally point to an employment relationship. On the other hand, payments based on a contract or for completing a particular job or task will generally indicate an independent contractor relationship.
13. **Payment of Business and/ or Traveling Expenses.** If the company ordinarily pays the worker's business and traveling expenses, the worker is ordinarily an employee.
14. **Furnishing of Tools and Materials.** If the company furnishes significant tools, materials, and other equipment, an employment relationship is indicated.
15. **Significant Investment.** If the worker does not invest in his or her own facilities, control is indicated because the worker depends on the company for such facilities.
16. **Realization of Profit or Loss.** A worker who cannot realize a profit beyond an ordinary salary or suffer a loss is generally considered to be an employee.
17. **Working for More Than One Firm at a Time.** If the worker cannot perform services for more than one company at a time, the company generally controls the worker. However, a lack of control is indicated when the worker is able to perform services for multiple companies at the same time.
18. **Making Service Available to General Public.** If a worker is not free to advertise his or her services to the general public on a regular basis, control is indicated. Workers who advertise their services are generally considered independent contractors.
19. **Right to Discharge.** The right of the company to discharge a worker without breaching a contract indicates an employment relationship as control is exercised through the threat of dismissal.
20. **Right to Terminate.** If, at any time without incurring liability, the worker has the right to end his or her relationship with the company, an employment relationship is indicated.

See Rev. Rul. 87-41; see also IRS Form SS-8. None of these factors are singularly determinative. Instead, all factors should be considered to make an accurate determination.

It is important to note that the various state revenue and labor departments are also concerned with worker misclassification and have been increasing enforcement at varying speeds. The worker classification analysis

used by many states will differ substantially from the 20-factor test utilized by the IRS, resulting in different classifications based on the same facts. As such, a state may classify a worker as an independent contractor while the IRS may classify the same worker as an employee.

If your construction company utilizes subcontractors and you have classification questions, either at the federal or state level, after reviewing this 20-factor test, please contact your Baker Donelson attorney for assistance.