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The tax law covering subcontractors is very complicated. This chapter is designed to give you a basic understanding of the difference between subcontractors and employees so you can discuss your situation with your tax professional.

If you hire an employee, you are responsible for withholding and paying the employment-related taxes. You issue a Form W-2 to an employee. A subcontractor is a worker who is not your employee. You give a Form 1099 to a subcontractor showing the amounts you paid him. The subcontractor is responsible for keeping his or her own records and paying his or her own income and self-employment taxes. It is important to note that either classification-employee or subcontractor-can be valid.

The difference between an employee and a subcontractor depends on your right to direct and control the worker. In determining the employment tax status of a worker, the IRS considers three categories of evidence:

- **Behavioral control**,  
- **Financial control,** and  
- **Relationship of the parties.**

It is important to remember that all the facts of your situation must be examined to determine whether the control test is satisfied—no single fact provides the answer.

**Behavioral Control**

Behavioral control deals with whether you, as the employer, have the right to direct and control HOW the work is done. You do not have to actually direct or control how the work is done—as long as you have the right to direct and control the work. Instructions and training provided to a worker are important factors to be considered under behavioral control.
Instructions

If you give the worker detailed instructions on *how* work is to be done, the worker may be an employee. Instructions can cover a wide range of topics, for example:

- how, when or where to do the work,
- what tools or equipment to use,
- what assistants to hire to help with the work, and
- where to purchase materials and services.

A subcontractor does not need or receive detailed instructions on *how* the work should be done. The subcontractor generally provides his own tools, equipment, and materials and can hire employees or subcontractors himself.

Example:

Joe is a carpenter who works for a construction company. He is required to begin work at 7:00 each weekday morning. The company provides all the tools and materials he needs at the job site.

Joe also does carpentry on the side. He has his own tools and buys the materials for these side jobs. As long as he meets his customers’ deadlines, he can work on the side jobs anytime.

Joe is an employee of the construction company and receives a W-2 that shows his wages, tax withheld and social security tax. Joe is a self-employed subcontractor on his side jobs. He receives 1099 Forms for most of his jobs that show the income he has earned. He must keep records of all his income (whether he got a Form 1099 or not) and he has to pay his own self employment tax.

Training
If you, as the employer, train the workers to perform tasks in a certain way, then they may be employees.

**Financial Control**
The financial control category deals with whether you, as the employer, have the right to direct and control the ECONOMIC aspects of the work. Several factors of evidence considered under the financial control category are significant investment, expenses, and opportunity for profit or loss. There is no precise dollar amount that you can use to measure your financial control over the worker.

**Significant Investment**
This rule covers the extent of the worker’s financial investment in the project. If the worker must own or rent costly equipment to do the work, he may be a subcontractor.

**Examples:**
Jack is a backhoe operator. He claims he is a subcontractor because he has to rent a $75,000 backhoe. The monthly lease payment is less than the fair market rental value. He can terminate the lease at anytime without penalty. The company he does work for pays his liability insurance and does all the maintenance on the backhoe. Jack does not have a significant investment and is most likely an employee.

Hank is a backhoe operator. He owns two backhoes and has hired an employee to work with him. He works mainly for one company but has to bid on each project. He pays his own liability insurance on the backhoes and for his employee.
Hank has a significant investment and is most likely a subcontractor.

**Expenses**
This rule deals with whether or not a worker is reimbursed for expenses and considers the amount of the expenses the worker must pay. A worker that has high, on-going expenses that are not reimbursed may be a subcontractor. Employees generally do not have high, unreimbursed expenses.

**Opportunity for Profit or Loss**

This factor covers the worker’s freedom to make decisions that can impact his profit or loss. An employee may make the same kind of decisions, but the decision usually does not affect his salary. Examples include deciding how much inventory to carry or whether to buy or lease equipment.

**Example:**
Bill signed a contract with Elm Company to roof a housing complex. The signed contract states a flat fee for the job. Bill is a licensed roofer and carries worker’s compensation and liability insurance in his business name, Bill’s Roofing. He hires his own employees. Any problems with the roofing work are his responsibility to repair. Bill is most likely a subcontractor.

**Example:**
Harry works out of the union hall as a roofer. He works for various companies when they call in for extra workers. Harry is a journeyman roofer so he doesn’t need much instruction but he has to follow the particular procedures and policies at each company he works for. The companies provide the tools and equipment Harry needs to do the work. Harry is paid the standard hourly rate for roofers. Harry is an employee.

**Relationship of the Parties**
This category of evidence looks at how the business and the worker view their relationship. Several factors of evidence considered are employee benefits and written contracts.

**Employee Benefits**

If you provide benefits such as paid vacation, sick days, health insurance, or a pension, the worker may be an employee. However, many workers whose status as employees is unquestioned, do not receive employee benefits. Consequently, the absence of employee benefits may not be important in deciding the worker’s status.

**Written Contracts**

While a contractual designation, in and of itself, is not sufficient evidence for determining worker status, a written agreement describing the worker as a subcontractor may be viewed as evidence that you and the worker intended the relationship to be independent. If the parties are not acting in accordance with the terms of the contract, however, the contract may be ignored. The actual facts in each situation are more important than a contract, but the contract may be a deciding factor, all other things being equal.

**Example:**

Lindy, an electrician, bid on a job at $30.00 an hour. She estimated the job would take 400 hours. She would be paid $2,400 every two weeks for ten weeks. Even if she works more or less than 400 hours to complete the job, she will be paid $12,000 ($30.00 x 400 hours). Lindy also does other electrical jobs she gets through her ad in the yellow pages of the phone book. Lindy is most likely a subcontractor.
Summary

The decision to hire employees or use subcontractors will have both tax and non-tax consequences. The decision must be based on how you actually want to run your business. Look at the whole relationship, not just a single factor.

IRS Opinion

If you want to get an IRS opinion on your situation, a Form SS-8 can be filled out by either the employer or the worker and sent to your local Internal Revenue Service office for a decision. The form includes all of the above questions and is designed to bring out all the facts of your situation.

WHAT IF I HAVE AN EMPLOYMENT TAX AUDIT?

Many IRS audits of employment tax issues end with all parties reaching a mutual decision. If, however, it appears that your workers should be classified as employees, the first step the auditor will take is to see if the relief provisions (under section 530 of the Revenue Act of 1978) will limit your liability for the employment tax. The auditor will provide you with written notice of these provisions at the start of the examination. If the requirements of Section 530 are met, you may be entitled to relief from federal employment tax obligations. Section 530 terminates the business’s but not the worker’s employment tax liability, including any interest or penalties attributable to the liability for employment taxes.

Under Section 530 there are two tests that must be met:

⇒ Consistency Test
⇒ Reasonable Basis Test

Consistency Test
You must have filed all required Forms 1099 with the IRS on time, reporting the amounts paid to the workers
you must have treated all workers in similar jobs in the same manner as the workers in question. That is, if you pay two of your painters as employees and four as subcontractors, you won’t meet this test.

**Reasonable Basis Test**

In order to meet this test, you must have treated the worker as a subcontractor because you reasonably relied on:

- a court case or ruling to support your position,
- a prior IRS audit,
- a long standing practice in your industry, OR
- demonstrate, in some other manner, any other reasonable basis for treating worker as subcontractor

If an IRS audit finds that your workers are employees BUT you meet the consistency and reasonable basis tests, you will not have to pay employment tax on the workers. The workers, however, remain liable for paying their share of the FICA tax on the wages received. If the workers have paid self-employment tax on their income, they may be entitled to a refund of the tax paid.