D
oes your firm use independent contractors as part of your every day work-force? Examine your operations carefully, and you will probably find out that you do. In that event, you run the risk of reclassification for tax purposes. Indeed, the Internal Revenue Service has been increasing its efforts to prove that many so-called independent contractors actually are employees; particularly in the construction industry.

At first glance, the distinction may not appear significant. But that distinction can have a significant impact on the cost of doing business.

The big difference arises from the fact that employees—as opposed to independent contractors—are subject to federal, state, and local income taxes, social security (FICA), federal and state unemployment taxes, and state disability benefit contributions. That increases the cost of having an employee on the payroll well above his apparent wages.

In many cases, you—as an employer—must match each employee’s payment to the government (as in the case of social security taxes). In other instances, you must pay all or part of the payroll or unemployment taxes that arise from an employee’s compensation. In still other instances, you are obligated to pay for the eligible participants’ in pension and profit-sharing plans or other fringe benefit programs.

The real problem arises from a potential difference of opinion. If you are currently paying some individuals as independent contractors, but the IRS views them as actual employees, you’ll be obligated to pay back taxes, as well as interest and penalties.

Contending with that potential difference of opinion becomes a challenge because of the distinction between an employee and an independent contractor is not always clear. The Internal Revenue Service annually publishes hundreds of case rulings. The accumulation of cases that stand as precedents now runs into the thousands.

At the same time, the IRS has established some basic criteria to help you determine whether or not an employee-employer relationship exists. Those criteria are spelled out in Sections 3121, 3306, and 3401 of the Income Tax Regulations.

The regulations focus on the matter of potential control. Thus, the employee-employer relationship presumably exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only in terms of objective accomplished, but also in terms of the details...
and means by which that objective is accomplished. Note that actually exercising that control isn’t a prerequisite necessary to define the employer-employee relationship. From the perspective of the IRS, the potential exercise of that control is sufficient to define the relationship.

As a start, the government uses a four part test to distinguish an employee from a contractor. That test asks the following questions:

1. Does the individual in question maintain a principal place of business other than the premises where the work was performed?
2. Does the individual generally proclaim self-employment and make his services available to the public?
3. Does the individual maintain a set books in a business-like fashion that records income and expenses?
4. Does the individual incur a risk of losing money, as well as the opportunity to make a profit?

Generally, the individual that can offer affirmative answers to all four questions qualifies as an independent contractor. The individual that can answer three of the four positively occupies a cloudy area, with disputes resolved utilizing the precedents established by common law. The individual who can respond positively to no more than two of the questions stands—in the watchful eyes of the IRS—as an employee.

Of course, the above criteria oversimplify the matter. The directive issued to IRS agents provides 20 factors which demonstrate control by the person for whom the work is being performed. The explanation to the agents includes the following:

“These common law factors are now always present in every case. Some factors do not apply to certain occupations. The weight given to each factor is not always constant. The degree of importance of each factor may vary depending upon the occupation and the reason for its existence. Therefore, in each case the agent will have two things to consider: First, does the factor exist; and second, what is the reason for or importance of its existence or nonexistence.”

Thus, the criteria that distinguish between employee and contractor status often can come down to the discretionary opinion of a particular
agent. While you can challenge that opinion, any challenge can be time-consuming, expensive, and—ultimately—unsuccessful.

So, what can you do to protect yourself and your business?

Certainly, no straightforward answer exists. But recognizing the basic standards set by common law and exercising the proper caution can lessen your exposure to challenges by the IRS:

1. Be careful when advertising for independent contractors. Don’t place the ad in the “help-wanted” category; don’t use the words wages or steady work. Indeed, as a desirable alternative, don’t use such ads at all. Instead, find independent contractors who have placed their own ads under “situation wanted” or “trade services.”

2. Avoid a regular pattern of a set number of daily or weekly hours. After all, a self-employed individual presumably has the opportunity to select the sequence and number of hours worked for a customer.

3. Let a contractor supply the tools necessary to perform his services. That demonstrates independent capital investment on his part, as well as the opportunity to select his own tools.

4. A contractor normally advertises his services in some manner. Ensure that any you employ on a regular basis have business cards, circulars of some type, and—if appropriate—an ad in the Yellow Pages.

5. Allow the contractor to hire assistants, if necessary, and insist that the contractor pays the payroll taxes normally required for employees.

6. Never include contractors in blanket coverage provided for your employees. Such coverage transforms an independent contractor into an employee. Ideally, an independent contractor should carry a reasonable level of liability and other insurance. It is not unreasonable to request evidence of insurance covering the contractor’s employees. Under no circumstances should you provide any job benefits for an individual employed by a contractor.

7. Ordinarily, a bona-fide employee does not pay for accidental damages to an employer’s equipment or premises. Consequently, require a contractor to pay for any damage that results from his negligence, as well as that resulting from the negligence of any of his employees.

8. If possible, pay a contractor on a ‘job basis,’ rather than by the hour or week, although many bona fide contractors—e.g. plumbers—do not charge by the job, but in terms of the time spent completing the job.

9. Always ask for a printed invoice—i.e. bill—for any work performed. Ideally, a contractor should register a trade name, so you can make your check payable to a company, rather than an individual.

10. Make sure your contractor has registered or obtained the occupational licenses required by local or state laws. However, under no circumstances, should you pay for the license fees.

11. Do not directly reimburse a contractor for any expenses such as gasoline, meals, etc., regardless of where he performs the work. Such expenses should stand as part of the contractor’s set fees.
(12) Ensure that the contractor possesses the skills representative of his profession. Your company’s personnel should not provide any training or direction at all.

(13) Do not provide a contractor with office space on your premises. Nor should you allow a contractor to use any of your office space or personnel for his benefit.

(14) A contractor should not exhibit any visible identification with your business—e.g., the name of your company on his shirt, or the name of his company on a shirt worn by one of your employees.

(15) Remember that you can’t fire a contractor. If you aren’t satisfied with a contractor’s performance, look to the contract for remedy. No contract? Severe relations with the contractor. Offer no more work.

(16) Do not invite contractors to company staff meetings. If necessary for communication, arrange individual conferences with contractors and invite only those employees directly concerned with the matter.

(17) Do not require or expect written reports following completion of a contract job. However, estimates prior to the job are not only permissible, but recommended. Specific contract bids are even better.

(18) Presumably, a contractor offers specific skills, even though the tasks appear menial. Consequently, never provide specific job directions in a manner appropriate for many employees. Instead, only provide general instructions.

(19) Clearly separate a contractor from your employees. For example, if you hire an electrician, don’t ask him to pitch in to help clean up your premises. That clouds the distinction between a contractor and employee.

(20) Note that the above “one-job-rule” does not apply if you hire a worker from a manpower employment agency. Such workers are employees of those agencies. Consequently, the agencies clearly have the responsibility for withholding the appropriate taxes, as well as providing any fringe benefits due to such workers.

(21) Do not, under any circumstances, provide a contractor with any fringe benefits. That doesn’t preclude token gifts, such as those provided to a mail-carrier at Christmas. But don’t
AWCI Strikes Pact with Fails Management Institute

AWCI has signed a consulting agreement with The Fails Management Institute, the nation's oldest management consulting firm exclusively serving the construction industry.

Under the terms of the agreement, AWCI members will receive reduced rates for management consulting services provided by Fails in the areas of corporate stock valuations, business continuation planning, mergers and acquisitions and employee stock ownership plans (ESOPs).

According to Hugh L. Rice, senior vice president with Fails and the head of the company's equity transfer consulting services, the division of the firm with which AWCI has struck the agreement, a wave of ownership changes within the construction industry has made equity transfer counseling a growing concern of construction management.

"Once, these services were only occasionally required. Today, they represent a substantial concern to the owners of all construction firms, including those in the wall and ceiling industry," Rice said. The Fails Management Institute has worked solely in the construction industry for 35 years and is widely known for its management seminars, educational programs and industry research.

Fails recently completed a survey of 51 construction firm owners which revealed some interesting facts about contractors, said Rice. One of those was that despite the heavy emphasis that has been placed on the topic of management and ownership succession in the last 10 years by attorneys, accountants, insurance agents, consultants and trade associations, most contractors, including those in the wall and ceiling industry, still are avoiding dealing with this critical issue.

"Optimistic as always, 84.3 percent of the contractors surveyed believe that their businesses will survive into the second generation; however, statistics reveal that only about 20 percent actually will. Managing the successful transition of a contracting business takes proper planning, not luck," Rice said.

Rice said that members of AWCI interested in learning more about the services provided under the recently signed consulting agreement and the details of special terms and rates that will be offered to association members should phone Fails directly.

Members interested in more information should call Hugh Rice (western United States) in Denver at (303) 744-3617 or Joel H. Miles, Vice President (eastern U.S.) in Raleigh at (919) 787-8400.

Fails will be advertising the details of the consulting agreement in Construction Dimensions and also will be on hand in the AWCI booth at the annual meeting which will be held March 4-8, 1987 in New Orleans, said Rice.

make any company-wide grants that include a contractor.

(22) Handle the billing process with care when you have a contractor perform work on a customer’s premises. Have your office bill the customer. Discourage any effort — however generous — on the part of the contractor to pick up the check that pays for the work. If the customer insists on paying the contractor, have the check made payable to your firm.

(23) Maintain a file that accumulates information that supports a contractor relationship. Funnel payments to a contractor through your regular accounts payable. Treat all payments to contractors in the same manner as payments to other vendors.

In any event, recognize that the mere execution of a contract with an individual performing services does not preclude an attack by the IRS that dissolves the contract for tax purposes. While a contract helps support the existence of a contractor relationship, the above operating guidelines clarify the distinction between an employee and a contractor, and can help you avoid an expensive mistake.

Of course, should the IRS disagree with your distinction between employees and contractors, you can challenge any associated tax assessments in court.

In some circumstances, a potential financial safety net exists even though you ultimately lose or back off from your challenge. That potential exists if the worker has also paid taxes that would make your payments a duplication. Since income taxes represent the largest part of most assessments, you gain further protection by requiring contractors to provide you with a signed Form 4669.

As final note of caution, exercise some self-protective prudence. Recognize your potential liability if a contractor gets hurt or killed while performing services for your business. If you neglected to purchase compensation insurance on the presumption it wasn’t necessary, you may be financially ruined if the court determines that the individual was, in fact, an employee.

If you have any doubt, discuss this final matter with your attorney. A mistake could break your business.