

Subcontractor—or Employee?

By Jim Parrie, Ph.D., CPF

If you are hiring people as subcontractors to save money, make sure that they really don't qualify as employees

In an effort to reduce labor costs, many framing facilities have reduced the number of full-time employees and have begun using more subcontractors. This can be an effective tool to control costs. However, there are many pitfalls that could end up wiping out any realized savings. Recently I have seen varying methods of using temp help, subcontractors, and employees, both part and full-time. Some of the hiring methods would never pass an IRS audit and could lead to heavy IRS penalties and fines.

The one common problem is that many employers do not understand the legal definition of a subcontractor. It is not just the IRS that seeks to challenge a subcontractors' status. Some subcontractors themselves have filed suit against employers for additional wages and benefits. The determination for grounds of employment for court cases and the IRS are generally similar. You need to consult with your tax professional and perhaps legal counsel, but here is a brief guide. The IRS uses a 20-point test to determine if a person is an employee or a subcontractor:

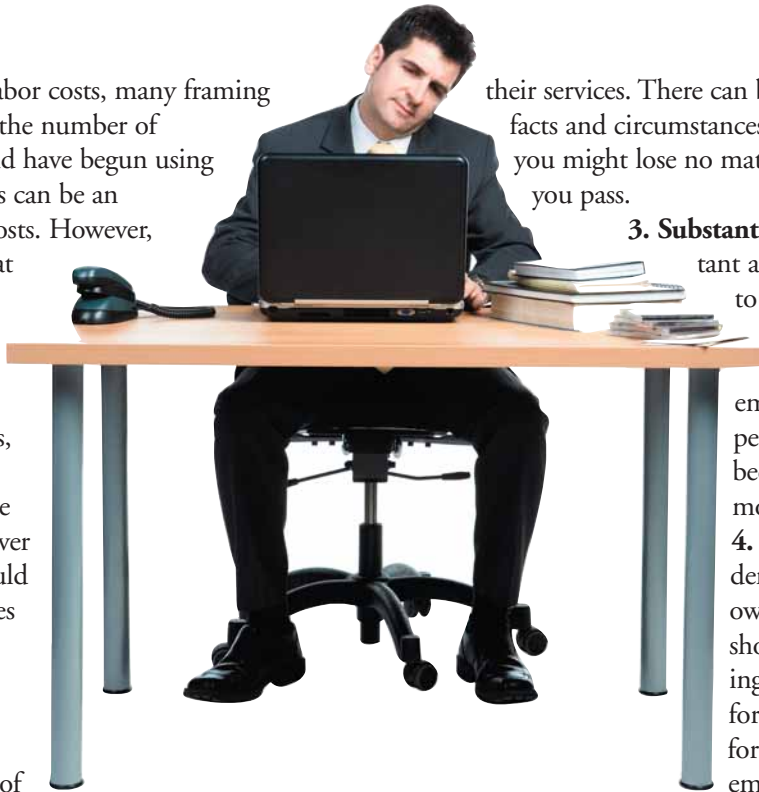
1. **Directions**—Workers who must comply with your directions as to time, place, and work methodology are more likely to be employees than independent contractors. An independent contractor will generally decide how a project should be completed and use his own methodology.
2. **Training**—The more training your workers receive from you, the more likely it is that they're employees. The underlying concept is that independent contractors are supposed to know how to do their work and, thus, shouldn't require training from the purchasers of

their services. There can be exceptions based on the facts and circumstances. But if you fail this test, you might lose no matter how many of the others you pass.

3. **Substantial Value**—The more important a person's work or service is to your business's success or continuation, the more likely it is that they're employees. This shows that the person has employee status because you will be exercising more control.

4. **Personal Service**—Independent contractors may have their own employees or at least should have the option of hiring other contractors to perform their work. Agreements for personal services indicate employee status.

5. **Who Hires Their Assistants**—If workers do not hire, supervise, or pay their own assistants, they are more likely to be employees. Let the independent contractor pay his or her own assistants.
6. **On-going relationship**—If a worker performs work for you for significant periods of time or at recurring intervals, he may be considered an employee. This is a tough one for many employers because you may use a contractor that you like for many years.
7. **Controlling Work Hours**—Independent contractors generally can set their own work hours. If you set the hours for them, then they will probably be considered employees.
8. **35-40 hour workweek**—Independent contractors generally can work whenever and for whomever they choose. If you require 35 or more hours' work per week, the worker may be considered an employee.
9. **Workspace Provided**—Independent contractors generally have their own places of business where they can do their work for you. If you do not allow work-



ers to work offsite, then they may not be considered subcontractors.

- 10. Order or Sequence Set**—Workers for whom you set the order or sequence in which they perform their services are more likely to be employees.
- 11. Reporting**—Workers whom you require to submit regular reports are more likely employees. The IRS believes that regular written or oral reports detailing the work completed indicate employee status. In reality, this is and should be expected from independent contractors as well.
- 12. Method of Payment**—If you pay workers by the hour, week, or month, they will likely be considered employees. Independent contractors are usually paid by the job or the number of units delivered.
- 13. Reimbursed Expenses**—If you cover travel and office expenses, workers are more likely to be considered employees. Independent contractors are usually expected to cover their own overhead expenses.
- 14. Tools and Materials**—Workers whose tools, materials, and other equipment you furnish are more likely to be employees.
- 15. Who Owns the Equipment?**—The greater your workers' investment in the facilities and equipment they use in performing their services, the more likely it is that they're independent contractors.
- 16. Risk and Reward**—The greater the risk that your workers can either make a profit or suffer a loss in rendering their services, the more likely it is that they're independent contractors.
- 17. How Many Customers Do They Have at One Time?**—The more businesses for which your workers perform services at the same time, the more likely it is that they're independent contractors.
- 18. Who Can They Offer Their Services To?**—Workers who hold their services out to the general public (for example, through business cards, advertisements, and other promotional items) are more likely to be independent contractors.
- 19. Fire at Will**—Workers whom you can fire at any time are more likely employees. In contrast, your right to

terminate an independent contractor is generally limited by specific contractual terms.

- 20. Quit at Will**—Workers who can quit at any time without incurring any liability to you are more likely to be employees. In contrast, independent contractors generally can't walk away in the middle of a project without running the risk of being held financially accountable for their failure to complete the project.

There are many other considerations when hiring subcontractors other than the IRS. Subcontractors are subject to the protection of OSHA and workers rights. Contact your insurance agent and legal counsel to determine if you have sufficient liability insurance coverage. One item you may ask your attorney about is placing in the contract you use for subcontractors that each subcontractor is required to provide his or her own insurance. That protects you in case they are at fault. You will probably need a public liability policy to cover subcontractors working on your premises, but you need to make sure there is a similar policy carried by the subcontractor.

FedEx was sued a few years ago because a group of 203 drivers felt they were employees and not subcontractors. This class action suit cost FedEx hundreds of thousands of dollars in attorney fees and damaging publicity. In 2008 a Federal judge awarded the plaintiffs \$27 million in damages. If FedEx, with its massive legal team, struggles with subcontractor classification, it may be wise for you to seek legal counsel and make sure you are doing it right.

When using subcontractors, consult legal counsel and then have a contract drawn up and purchase the appropriate type and quantity of insurance. Using subcontractors can save your company considerable money and relieve you from onerous overhead. However, there are hidden dangers. Make sure you get legal advice. ■

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