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## Chapter 1

# The Business of Contracting

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## Construction Contracting Means Providing Services

*"It takes five years of very hard work to become an instant success."*  
William A. Shea Jr.

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Whether you build a dog house or a sky scraper, you are normally working for a property owner or property tenant. The service of constructing something, repairing something or inspecting something, is the basis of the work you do as a contractor.

As the contractor you bring things together for assembly at the project site. Many manufacturers supply materials to the project. It is your job to construct the project according to plans and specifications, bringing all materials into proper placement. This is a service.

### Work on Owner's Property

Contractors generally work on an owner's property. The owner can be:

- A homeowner
- A church group
- A commercial property owner
- A city that owns a road, park, or building
- A school district
- A state that owns a road, park or building
- A tenant that is responsible for maintaining a certain portion of the building
- The federal government that owns a road, park or building

The work of a contractor normally consists of altering or providing maintenance on the property, or the buildings on the property.

*Direction is a critical issue for contractors. Small differences here can create huge problems. Contracts give contractors direction on what work is to be done, not exactly how to do it. The contractor uses their skills as they see fit, within the scope of the contract documents, to perform the work. An owner or contractor does not oversee or direct the work of a contractor or subcontractor. In some cases, which you should always avoid if possible, you may make a verbal contract to perform work. A verbal contract is the first step to a misunderstanding about whether there is really a contract in place for the work on the property. In addition, the owner gives the contractor direction in the form of a contract, if an independent contractor, or direct instructions, if an employee.*

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The owner has the choice of hiring an independent contractor or an employee to do the work in every case. The way you get paid for the work may differ greatly in either case of contractor or employee, but how would you actually do the work differently? Let's take some common project examples.

### **Carpentry**

An owner wants a house built and wants you, as a fine carpenter, to arrange to have it done with you doing all the carpentry in addition to project management. You have the option of working as employee or independent contractor. How would your carpentry work differ (if at all) in either case?

### **Construction Management**

The owner has hired an architect and an engineer to design a project and wants you to manage the project to completion. What would be the difference in your performance if you did the work as an independent contractor or as an employee?

### **Plumbing**

A home builder has twenty houses in a subdivision and is asking you to consider doing all the plumbing as either an independent contractor or as an employee. Who would be able to tell, as they watched you work, whether you had chosen to work as an independent contractor or employee?

### **Handy person**

You are retired but want to stay active. You decide to offer to do general repair work in the neighborhood. The owner of a small apartment building hears about you and offers you work. You can work as an independent contractor or an employee. The difference to an observer?

*"The secret of success is constancy of purpose."*  
Benjamin Disraeli

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## The Independent Contractor Difference

One of the great joys in life is doing what people say you cannot do.

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The independent contractor is a business. In some cases the business may be hard to see. This occurs when the contractor is mainly doing trade work as a subcontractor and works for just a couple of general contractors.

There can be no independent contractor status without a business structure. When you are licensed by or registered with the appropriate contractors agency, you publicly declare that you are a contracting business. Yet on any given project, you may still choose to work as an employee.

### Who Says You Are a Contractor?

In most states a contractors licensing or registration agency acts as the authorizing agent which sets the standards for becoming a contracting business. In these cases you are recorded as a contracting business. See the *Advantage Contractor Business Success Series* course, *Licensing, Registration and Regulations Affecting Construction Contractors* for a list of licensing and registration requirements in your state.

The licensing or registration process completes the organization of a contracting business in those cases where it occurs. In other cases other tests apply. We will deal with this in Chapter 2.



#### **Warning**

In those states requiring licensing or registration, a construction contractor is not recognized by law unless registered or licensed with the appropriate agency.

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Construction contractors work under contract. It's in the name. Where is the confusion?

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### The Contract as a Key to Independent Contractor Status

In those states where licensing and registration is not required, other laws may apply. Usually there are requirements that a contract be made between the parties.

While a contract does not establish an independent contractor status by itself, it goes a long way to explain the agreement the

parties have if the status is genuine. In addition, the contract spells out the nature of the work to be done and sets many other limitations and conditions.

In general, while operating as a construction contractor, you have to make contracts with anyone you work for. These contracts should be in writing. (For further information see *Contract Law for Construction Contractors* in the *Advantage Contractor Business Success Series*.)

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*A contract cannot be made for an illegal purpose. Therefore, if the parties to a contract are making the contract specifically to avoid the taxes and charges in having employees, the contract will be voided. Just because you call someone an independent contractor does not make them one.*

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## Contractor or Employee

The simple fact of the law is that you, or someone working for you, work as an independent contractor or as an employee. There is no other alternative.

Whichever situation you, or someone working for you, fall into it will be governed by laws. If you are an independent contractor, you are liable for the taxes on money earned as well as taking care of any expenses for any injury on the job that you may suffer. If you are an employee, the employer takes care of federal and state withholding taxes, paying social security and Medicare taxes, and covering you for workplace injuries through workers' compensation.

The main reason for concern over the difference is in who pays taxes and employee benefits. All construction employees in all states must have taxes and required fringe benefits withheld and paid by the employer. This includes, but is not limited to:

- Federal withholding on income taxes
- State withholding on income taxes
- Social security taxes
- Medicare taxes
- Federal unemployment taxes
- State and local unemployment taxes
- Workers' compensation taxes or premiums
- Payroll taxes for other purposes

People judge you by your actions, not your intentions. You may have a heart of gold, but so does a hard-boiled egg.

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An independent contractor has to pay estimated income taxes and social security and Medicare taxes, but no other employment or

payroll taxes including the big one; workers' compensation. In most states the workers' compensation rates range from 15% to 40% of payroll. This means \$15.00 to \$40.00 for every \$100.00 in gross payroll, depending on the type of work being covered. Unemployment taxes could easily range up to 15% of payroll in states where workers experience seasonal layoffs. As you can see, there is a lot of money involved!

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*The Internal Revenue Service and all state revenue and employment departments know that contractors try to work out every angle they can on hiring workers. For this reason, contractors are audited much more often than the public as a whole.*

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Concerns about paying all these taxes are very real. There are auditors and inspectors in the field, as well as in your office, checking for violations of employment law. Usually the issue comes to light in a couple of common ways; under-reporting of income or audits.

### **Caught by the 1099**

The Internal Revenue Service (IRS) requires that you prepare and submit Form 1099, Miscellaneous Income, to them for all independent contractors you hire. In order for you to deduct the expense of the independent contractor, you have to send the form. No tax preparer will allow you to claim a deduction without filing the 1099 if they prepare and review your tax form. If you hire work done by others, you either file employee payroll forms or the 1099 for the independent contractors. No exceptions.

"It is not size or age that separates children from adults. It is responsibility."  
Jules Feiffer

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Once the 1099 is filed, the IRS will seek the matching independent contractor's tax form. This means that the person who got the form, and is named on the form and identified with their Social Security number or business identification number, has to file their copy of the 1099 with their tax form. Sometimes they do not do this. If this happens, the person named on the 1099 will most certainly be audited. While this is not usually a problem to you, it could develop into one.

Suppose the reason that the independent contractor did not file the 1099 was that they did not have the money to pay estimated taxes. Now it is time to file the tax return and there is still no money to pay the taxes due, but now there is also a penalty. So the income is not reported. The tax return goes into the IRS without the 1099 and without reporting the income.

The IRS now decides to check the tax return of the independent contractor to find out why the 1099 income is not reported. The audit date is set and the independent contractor is asked about the unreported income. "The reason I didn't report it was that I was an employee and I didn't get a W-2 form." After more discussion the auditor and the independent contractor decide that the best bet is to talk to the contractor who did the hiring. This is you!

The situation has now developed that there is some question whether this person was an independent contractor or an employee during the time the work was going on. It will be up to you, the one doing the hiring, to prove that there was an independent contractor status. How you can do this will be discussed further in the course.

"A good scare is worth more to a man than good advice."

Edgar W. Howe

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### **Caught Again by the 1099**

As stated, contractors are subject to audits because of the way contractors have done business in the past. The IRS looks for items on the tax return that indicate there may be problems. One of the items they look for is how much labor is done by independent contractors as evidenced by 1099 filings. If there is no payroll and a lot of independent contractor labor, the IRS may choose to audit to check the validity of the labor arrangements.

In this example, the IRS wants to see the evidence of the legal independent contractor relationship between the parties. Because of the nature of audits, records may be requested for some years back to validate these 1099 filings. You have to keep good records.

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*Many general contractors choose to operate without trade employees, choosing rather to hire subcontractors. There is no legal problem with this practice as long as the independent contractor status can be maintained. These contractors do seem to be audited regularly though.*

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### **Caught by a Worker Injury**

The other common source of independent contractor problems comes from worker injuries. A worker, while working on a roof building the roof frame, loses balance and falls to the ground. In some cases the worker makes a transformation from independent contractor to employee just before hitting the ground. How can this be? The worker can make a claim for workers' compensation coverage. The claim investigator can rule that the worker's status was employee, not independent contractor.

If the worker is determined to have been eligible for the claim and was, in fact, acting as an employee, you could be liable for:

- The costs of the claim
- The costs of payroll taxes
- The penalties of not covering the worker as an employee from:
  - ◆ The IRS
  - ◆ The state revenue department
  - ◆ The state employment department
  - ◆ The workers' compensation department

Let me assure you that the cost of just one of these claims could be business breaking.

Have you got the idea that the independent contractor issue is determined as a matter of legal definition, and not by what you agree to between you?

## The Business Entity

*While the odds of you having this problem yourself are not high over the time you may be in business, the odds are high for the contracting industry. Most people never consider driving without liability insurance because of the potential for financial ruin. Yet contractors consistently take financial risks with independent contractors.*

The business of contracting requires that there be a business identity. This is your first protection against problems with independent contractor/employee status. In many businesses you can simply open an office and declare yourself "in business." Construction contracting normally requires that you get licensed or that you register with some agency of a city, county or state.

Licensing or registration is the first step in creating your business identity as an independent construction contractor. After you register, you have to continue to hold your business out as separate from yourself as an individual. This, of course, is what any independent contractor has to do for you. They have to show that they are a legitimate business.

The problem with licenses and registrations is that they can expire. For a number of reasons a contractor may fail to keep their business entity legal. Usually this is because of:

- Failure to keep insurance coverages up
- Failure to pay a renewal fee
- Taking on work with other contractors as an employee
- Failure to meet other requirements of licensing or registration.

*The law can be strange. You can suffer for the errors of others. If an independent contractor that you hire lapses their independent contractor status during the course of the project that you hire them for, and they or their employees have an injury or some other problem, the agencies involved may come after you for damages. For example:*

*The independent contractor you hire is a drywall firm with two employees. You check with the correct agency and are told that they are legally recognized as an independent contractor. What you do not know is that the owner did not pay the required workers' compensation premium on time for this quarter to their carrier. In addition, the liability insurance coverage has a renewal date that falls during the time that the crew will be working on your project. In your state, liability insurance may be required for an active license or registration. If the premium is not paid and the coverage lapses, the drywall firm's independent contractor status will be invalid because the firm is not legally licensed. Under your state laws liability for employees may revert to the one hiring the crew.*

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Now the drywall firm is operating illegally. You have a good chance of being held liable for all problems that the crew may suffer while they are on your project site, including injuries, payroll and payroll taxes. While the drywall firm's owner may be liable as well, there is no money there to pay potential claims and shortfalls. You are next in line, believe it or not.

## **Maintaining the Business Identity**

There has to be a businesslike procedure that you follow as you go about your trade or contracting service. For example:

- *Soliciting business.* You regularly let people know that you do a certain form of construction contracting through business cards, flyers, and advertisements.
- *Pricing.* You set a price for materials and labor for a project. You do not work for an hourly rate with the owner or general contractor purchasing the materials.
- *Billing.* You bill the owner or general contractor for work done according to the written agreement which states the times and amounts of payments.

"No one is ever old enough to know better."

Holbrook Jackson

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## **Maintaining the Business Separate From Yourself**

In order to maintain your separate business entity, you have to do those things that keep you and your business as separate in the eyes of the customer as in the eyes of the law. This separation protects both you and your customer.

These business identity issues are important for all those you hire. Insist that your independent contractors show clearly that they are separate business entities.

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The main activities you want to do are as follows:

- Write a contract for each project
- Maintain a separate place for business work
- Bill according to the payment arrangement stated in the contract

### **Write a Contract for Each Project**

As a construction contractor it is indeed hard to maintain your identity as a contractor without a written contract. Whether you are the subcontractor or the general contractor, you want a written agreement laying out all terms of the agreement.



#### **Note**

Many state laws require a written contract on all construction projects over certain minimum contract amounts, usually between \$1,000.00 and \$2,500.00.

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Even though you may write a contract, it could be so incomplete that it is of no use in a dispute where a court or hearings officer is trying to determine what the agreement is. For example, written agreements may be missing information pertaining to the:

- Scope of the work. This would include all the documents that describe the project including:
  - ◆ Plans
  - ◆ Specifications
  - ◆ Addenda to the plans and specifications
- Details of the work. Details include:
  - ◆ Starting time for the work
  - ◆ Finishing time for the work with penalties listed
  - ◆ Times when the site is unavailable because of closure or because of other work going on
- Who is responsible for specific aspects of the project. These include:
  - ◆ Access to the project site and storage of materials
  - ◆ Safety procedures for the project site
  - ◆ Securing the project site and protecting other property
  - ◆ Keeping the project site clean and in order

- Who buys materials. In many cases the owner or general contractor will supply materials for the work to be done. This is not a problem if the contract sets this out.
- The standard of the work. The contract should set out the standard of the work and may be stated as follows:
  - ◆ "Contractor shall install siding according to manufacturer's requirements using the correct fasteners and set as described in the instructions."
  - ◆ "Contractor shall paint the house exterior using an oil base primer and a top coat of latex paint as called for in the specifications as amended June 3, 1998, and applied according to paint manufacturer's recommendations."

"Integrity simply means a willingness not to violate one's identity."  
Erich Fromm

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### **Payment Schedules**

The contract should specify payment schedules. Even if there is only one payment called for, you want the language clear as to how much is owed and when it is due during the course of the project. The payment amount is a major part of a contract and is called the consideration. If a specific payment designation is not called for, it could show that the contract is not valid.

In projects where there is only one trade of work being done (such as when painting a house or replacing the electrical service panel) the contract may not describe the complete task. That is, the owner may not have agreed that when a certain amount of work is completed, a specific payment amount is called for. Your contract, and any contract you do with subcontractors, has to specify these schedules and then you must be sure that everyone agrees about what they mean.

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*Many contractors do not have a separate office or place where they keep a business location. For this reason it is important to establish an office in your home. You confirm this by filing IRS Tax Form 8829, Expenses for Business Use of Your Home. In this way you are declaring that you have a separate area where you do business activity.*

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### **Separate Place of Work**

One of the best ways of demonstrating your business as separate is to do business for a number of owners or contractors at their property locations. While any one of the projects could be a problem for the reasons discussed above, at least working for a number of different people helps you establish that yours is a separate business.

Your actions as a contractor should show that you are bringing your business to the owner's property. You demonstrate this by:

- Putting up a project site sign while working
- Bringing your own tools to the project
- Supplying all materials for your work
- Establishing work hours different from others on the project

### **Billing According to the Contract**

Many contractors are shy about asking for money. You have to get over any shyness and be diligent about collecting payments when they are called for. If you are not collecting your money on time you will risk falling behind in your payments to:

- Suppliers
- Subcontractors
- Payroll accounts
- Bank loan payments

All of these cases are unhealthy for your business.

To further establish your status, or another contractor's status as an independent contractor, you want to set up your payment schedule based on completed parts of the project, not hours of work done. It is easy to use an hourly rate billing process to tear down the validity of an independent contractor's legal status.

In addition you want to make sure your collection of payments are made at the intervals described in the contract. A test of the quality of the contract as an agreement between the parties is whether the parties act according to the terms of the contract. All parties should agree that the contract will guide their actions and then abide by them.

It is almost never to the benefit of the owner or the contractor to have a verbal contract.

"Every day you  
learn something."  
Michael Jordan

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