

A matter of control

Why you need to take caution when using independent contractors

INTERVIEWED BY MARK SCOTT

As independent contractors continue to become a bigger part of the American workforce, the Department of Labor (DOL) is investing more time and energy to make sure companies follow the law when it comes to classifying these workers, says Timothy J. Gallagher, an attorney at Kegler Brown.

“Employers are shifting toward using more independent contractors,” Gallagher says. “It’s a direct result of companies trying to control costs where they can. You can’t keep reducing the price on goods or you’ll never make a profit. You can’t keep limiting services or you’ll be swallowed up by the competition.”

“If you can minimize your labor costs by paying a lump sum for a project and avoid paying benefits or taxes for an employee, it’s easier and cheaper for the employer.”

The practice of using independent contractors has grown significantly since the recession as companies look to reduce long-term costs. In a 10-year period, usage of this contingent workforce has grown from under 30 percent of the overall workforce to more than 40 percent of that group, according to the U.S. Government Accountability Office.

Smart Business spoke with Gallagher about what companies should know before utilizing independent contractors.

What is the difference between an employee and an independent contractor?

An independent contractor is not entitled to benefits from the employer. This person doesn’t have to be paid overtime or a minimum wage and bargains for terms that he or she is willing to accept. Employees are entitled to benefits from the employer and certain protections for minimum wage and overtime compensation. The employer is also required to pay unemployment tax,

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income tax and worker’s compensation for employees. These costs are not required with an independent contractor, which is where the financial savings can be achieved.

How do employers get into trouble with independent contractors?

You could decide that rather than call these individuals you’ve identified as employees, you’ll change their hours and duties a bit, provide them each with 1099 tax forms and call them independent contractors.

The IRS, however, does not base its worker classifications on what the employer chooses to call its workers. Rather, the federal agency looks at 20 different factors with the goal of determining who it is that controls the relationship. If you’re telling people where to show up, where to work, what tools to use, what equipment to use and you’re providing training and instruction, at that point, you’re controlling the whole relationship. They will likely be seen as employees, even if you’ve decided to call them independent contractors.

What happens if the IRS determines you’ve misclassified your employees?

If you’ve labeled someone as an independent contractor when the individual should be an employee, the IRS will come after you for the unpaid taxes. If it’s determined that you willfully

changed someone’s classification, you’ll also incur a \$1,000 penalty per each worker that you misclassified.

The DOL has developed memorandums of understanding and is sharing data with the IRS and state tax departments and agencies in 28 states. Ohio is not currently one of those states, but the trend is moving toward getting those memorandums with every state. So if you’re reporting one thing to the federal government and something else to the state, you’re at increased risk of those discrepancies being identified and then audited and penalized.

What should employers do?

If you’re a small business that has changed employee classifications to save money, talk to an attorney about the risks and how to do it the right way. If you’re a larger company and you use a staffing company to open a new factory or support a large expansion, you could be considered an employer or a joint employer with the staffing firm for the people you bring in, depending on how much control you exert over these workers. Review the IRS and DOL worker classification factors and do a self-audit. You’re better off paying for a \$500 consultation with an attorney before you make changes versus paying that attorney \$50,000 to defend you in a lawsuit for a class action by workers you misclassified. ●