

19.14: Employees vs Contractors

Learning Objectives

- Evaluate the use of resources: employee vs. independent contractor

To employ or not to employ? That is the question of the small business owner much of the time. The answer lies in the answer to a couple of other questions—mainly how much responsibility does the owner want to have for that employee, and how much control does the owner want to have over the final product or service?

Independent contractor growth is outpacing small business hiring, which means that more small businesses are opting to contract over bringing on a new employee.^[1] And even though an independent contractor works from her own office, bringing her own equipment to the job and paying her own benefits, she's not always the best choice for a small business.

Let's start by understanding the difference between an employee and an independent contractor.

Employees



An employee is someone whose quality and manner of work the employer has a right to control. They are, legally speaking, in a master/servant relationship, and often referred to as W-2 employees, a reference to the federal income tax form they are served at year end with their total wages for the year.

As an employer, the small business owner controls the behavior of the employee, including a method for doing the work, a schedule on which that work will be done, and so on. The small business owner, as employer, handles the pay rate and pay schedule of this individual, as well as associated payroll taxes and benefits costs. Often, this employee will develop relationships with other co-workers at the owner's place of business.

The cost of an employee goes beyond a normal salary or hourly rate. A payroll function goes along with that first employee, one that takes time and costs money. Checks must be written on a regular basis. Taxes, social security, and Medicare must be withheld, and payroll taxes paid. Other costs incurred with an employee would include the cost of a place to work, and the supplies with which to do that work, which can include a computer, office supplies, and more. Creating a positive, motivating work culture for that employee is also important, and that comes at a cost.

Independent Contractors

An independent contractor, on the other hand, is someone the small business owner engages to perform a certain task, but whose manner of work the owner does not have a right to control. This person is sometimes legally referred to as a 1099 employee, in reference to the tax form he or she receives at year-end outlining how much the business has paid to the contractor that year.

The contractor works either short term, or on a project-by-project basis. He or she pays all taxes on earnings, including any federal, state, local taxes, or social security. Sometimes, the quality of the contractor's work is governed by professional standards or codes, like that of an electrician or plumber. These are standards and codes the small business owner doesn't have to know or understand, and for that reason contractors can be attractive.

Another reason why contractors can be attractive to small business owners is because they get the work done without all the extra paperwork that comes along with having one's own employees. But there is danger in treating a contractor like an employee. While

the IRS doesn't have any hard and fast definition of contractor vs. employee, they do provide a [20-item checklist](#) that helps small businesses understand if they're crossing the line. There are some hefty penalties in store for those business owners that don't stay within those guidelines.

So what's the cost of a contractor? Basically, costs with a contractor are negotiated up front, before the work begins, and the final fee is paid when the work is complete. Because contractors are responsible for all their own taxes, social security and Medicaid payments, their fees are usually higher to cover such costs. An employer's only obligation to the contractor is to pay their invoices in a timely manner and issue a 1099 at the end of the year for their tax purposes.

The downside is that a contractor isn't as loyal to the small business as an employee would be, and he or she is legally limited to only 1,040 hours of work (which is six months at 40 hours a week). And, because that contractor is self-employed, his or her timing might not match that of the owner, and the owner doesn't really have any control over the quality of work or the time it takes to complete. While you can create contracts that stipulate acceptance criteria, there's additional cost of time or money to get work redone. These are all hidden costs to a small business owner.

? PRACTICE QUESTION

<https://assessments.lumenlearning.co...essments/18252>

Employee or Contractor?



As an HR professional, it can be difficult to determine which way to go with this position that needs to be filled. Will the contractor be less expensive and more efficient, or is it time to bring a new employee on board?

A contractor is the best choice when

- The work requires a level of expertise no employee in the business has, and it would cost too much time and money to train someone to do it (e.g., IT specialty, an electrician, a physician)
- The work is seasonal, and extra hands are needed to fulfill orders
- The work is administrative, like bookkeeping or other tasks that can be done remotely and typically don't require a full-time employee

An employee works best when

- The work requires close supervision in order to be completed
- The work requires regular local knowledge and an employee can bring specialized local knowledge to the table
- The work requires extensive knowledge of what's going on within the walls of the small business

HR professionals can help small business owners determine the cost and relationship benefits of a contractor versus an employee and can assist in avoiding any misclassification of either.

Sources

Fleischer, Charles H. *HR for Small Business: An Essential Guide for Managers, Human Resources Professionals, and Small Business Owners*. Naperville, IL: Sphinx Pub., 2009.

1. Paychex, Inc. "[New Paychex Data Shows Independent Contractor Growth Outpaces Employee Hiring in Small Businesses.](#)" PR Newswire, January 9, 2019. ↵

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