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Employees vs. Contractors: Which is Best for Your Business?

Whether you go for a full-time or part-time employee or settle on a 1099 contractor will be determined less by the type of small business structure you choose than where you are in scaling your business.



 By Team Roll on May 23, 2022

7 min read



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We know behind every successful business is an amazing support team. Whether you go for a full-time or part-time employee or settle on a **1099 contractor** will be determined less by the type of small business structure you choose than where you are in scaling your business.

So which is better when you consider **contractors vs. employees**? Contractors and employees both offer unique benefits for small business owners. It's important to understand when to use each option, especially when you're just starting your own business.

What are the types of business structures?

The IRS lists **five types of business structures** any sized business can take:

- **Sole proprietorship.** You own an unincorporated business by yourself.
- **Partnership.** You and one or more people do trade or business. Each contributes money, property, labor, or skill, and shares in the profits and losses of the business.
- **Corporation.** Prospective shareholders exchange money, property, or both for your corporation's capital stock.
- **S Corporation.** S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes.
- **Limited Liability Company.** This structure is allowed by state statute. Owners (called "members") may be individuals, corporations, other LLCs, and foreign entities. While there are no maximum number of members, most states also permit "single-member" LLCs.

The structure you choose will affect the amount of taxes you will pay, your ability to raise money, the paperwork to be filed, and your personal liability. You must choose your structure before you register your business with your state. Depending upon your company type (and sometimes state), you may also need to **obtain a tax ID**



number as well as file for any applicable licenses and permits.

When should you add employees or contractors to the mix?

When your business is financially feasible and there is enough additional work to warrant taking on help, that's the time to add employees and/or contractors.

If you're a solopreneur or have staff, regardless of your business structure, you'll know it's time to take on help when you must decline work because you (and your people) are overwhelmed or overworked, your revenue starts to stagnate, and/or your customer service begins to suffer.

How do you choose between an employee and independent contractor?

Making the choice between hiring an employee or contracting an independent contractor depends upon where you are in the scale of your business, how much work you have to dole out, and whether the type of work you need to be done is an integral part of your business. Learning the difference between an employee and an independent contractor can help you in your decision-making process.

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

At least three federal government agencies have a test to define a 1099-NEC independent contractor, sometimes referred to as 1099s. (Some states refine the definitions even further.) Each agency has its own angle, so each test has a slightly different focus. That said, many test factors coincide, while others contradict each other.

To determine whether a worker can be classified as an independent contractor, you cannot use just one test — you must use them all. Just making a good faith effort to clear as many factors as possible will set you on a course to the correct classification.



Three tests for independent contractor classification

The three tests come from the Department of Labor, the IRS, and the National Labor Relations Board (NLRB).

FLSA Test. The most familiar test is the one from the Department of Labor (DoL), known as the FLSA Test because it refers to the Fair Labor Standards Act. While the U.S. Supreme Court has repeatedly held **there is no single rule or test** for determining whether someone is a 1099 or an employee (also called a **W-2**) for purposes of the DoL, it does say the total activity or situation controls.

The factors the court wants business owners to look at are:

- "The extent to which the services rendered are an integral part of the principal's business.
- The permanency of the relationship.
- The amount of the alleged contractor's investment in facilities and equipment.
- The nature and degree of control by the principal.
- The alleged contractor's opportunities for profit and loss.
- The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor.
- The degree of independent business organization and operation."

The Court considers immaterial:



- The place where work is performed.
- The absence of a formal employment agreement.
- Whether an alleged independent contractor is licensed by state or local government.
- The time or mode of pay does not control the determination of employee status.

Though there is not one single determinative factor, control is key. The DoL is going to look at whether the individual:

- Chooses their work hours – 1099s choose
- Is monitored or supervised – 1099s are not
- Receives a performance evaluation – 1099s do not
- Is not bound by a non-compete agreement – 1099s are not
- Is permitted to work for other businesses – 1099s can

If an individual must be available to work 30, 50, 70, or more hours a week for one company, that makes it impossible to work for anyone else, let alone competitors. That looks like an employee. Other factors that make an individual look like an employee include whether the person:

- Works in flexible shifts, e.g., 12- or 15-hour days
- Signs a non-compete
- Has work inspected
- Receives performance evaluations
- Receive an employee handbook

So, the DoL is looking at control factors. The more control you exert over someone's work, the greater the chance the DoL is going to say you have an employee.

IRS Test. While the DoL focuses on the total activities and situation of individuals to make its determination of 1099 vs. W-2, the IRS is concerned about its tax base. As an employer, you must withhold income taxes, pay Social Security, Medicare taxes, and unemployment taxes on all wages paid to employees. None of that



happens with independent contractors. (Independent contractors must pay their own taxes.)

To satisfy the IRS, you must keep **two key points** in mind when classifying employees:

1. **“Control.”** If the business controls what work is accomplished and directs how it's done, it exerts *behavioral* control. If the business directs or controls financial and certain relevant aspects of a worker's job, it exercises *financial* control. This includes:

- The extent of the worker's investment in the facilities or tools used in performing services
- The extent to which the worker makes services available to the relevant market
- How the business pays the worker
- The extent to which the worker can realize a profit or incur a loss

2. **Relationship.** How the employer and worker *perceive* their relationship is also important for determining worker status. Key topics to think about include:

- Written contracts describing the relationship the parties intended to create
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation, or sick pay
- The permanency of the relationship
- The extent to which services performed by the worker are a key aspect of the regular business of the company
- The extent to which the worker has unreimbursed business expenses"

If you still cannot determine if an individual is an employee or an independent contractor, use IRS **Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding** (PDF).

NLRB Test. Since many small business owners do not have unionized employees, they aren't as familiar with this test. Whether or not your employees are unionized, however, these factors still apply.



There are 11 factors the NLRB looks at to determine status:

- The extent of control the company has over the worker
- Whether or not the one who's working is engaged in a distinct occupation or business
- Whether the work is usually done under the direction and supervision of an employer
- Whether a skill or license or specialized training is required
- Who buys the supplies, instrumentalities, or tools
- The length of time workers provide services, e.g., two months versus two years
- Method of payment, e.g., hourly or by project
- Whether or not the work is part of the regular business of the employer
- Whether or not the parties engaged in an independent contractor agreement
- Whether the principal is or is not a business
- Whether the evidence tends to show that the individual is, in fact, rendering services as an independent business

No one factor is decisive. You have to visualize a scale with this test. On one side, there's the independent contractor plate. On the other, the employee plate. You're never going to get every factor on one plate. Some are going to go on each plate. In the end, whichever side drops is the determinative side, and that's where the NLRB will go with its findings.

Which test is more important?

Each test is equally important. You must consider all three.

With the federal government's focus on making it difficult to be classified as an independent contractor, there are going to be more challenges. If you haven't already audited your positions and contracts, now's the time to start. You need to show a good-faith effort.



Which worker type is best for your business?

So, which type of worker should you choose for your type of business? Employees are better for your business when you must have a position covered at all times. Independent contractors are better for your business when you need intermittent (by project) work done. Just make sure that when you classify someone as an independent contractor, you weigh the position to be filled against each test *and* check with your [state department of labor](#) for local rules. Getting it wrong can be costly. The prudent move would be to have an employment attorney double-check any position you create.



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