

Employees or Contractors

Which Option is Right for My Business?



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Introduction

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At some point in time, every business owner is faced with the question - “Do I hire staff, or work with contractors / freelancers?”

Ever since the recession there have been more people who have gone the independent route, and more companies willing to work with them instead of hiring full-time employees.

Hiring contractors is a great way to manage supply - demand shifts, so if there's less work you can let them go more easily. They're also responsible for their own taxes, which usually reduces the cost burden on companies.

And if you are hiring contractors who are working on your company almost full-time, on-site using your company's equipment, it would result in them being classified as employees in the eyes of the Internal Revenue Service (IRS).

Employees don't have the same freedom of movement, or the ability to work under their own direction, nor do they normally seek to make a profit from the relationship. It all comes down to the nature of the overall relationship, should you be uncertain as to whether someone working for you is an employee or contractor.

In order to help you answer whether you should hire contractors or employees, we've put together this handy quick reference eBook. But it goes without saying, employment law, especially when classifying whether someone is an employer or contractor is a complex legal matter, for which we recommend you seek legal advice and consult your relevant government agencies. And on that note, we hope you find the eBook useful, and we wouldn't mind if you wanted to share the wisdom!





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Workforce Trends

Self-employment is on the Rise

Trends in the Workforce



In the US self-employment rose to 17.7 million people, between 2008 - 2013, representing a 5% annual increase during the last few years, which indicates that the 'shift to independent white-collar work' is here to stay.¹

The recession accelerated this trend globally, with financial necessity encouraging many to seek alternative careers, including self-employment and building startups.

Self employment has particularly benefitted startups, because depending on the job role, startups can employ contractors more easily than employees, thereby lowering their burn rate. This has also gone hand-in-hand with Millennial's starting their careers as a result of fewer traditional job opportunities, and newly unemployed skilled middle aged workers making a career shift into self employment.

Unfortunately for startups, we are seeing a market backlash against employing contractors when they are actually employees. A case in New York against a strip club, another against Lowe's in 2014, and [eight other cases currently in various courts](#), including one against the Silicon Valley cleaning startup, [Handy](#), is a clear indicator that the government won't put up with startups purposely misclassifying contractors and hoping to get away with it.

This practice is also common amongst the likes of Uber, Lyft, Homejoy, SpoonRocket, Taskrabbit, and Postmates, but with recent cases this policy will need to be reviewed in order to mitigate risk of fines and penalties.



Deep Dive on Employees

Deep Dive on Employees

Tax Benefits, Pros & Cons of Hiring Employees



There are a number of benefits and advantages to hiring employees for your company, and we cover all the benefits, pros and cons that come with your decision to hire employees vs. contractors.

Tax Benefits of Hiring Employees

- [Work Opportunity Tax Credit \(WOTC\)](#) allows companies to hire certain specific groups, like veterans and claim the tax credit as a general business credit against their income tax.
- The [Americans with Disabilities Act \(ACA\)](#) allows for tax credits when employers hire people with disabilities, provided all legal requirements are met.
- The [Hiring Incentives to Restore Employment \(HIRE\)](#) Act gives tax breaks to employers when they hire certain previously unemployed workers (“qualified employees”).

Pros & Cons of Hiring Employees

PROS	CONS
<p>The employer is able to guide and supervise the work outcome using management techniques, workplace guidelines and KPIs - thus ensuring work is done as planned, regardless of the volume of work. Essentially, the employer has more control over their deliverables.</p>	<p>More management required - needs strict processes and KPIs in order to manage employees. Employers are also responsible for all in-house training and the associated costs.</p>
<p>While employees only work specified hours and days as per their contract of employment, they are generally, depending on the type of skill required, more cost effective on an hourly basis, as a result of supply - demand factors influencing less specialist skills on the employment market.</p>	<p>Salary costs, including all withholdings, employment taxes and other payments due to the Federal government, agencies and state / local government are payable by the employer.</p>
<p>Maintaining employer - employee relationships is generally easier for employers, compared to client - contractor relations, due to the control factor and ability to measure work outputs more easily. Working in the same office is also beneficial for both parties.</p>	<p>Depending on the role, skills and seniority the talent pool can be limited to the locality the business operates, which means even where talent is plentiful there's usually a talent war amongst competitors and thereby impact an employer's ability to recruit the best talent.</p>



Deeper Dive on Contractors

Deeper Dive on Contractors



Tax Benefits, Pros & Cons of Hiring Contractors

Contractors can be a cost-effective alternative to hiring employees for your company, but there are more than just the advantages you need to be aware of when you make a decision to hire contractors vs. employees.

Tax Benefits of Hiring Contractors

There are no direct (government funded) tax breaks for hiring contractors, except that the employer is absolved from the responsibility of paying federal, state and local taxes. That does make hiring contractors a financially viable alternative for many companies, providing the correct client - contractor relationship is maintained.

Pros & Cons of Hiring Contractors (1/2)	
PROS	CONS
Employer's don't need to invest in equipment, office space or any capital outlays as that is the contractor's responsibility. Additionally, the contractor is also responsible for all their own training in order to have the skills, which make them valuable to a client.	Clients can't deduct any of those expenditures off their corporate tax bills.
All taxes are paid and reported by the contractor, either as an individual, an incorporated business or a mix of the two.	Contractors can be more expensive than employees due to supply - demand factors favouring contractors on the open freelance market (which is more international than the employment market; although that is changing for some sectors, depending on new immigration policies).

Pros & Cons of Hiring Contractors (2/2)

PROS	CONS
<p>It can be easier for companies to find specialist skills at a more cost effective price from contractors than employees, especially if that contractor is not needed at a comparable rate to full time hours.</p>	<p>Clients don't have control over the sourcing of skills. Contractors need to look for clients, which means they may contact one or your potential clients or competition when services aren't needed and vica versa - a contractor can't always take onboard new clients due to capacity limitations.</p>
<p>The relationship can expand and contract depending on the needs of the client, and contractors can subcontract out other aspects of work, thus making it easier for the client to receive a wider range of services while only doing so through a single provider. Additionally, both parties are free to cancel the working relationship, depending on the terms of the contract.</p>	<p>It's not always possible to have deliverables completed exactly on the client's timescale as a contractor will have other clients (otherwise they are actually an employee) and is therefore free to set their own working schedule - within reason.</p>



Transitioning from Contractors to Employees

Transitioning from Contractors to Employees



Relationship is the Driving Factor

Does a Contractor ever turn into an Employee after a certain amount of time?

The short answer is no: not if the nature of the relationship remains unchanged for the duration of the contract / time a freelancer and client company work together.

If it remains a business relationship where one provides a service to the other, then there is no natural transition from contractor to staffer. Businesses should aim to maintain this relationship, otherwise it could cause potentially expensive problems with the IRS.

Here are the [guidelines the IRS uses to assess the overall nature of the relationship](#).

Common Law Rules (IRS)

Facts that provide evidence of the degree of control and independence fall into three categories:

Behavioural

Does the company control or have the right to control what the worker does and how the worker does his or her job?

Financial

Are the business aspects of the worker's job controlled by the payer? (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)

Type of Relationship

Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor.

Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no “magic” or set number of factors that “makes” the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

If there is any confusion or concerns, you can ask for an IRS ruling, which can take up to 6 months. The IRS uses their 20-Test Factor guidelines, based on court rulings and previous investigations. IRS agents have been instructed in recent years to focus on the overall relationship between the company and individual working with or for them.



Consequences of Misclassification

Consequences of Misclassification



Risks of Classifying an Employee as a Contractor

Unintentionally classifying an employee as a contractor will result in some financial liability (if an IRS Form 1099 has been filed): generally 1.5% of salary of the federal income tax withholding amount, plus 20% of FICA taxes paid by the employee, plus all of what the employer should have paid.

However, if no IRS Form 1099 has been sent in, but it is still unintentional, the IRS would double the amounts - 3% of withholding taxes, 40% of FICA taxes, plus the employer's contribution to FICA.

Intentionally misclassifying would result in much harsher penalties.

The IRS is very clear when it comes to intentional misclassification: "If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker." This is based on Internal Revenue Code section 3509.

All of the employment taxes would be due, all of FICA (unless the "employee" paid some of those taxes, which offsets the cost), plus penalties in many multiples of the percentages of taxes withheld, plus potentially civil and criminal liability charges.

If you don't employ anyone as an employee doing a similar role to a contractor, and have appropriate justification for using a contractor and not an employee then it might be possible to get relief from federal employment tax obligations under Section 530.

According to Section 530 of the Revenue Act of 1978 there is a reasonable basis (known as a safe harbour) for an employer misclassifying a worker, if the following criteria are met:

- Judicial precedent, published rulings, or technical advice with respect to the taxpayer;
- A past IRS audit in which there was no employment tax assessment attributable to the treatment of the individuals holding positions substantially similar; or
- A long-standing recognised practice of a significant segment of the industry in which such individual was engaged.

There must also be a precedent within the company, previous business, or sector for those types of workers to be treated as independent contractors, and the employer must have filled out Form 1099 MISC (Miscellaneous Income) for each worker, if such form was required.

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We hope you found this content helpful in determining whether you should hire employees or contractors for your business. At Wagepoint, we can handle payroll for both your hourly or salaried employees and independent contractors. To learn more about how Wagepoint can help your business, visit our website wagepoint.com or call us at **1-877-757-2272** today.
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Disclaimer: The aim of this Wagepoint eBook: "Employees vs. Contractors: Which Option is Right for My Business?" is purely informational and should not be considered as advice. Employment law, especially when classifying whether someone is an employer or contractor is a complex legal matter, for which we recommend you seek legal advice and consult your relevant government agencies.

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