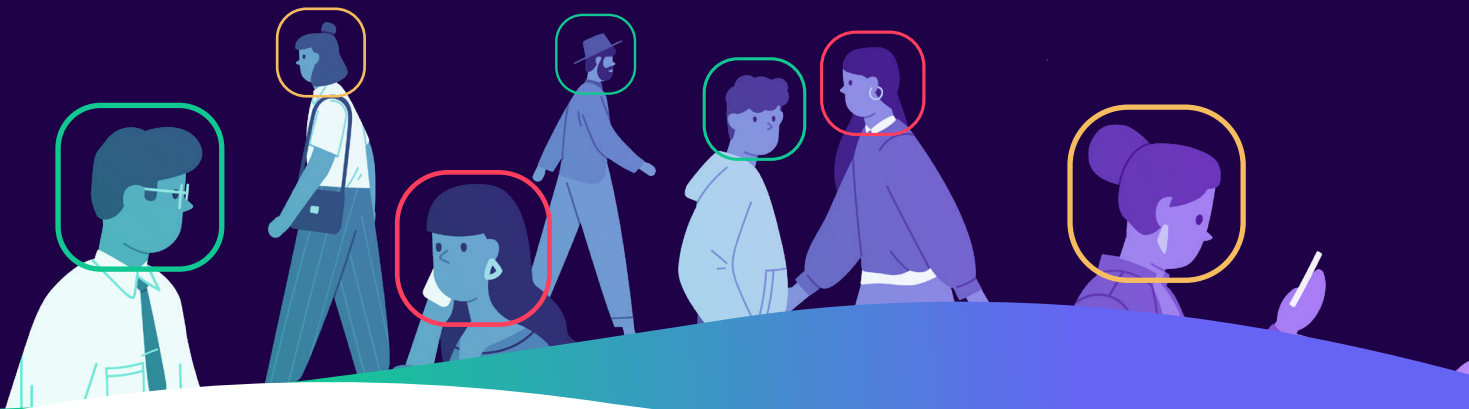




The Complete Guide to Employee Classification



Everything you need to know about properly classifying your non-payroll workers (e.g. freelancers, independent contractors and consultants)

In 2020, 59 million Americans considered themselves freelancers; that's 36% of the U.S. workforce. That number is expected to [surpass 90 million by 2025](#).

This has attracted the attention of both the legal and tax systems. Companies face significantly different legal obligations depending on whether a worker is classified as an employee or an independent contractor, particularly in terms of worker protections and tax revenue. Therefore, governments, both state and federal, have been taking a hard look at how companies are classifying their workers.

Unfortunately, the result of this increased government involvement has created a complex patchwork of evolving laws on how to classify a worker – and an increasingly aggressive framework of penalties for misclassification.

The legal and business consequences for a company that misclassifies workers as independent contractors when the government or the tax authorities consider them to be employees can be costly to the tune of millions owed and a damaged reputation.

This white paper covers the definitions and differences between employees and different types of non-payroll workers definitions, and outlines some of the most common legal tests used to determine how to classify a worker.

It provides an overview of recent changes in the legal landscape regarding worker misclassification. Last, it explains the risks and penalties for worker misclassification and steps companies can take to ensure their full compliance.

Non-payroll workers go by many names: freelancer, independent contractor, gig workers, self-employer, consultant... For simplicity, they'll be referred to as independent contractors throughout this white paper.

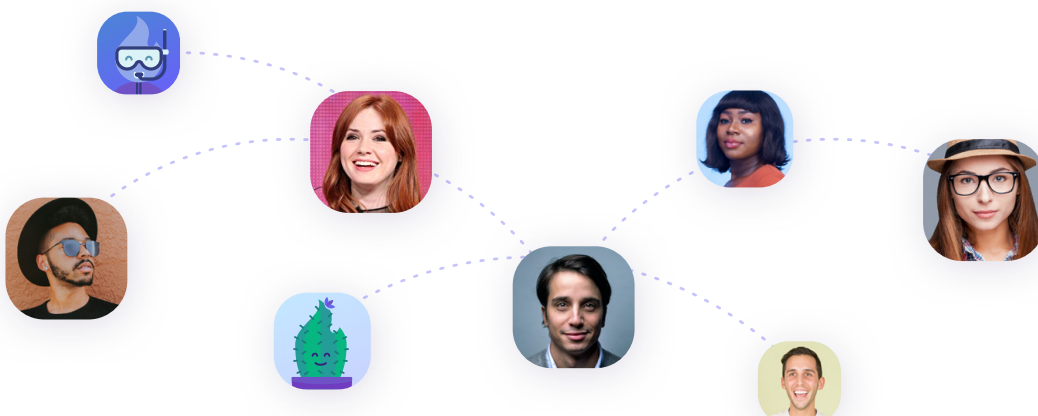


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1. Differences Between Employees and Independent Contractors



The unambiguous difference between an employee and independent contractor is the tax documentation used to report their annual compensation. Organizations file a W-2 form for employees and 1099-NEC (non-employee compensation) for independent contractors.

Yet the classification occurs before the company sends annual compensation forms to the IRS. How a company classifies a worker reflects circumstances and triggers consequences that define the legal relationship between it and the worker.

1.1 Laws applicable to the relationship

A variety of state and federal laws govern the employer-employee relationship. Employers are bound by laws that define compensation, benefits, and provide financial safety nets. These laws often require employers to make financial contributions to public entities that administer and enforce these laws.

In contrast, contract law governs the relationship between an organization and an independent contractor. None of the employee laws providing benefits or protections apply. The independent contractor and company negotiate the terms of the relationship.

1.2 Work conditions

Independent contractors have more autonomy over when, how, and where they do their work than employees. If an organization exerts too much control over one's work conditions, it may be considered an employer under the law, even if it classified the worker as an independent contractor. Worker classification tests assess various work conditions, looking at who has the power to define work conditions. These tests are explored in detail later in this white paper.

1.3 What is Worker Misclassification?

Classifying each worker is a legal decision that defines the legal relationship between the company and the worker. Classification impacts everything from what taxes are owed to how the worker delivers services.

When companies decide to classify a worker as an independent contractor, they are responsible for ensuring that the worker is qualified as an independent contractor according to applicable federal, state, and local laws.

Worker misclassification occurs when a company classifies a worker as an independent contractor, while the federal, state or local law consider them as an employee.



2. Why Do Governments Care?



The federal and state governments regulate many areas of the employer-employee relationship. Thus, they are concerned about worker misclassification because it defines people outside the regulated work relationship. There are four reasons why they take worker misclassification seriously:

#1. Serious Loss of Public Revenue

Employers pay payroll taxes for each employee. Payroll taxes include Social Security, Medicare, and federal income tax withholdings. When an organization misclassifies an employee, it doesn't pay these taxes for that worker.

The government may also lose out on tax revenue when the worker files their individual income taxes. Independent contractors can make business expense deductions that employees cannot.

They're also required to contribute to funds like unemployment insurance and workers' compensation. Misclassifying an employee results in employers not making their full contributions. Workers' compensation insurance premiums are also determined based on employee count. Governments rely on this revenue to fund the social safety net and other public programs.

#2. Lax Legal Protections for Workers

Governments at the local, state, and federal levels have all passed legislations to protect employees. Minimum wage laws, paid sick leave, and overtime restrictions are but a few. None of these laws apply to independent contractors.

Governments want as many people covered by these laws as possible as a matter of public policy. In contrast, contract law relies on the parties to negotiate for their interests. A negotiated relationship provides greater flexibility for the independent contractor, but also greater risk.

#3. No Social Benefits for Independent Contractors

Most Americans receive health care insurance subsidies from their employer. Nearly all employers are required to offer health care to employees. Many employers contribute to employee retirement funds in addition to providing regular compensation. Governments assert a public policy interest in ensuring everyone has health insurance and is preparing for retirement.

As companies compete for global talent, they also offer employees an increasing range of optional benefits. Popular added benefits include student loan payments, wellness programs, and financial planning assistance. These benefits aren't offered to independent contractors. The concern is that misclassified independent contractors are providing the same services to companies as employees, but on inferior terms.

#4. Level the Playing Field

Employees cost about 35% more than independent contractors. Their direct compensation may be comparable (this varies across industries and professions), but companies incur significant administrative and operational costs for managing employees.

All those laws that govern the employer-employee relationship come with a cost to the company, both monetary and in the flexibility they have to pivot with a changing market environment. Companies that work primarily with independent contractors don't bear these costs or constraints, which provides them a competitive edge. Governments are concerned that some companies may avoid hiring employees specifically to avoid these additional costs.

3. The Evolving Legal Landscape of Worker Misclassification



In 2020, there were 64.8 million independent contractors in the US. By 2027, that number is expected to hit 86.5 million, accounting more than 50% of the total US workforce.

The steep increase in the number of independent contractors — and the realization that non-payroll workers will soon account for a larger share of the US workforce than employees — has attracted the attention of the legal and tax governing bodies.

Lawmakers on the state and federal levels are increasing their focus on how to accurately classify workers, as well as defining the legal repercussions for misclassification.

Unfortunately, in almost all cases the classification tests do not distinguish between white and blue collar workers, although there's a significant difference for the two groups and one that needs more protection from the hiring companies.

3.1 State Freelancer and Independent Contractors laws

Here are some of the state level legislation regarding worker classification in recent years:

New York: Establishing Protections for Freelance Workers Act

This was one of the first freelance focused acts legislated in recent years. The law enhances the protections for independent contractors, specifically the right to a written contract, timely payment within 14 days and protection from retaliation.

The law establishes penalties for violations of these rights, including statutory damages, double damages, injunctive relief, and attorney's fees. The law also determines that if there is evidence of a practice of violations, the penalty can reach \$25,000.

California: AB 5 and Prop 22

California passed the most stringent restrictions on who qualifies as an independent contractor. In 2018 the California legislature codified the worker classification test set out by the state's supreme court. The state starts with the assumption that a worker is an employee unless it is shown otherwise using the "ABC" test (see section 5.2). Under the ABC test, only a worker providing services "outside the usual course of the hiring entity's business" can be an independent contractor.

The bill (AB 5) contained other restrictions that made working as an independent contractor difficult. In response to criticism, the law was modified in 2020 (AB 2577) by creating exemptions to its application.

Criticism of California's approach to worker classification persists, mainly due to a \$200M paid campaign sponsored by Uber and Lyft. In November 2020, Californians voted to approve Prop 22, which excludes gig workers, like Uber drivers, from the AB 2577. A new bill ([AB 25](#)) has been introduced in the California legislature that would repeal the ABC test.

New Jersey: New Requirements and New Penalties

New Jersey is another state with new worker misclassification laws that went into effect in 2020. These address informing workers of the issue of worker misclassification.

Organizations must now post notices that inform workers that worker misclassification is prohibited. The notice, provided by the state's department of labor, informs workers of the protections state laws provide for employees, the definitions of employee and independent contractor, remedies that exist if they're misclassified and contact information where they can file a complaint if they believe they've been misclassified.

The new laws also allow workers to sue an organization for retaliating against them for filing a misclassification complaint or asking about misclassification.

3.2 Potential Changes to Federal Misclassification Standards

Determining how to classify workers has been an ongoing battle on both the state and federal levels.

The U.S. Department of Labor (DOL) recently [published a regulation](#) clarifying the “Economic Reality” test it uses to classify a worker under the Fair Labor Standards Act (FLSA), which sets federal minimum wage and overtime pay requirements.

However, there are also clashing bills in the U.S. Congress regarding worker misclassification. The Guarantee Independence and Growth Act ([S.700](#)) sets out a three-prong test to classify workers for tax purposes. It allows for considering language in a contract that specifies the parties don't have an employer/employee relationship.

Taking an opposite approach, the Worker Flexibility and Small Business Protection Act ([S.4738](#)) would nationalize the ABC test, but without any exemptions. Like the current ABC test in California, it states that a work relationship is presumed to be employer/employee notwithstanding language in a contract that states otherwise.

The Biden Administration has signaled it intends to nationalize the ABC test and make it applicable to all labor, employment, and tax laws.

4. How to Classify Workers



For as important as it is to correctly classify workers, one would think there would be a clear test to guide this determination. Unfortunately, there isn't and properly classifying workers is hard.

First, there isn't just one test. The test used by the IRS is not the same one used by the DOL under the Fair Labor Standards Act (FLSA). States each have their own worker classification tests too.

Second, none of the tests provide a clear and definitive answer. They all weigh a variety of factors, a situation that lends itself to ambiguity and inconsistent application.

Third, many organizations try to manage classification decisions manually, which increases the risks of inconsistent decisions and overlooked factors. It also makes the decision process more expensive.

Below is an overview of the worker classification tests most widely used in the United States.

4.1 The “Right to Control” 20-Factor Test – Used by the IRS

The U.S. federal tax code uses a "right to control" test to determine whether there's an employer-employee relationship. The principle here is to determine

the organization's scope of control over the worker. The more control, the more likely the worker is an employee. If the worker has a high degree of independence, they may be an independent contractor.

The IRS issued a list of 20 factors organizations should consider when determining whether it has the "right to control" a worker. It's grouped the 20 factors under three categories:

- **Behavioral**: How much control does the organization controls have over where, when, and how the person works? Specific factors to consider include whether it's setting work hours, requires reporting, provides instructions and training, and specifies order in which tasks are done.
- **Financial**: These factors look at whether the worker operates as a business. One factor is how the person gets paid; are they paid on a regular timeline or do they submit invoices periodically? Other factors include whether the organization provides equipment to the contractor and whether they provide similar services for other organizations or are dependent on the company financially.
- **Type of Relationship**: One factor here is if the organization provides the worker with employee benefits. Whether other employees are doing the same type of work and, even, how each party can end the relationship.

A full list of the 20 factors is available on the [IRS website](#).

4.2 The “ABC” Test

The ABC test comes out of California. More than half the states use a version of the ABC test, but they aren't all the same. Application of the test is complicated in that a state may not use the ABC test for all situations. For example, a state may use the ABC test to determine applicability of wage and hour laws, but not for unemployment insurance.

Even so, the ABC test is widespread and presents a high barrier to classifying someone as an independent contractor. Its three prongs are:

- A.** The worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of the work and in fact.
- B.** The worker performs work that is outside the usual course of the hiring entity's business.
- C.** The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

Item B is the prong that sets the barrier so high. Under California's ABC test, all three prongs must be met to classify the worker as an independent contractor. Other states take a more expansive position, balancing the factors as a whole.

4.3 The “Economic Reality” Test – Used by the FLSA

The “Economic Reality” test asks the question whether the worker is economically dependent on the organization or whether they're in business for themselves. The Department of Labor (DOL) specifies two “core factors” to be considered:

- The nature and degree of control over the work.
- The worker's opportunity for profit or loss based on initiative and/or investment.

The DOL rule also provides additional factors to consider, especially if there's no clear answer after determining the two core factors. The secondary factors are:

- The amount of skill required for the work.
- The degree of permanence of the working relationship between the worker and the potential employer.
- Whether the work is part of an integrated unit of production.

A copy of the published DOL rule can be found [here](#).

5. The Risks of Worker Misclassification



Potential penalties vary according to different laws, as does how a penalty is calculated. Penalties may be imposed on a per-employee or per-statement basis. It's also common for penalties to be calculated as a percentage of compensation or benefits owed.

State and federal penalties generally fall into the following categories:

- Administrative fines and penalties for noncompliance
- Criminal penalties, including potential jail time for intentional misclassification
- Paying back pay and benefits with interest
- Damages as part of a civil lawsuit, including punitive damages

For example, the IRS could impose administrative penalties on a company equal to the taxes it should have paid for the misclassified worker. If it's found that the worker was underpaid under a state wage law or the FLSA, then the company may also owe back pay and benefits to the worker, which the worker may be able to sue in court to recover. In both cases, interest and late fees could also be applied.

Because each applicable law sets out its own available penalties and legal remedies, the total costs for misclassifying a worker can quickly compound.

Governments also seek to increase the reputational costs for companies that misclassify workers. The recent New Jersey misclassification laws allow its department of labor to publish the names of companies that have violated any state wage, benefit, or tax laws. The proposed federal Worker Flexibility and Small Business Protection Act would require companies to post publicly their level of compliance with labor laws. The law also provides severe penalties for not posting.

6. How to Stay Compliant



All companies work with independent contractors on some level, regardless of their size, industry or type of business. However, too many are unaware of the fact they are leveraging independent contractors or the amount of contractors they are working with.

Most CFOs underestimate the number of independent contractors they are working with by more than 70%.

These companies need to start by properly documenting all the independent contractors their company is working with. You cannot manage what you do not know you have.

Only then can you start reviewing the relationship of your non-payroll workers and then define the right internal processes to prevent future issues (i.e. recruitment, onboarding, payment and compliance processes).

You can do it manually or leverage a freelance management system, like Stoke Talent, to automatically and continuously audit all of your non-payroll workers.

6.1 Manual audits

The law demands companies to conduct an audit of all of their independent contractors every six months as working terms and conditions are flexible by definition and federal and state law may change.

#1. List all of your non-payroll workers

You first need to create a list of all of the non-payroll workers your company engages with, such as freelancers, independent contractors, consultants, gig workers, etc., as well as where they are located. The location of your contractors determines which test will be used to classify them as a contractor.

#2. Legal documents

Ensure all workers have signed a contract indicating compensation, working hours, expected deliverables and that the relationship between the contractor and the company is clearly defined.

#3. Legal audits

Beyond the different tests applicable in different states and countries to determine whether a worker should be classified as a worker or a contractor, there's an additional challenge when it comes to worker classification.

The challenge is that hiring managers — the ones who manage the independent contractor — lack familiarity with the labor laws in the contractor's state or country. Although they know the details of the contractor's engagement with the company (such as the level of control over the contractor's schedule, whether equipment is provided to them, the contractor's level of expertise, etc.) they are likely not suitable to make classification decisions.

At the same time, a company's legal counsel, which defines how to properly classify a worker, would not be familiar with the details of his or her engagement.

This means that in order to classify your worker, your legal team will need to interview both the contractor and the hiring manager before defining the risk level.

6.2 Automated and continuous audits

Due to the complexity of worker classification, Stoke Talent has developed an automated solution to track and identify relationships at risk to be defined as an employee-employer relationship. This is an automated and continuous process, therefore we are able to provide an early warning before there's a risk of misclassification.

Our process consist of 3 stages:

#1. Basic Data Gathering

Stoke collects information on the independent contractor as well as on the work they complete as requested by the company.

For every independent contractor that is invited by the company , Stoke collects basic information like location (country and state), and entity structure (1099 or S-Corp) to establish potential misclassification risk.

For every milestone (unit of work performed by a contractor) completed by the contractor, Stoke collects information such as length of engagement, price structure (hourly or fixed), average hourly wage, number of hours per month etc. Stoke continues to collect and analyze information for every payment cycle throughout the engagement to determine the risk of misclassification.

#2. AI Based Algorithm Screening

All these data points are aggregated and analyzed to establish whether there is any potential classification risk which will always be visible in the platform.

Risk level will be presented in real-time within Stoke UI for each contractor:

Compliance report for:

Sarah Jefferson
sarah.jefferson@gmail.com | Location: US

Workforce classification

Self-employed	YES
Versatile employment	YES
Time with company	9 MONTHS
Engagement type	HOURLY
On-site / Remote	REMOTE

Legal compliance (CoolCompany NY)

NDA	SIGNED
IP Assignment	NOT SIGNED


Finance

W8 / W9	SIGNED
Payable	YES

#3. Second Level Audit

If at any point throughout the engagement, the Workforce Classification Engine will establish that there is indeed a potential risk for misclassification, the platform will trigger a second level audit.

This means that two detailed questionnaires will be automatically dispatched, one to the contractor and a second to the manager who is responsible for approving the contractor's invoices. The goal is to gather additional information to help the engine establish a precise risk level and suggest actionable next steps to reduce risk. The questionnaires ask about the type of engagement, level of control over work, whether the contractor provides similar services to other companies, whether the hiring company issued equipment to the contractor, etc.



Workforce Compliance Audit

The name and photo associated with your Google account will be recorded when you upload files and submit this form.

Engagement Details

Have you ever been an employee of this company?

☐ Yes

☐ No

If your answer on the previous question is "Yes", as an employee, did you perform the same or similar work as you will be performing under this engagement?

☐ Yes

☐ No

#4. Detailed Report

The questionnaire results will then be analyzed as well as cross referenced with federal and state records to establish risk.

At the end of the process the system produces a detailed analysis report, updates contractor status on Stoke's UI and sends out notification to the hiring manager and the relevant admins.

The report will include the following information: risk by jurisdiction, suggested actionable steps to reduce risk, summary of independent contractor laws and the transcript of the questionnaires.

Summary

The workforce is changing. Companies rely more on non-payroll workers, and in a few years they will make up the larger share of the workforce.

Therefore, companies need to ensure they have the required processes and tools to manage their contractors, including the ability to properly, accurately and continuously classify their non-payroll workers.

Although the standards of worker classification are ambiguous, the legal and business implications of misclassifying workers are high.

The risk of misclassification is further complicated by the fact that the legal requirements about worker misclassification are in flux.

Both state and federal governments are actively addressing the issue with new and changing standards. They're also focused on increasing enforcement.

Thus, companies working with independent contractors have a heightened responsibility to ensure there's no ambiguity in the work relationship. The potential financial costs of a government agency retroactively redefining it as an employer-employee relationship are too high.

One issue that is certain is that how a company works with an independent contractor is more important than contract language stating the worker isn't an employee. Thus, using processes and platforms that show evidence of the worker's autonomy are critical to protecting the company.

**Stop worrying about workforce
misclassification**

[Book a Demo](#)