



AUGMENTIVE BUSINESS 7 SOLUTIONS PVT. LTD.

COMPLIANCE  
CHECKLISTS

# Remote Worker Classification Checklist

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*Determine if your remote workers should be classified as employees, contractors, or C2H placements. Covers US tax implications.*



## Executive Summary

Misclassifying workers as contractors when they should be employees (or vice versa) exposes your company to significant tax penalties, wage & hour lawsuits, and reputational damage. This comprehensive guide walks you through the IRS 20-Factor Test, the ABC Test used in gig economy states, and state-specific rules to ensure your remote workforce is properly classified.

<b>\$15K+</b> Average misclassification penalty per worker	<b>20</b> IRS factors to evaluate	<b>7-10 States</b> Use stricter ABC Test	<b>Back pay + Penalties</b> Employer liability
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## Overview: Three Classification Models

### Employee (W-2)

Workers classified as employees receive an IRS Form W-2 at year-end. Employers must withhold income tax, Social Security, and Medicare taxes. Employers pay the employer portion of payroll taxes and typically provide benefits such as health insurance, retirement plans, and paid time off.

- Best for: Long-term staff, workers integrated into your business operations
- Tax burden: Employer withholds and pays matching payroll taxes
- Benefits: Typically provided (health, retirement, PTO)

### Independent Contractor (1099)

Contractors receive a Form 1099-NEC and are responsible for all payroll taxes (self-employment tax of 15.3%). They are not employees and do not receive company benefits.

- Best for: Project-based work, specialized skills, temporary engagements
- Tax burden: Contractor pays self-employment tax
- Benefits: None provided by company

### C2H (Contract-to-Hire)

A worker starts as a contractor and transitions to employee after a defined period (typically 6-12 months). This model is popular for offshore staffing and allows companies to evaluate fit before offering employment.

- Best for: Offshore hiring, trial period before permanent employment
- Transition: Clear contract terms define conversion point
- Tax status: Contractor initially, then employee



## IRS 20-Factor Test for Employee vs. Contractor

The IRS uses a multi-factor analysis to determine worker classification. No single factor is decisive; the IRS evaluates all relevant facts and circumstances. Below is the complete 20-factor test presented as a checklist:

#	Factor	Points to Employee	Points to Contractor
1	Control – Instructions	Company provides detailed work instructions	Worker determines how to do the work
2	Control – Training	Company provides training	Worker is already trained in the field
3	Integration	Work is integral to the business	Work is supplemental/separate
4	Personal Service	Services must be performed by this person	Can hire someone else to do the work
5	Hiring/Firing	Company can fire at will	Written contract governs termination
6	Duration	Indefinite or long-term relationship	Specific project or short-term engagement
7	Part-time or Full-time	Full-time work indicates employee status	Part-time work indicates contractor
8	Work Location	Work performed at company location	Work performed at worker's location/own setup
9	Order of Work	Company controls order and sequence of tasks	Worker sets own work schedule and priorities
10	Reports	Worker submits regular reports to company	No regular reporting requirement
11	Payment Method	Regular salary or hourly pay	Lump sum or payment per project
12	Payment Period	Paid weekly, bi-weekly, or monthly	Paid per project or at completion
13	Expenses	Company reimburses expenses	Worker bears own business expenses
14	Tools/Equipment	Company provides tools and equipment	Worker provides own tools/equipment
15	Investment	No significant investment by worker	Worker has significant business investment
16	Profit/Loss	Only company can realize profit/loss	Worker bears business risk of loss
17	Other Clients	Worker does not work for other clients	Worker works for multiple clients simultaneously



#	Factor	Points to Employee	Points to Contractor
18	Availability	Services available exclusively to company	Services advertised to general public
19	Dismissal	Can be dismissed without breach of contract	Can only be dismissed for breach of contract
20	Benefits	Receives employee benefits	No employee benefits provided



## Interpreting the 20-Factor Test

To apply the 20-Factor Test:

1. Score each factor as "Employee" or "Contractor"
2. Count the total points on each side
3. The side with more factors wins (no strict threshold)
4. Document your analysis for IRS defense

### Key Principle

The IRS focuses on behavioral control (factors 1-10) and financial control (factors 11-19). Factor 20 (benefits) is less determinative. If factors 1-10 clearly point one direction, that often controls the classification.



## ABC Test – Stricter Classification Standard

California, New York, Massachusetts, and other states use the "ABC Test" from the Dynamex Optimization decision. This is stricter than the IRS 20-Factor Test and applies to wage and hour law (not just taxes). ALL THREE criteria must be met for a worker to be classified as a contractor:

Test	Requirement	What It Means
A – Control	Worker is free from control and direction of the employer in performing services	Company cannot direct how, when, or where the work is done
B – Work Performed	Worker performs work outside usual course of the company's business	Services are not integral to what the company does
C – Independently Established	Worker is independently established in the occupation or trade	Worker has own business, clients, licenses, advertising in that field

### ABC Test Analysis

In practice, the ABC Test is very restrictive. Factor B is the hardest to satisfy. For example:

- A medical coder working for a hospital likely FAILS Test B (coding is core to hospital operations)
- A software engineer building your product likely FAILS Test B (engineering is core to a tech company)
- A bookkeeper for an accounting firm likely FAILS Test B (bookkeeping is core to an accounting firm)

#### Critical Warning

Many companies have reclassified remote workers from contractors to employees due to ABC Test enforcement in California, New York, and Massachusetts. If you have contractors in these states, review their classification immediately.



## State-Specific Classification Rules

Several states have adopted the ABC Test or have their own stricter rules. Here is a summary of key states and their standards:

State	Classification Standard	Applies To	Key Notes
California	ABC Test (Dynamex)	Wage and hour law	Very restrictive; applies to all workers
New York	ABC Test variant	Wage and hour law	Similar to California; enforced by DOL
Massachusetts	ABC Test	Wage and hour law	Follows Dynamex model
Florida	IRS 20-Factor Test	Both tax and wage/hour	More permissive; often contractor-friendly
Texas	Common law test + ABC for some	Varies by context	Employer-friendly in most contexts
Washington	ABC Test for some workers	Gig workers specifically	Narrower application than CA
Illinois	ABC Test for gig workers	Gig economy only	Does not apply to general employment
New Jersey	ABC Test + common law	All employment types	Hybrid approach; recently strengthened
Oregon	ABC Test	Wage and hour law	Applies to all workers
Connecticut	Common law + ABC trend	Varies	Moving toward ABC Test adoption



## Detailed State Analysis

### California

California strictly enforces the ABC Test for worker classification under wage and hour law (Labor Code). This applies to all workers regardless of industry. Employers must prove all three prongs:

- Control: Company cannot direct the work
- Scope: Work is outside the company's usual business
- Independence: Worker is independently established

Most employees misclassified as contractors in California have been reclassified as employees, resulting in back pay claims and penalties. Many tech companies and gig platforms have had to reclassify workers.

### New York

New York uses the ABC Test for wage and hour law, similar to California. The New York Department of Labor actively investigates misclassification. Additionally, New York requires joint employers to be liable for any classification violations, meaning parent companies can be held responsible for subsidiary violations.

### Florida and Texas

Both Florida and Texas use the common law IRS 20-Factor Test rather than the ABC Test. Florida has had pro-contractor case law. Texas is generally employer-friendly. However, both states still require that all factors point toward contractor status for proper classification.

### Massachusetts

Massachusetts has adopted the ABC Test. Additionally, Massachusetts has a strict law (M.G.L. c. 149, Section 149) that applies ABC Test rules to independent contractors. The state has been aggressive in enforcement.



## Tax Implications: W-2 vs. 1099 vs. C2C

The classification you choose has significant tax and legal consequences. Here is a detailed comparison:

Aspect	W-2 Employee	1099 Contractor	C2C (Corporation)
Income Tax Withholding	Employer withholds based on W-4	No withholding; worker pays quarterly	No withholding; corp pays quarterly
Payroll Taxes (6.2% SS)	Employer pays 6.2%, employee pays 6.2%	Self-employed tax: 12.4% (both halves)	Corporate pays 6.2% if on payroll
Medicare Taxes (1.45%)	Employer pays 1.45%, employee pays 1.45%	Self-employed: 2.9%	Corporate: 1.45%
Total Employer Burden	~7.65% payroll tax + potential benefits	None (worker pays all)	Reduced if structured properly
Form Issued	W-2	1099-NEC	Invoice; no tax form
Business Deductions	Limited (standard deduction only)	Schedule C: broad deductions	Corporate deductions
Health Insurance	Often provided by employer	Worker responsible; self-insure or ACA	Corporate plan or individual
Retirement Plan	Often provided (401k, pension)	SEP-IRA, Solo 401k, or other	Corporate plan options
Workers Compensation	Employer provides	Worker responsible (may not apply)	Employer responsible
Unemployment Insurance	Employer pays	Not eligible (unless special state)	Not eligible if sole owner
Audit Risk	Lower risk	Higher audit risk for misclassification	Medium risk if aggressive deductions
Liability & Compliance	Covered under employment law	Limited coverage; contractor liable	Varies; depends on corp structure



## Self-Employment Tax for 1099 Contractors

If a worker is classified as a 1099 contractor, they must pay self-employment tax in addition to income tax. Here is the breakdown:

Self-Employment Tax Rate: 15.3%

- 12.4% for Social Security (on earnings up to \$168,600 in 2024)
- 2.9% for Medicare (on all earnings)
- Additional 0.9% Medicare surtax (on earnings over \$200,000 for single filers)

Example: A contractor earning \$100,000 must pay \$15,300 in self-employment tax alone, plus income tax. This is significantly more than a W-2 employee would owe (since the employer shares half the burden).

### Tax Planning Tip

Contractors often fail to budget for quarterly estimated taxes and self-employment tax. Educate your contractors about their tax obligations to avoid future disputes.



## 1099-NEC Reporting Requirements

If you pay a contractor \$600 or more in a calendar year, you must issue a Form 1099-NEC and file it with the IRS.

### Key Requirements:

- Send 1099-NEC to contractor by January 31 following the payment year
- File with IRS by February 28 (or March 31 if filing electronically)
- Report all payments in Box 1 (Non-Employee Compensation)
- Include contractor's name, address, TIN (or SSN), and your EIN
- For multiple contractors, file on Form 1096 (transmittal form)

### Backup Withholding:

If a contractor does not provide a valid TIN or SSN, you must backup withhold 24% of all payments and remit to the IRS.



## Schedule C: Self-Employed Business Income & Deductions

1099 contractors report their income and expenses on IRS Schedule C (Profit or Loss from Business). Common deductions for remote workers include:

### Deductible Expenses:

- Home office deduction (if exclusive business use): \$5 per sq ft or simplified \$300 deduction
- Internet and phone expenses (business portion)
- Software subscriptions and tools
- Computer equipment and technology
- Professional development and training
- Office supplies and equipment
- Accounting and legal services
- Insurance (liability, professional, disability)
- Travel expenses to client sites
- Meals and entertainment (50% deductible)
- Vehicle expenses (mileage or actual)
- Rent for office space
- Health insurance premiums (self-employed deduction)
- Retirement plan contributions (SEP-IRA, Solo 401k)

Properly documenting expenses can reduce taxable income by 20-40% for remote contractors.



## Quarterly Estimated Taxes

1099 contractors must pay quarterly estimated taxes using Form 1040-ES. Payments are due on:

- Q1 (Jan-Mar): April 15
- Q2 (Apr-Jun): June 15
- Q3 (Jul-Sep): September 15
- Q4 (Oct-Dec): January 15 (of next year)

If you expect to owe \$1,000+ in taxes for the year, you must pay estimated taxes or face underpayment penalties.

### Calculation:

Estimate annual income, subtract expenses, multiply by combined income tax rate (assume ~22-24% federal) + self-employment tax (15.3%), then divide by 4 quarterly payments.

#### Pro Tip

Many contractors underestimate quarterly taxes and face penalties on April 15. Set aside 25-30% of gross contractor income for taxes.



## Misclassification Penalties & Liability

Misclassifying an employee as a contractor exposes you to significant penalties:

### IRS Penalties:

- Unpaid employment taxes: Back payroll taxes for up to 3 years
- Failure to file 1099: \$50-\$270 per form (up to \$3 million annually)
- Negligence penalties: 20% of underpaid taxes
- Fraud penalties: 75% of underpaid taxes (if intentional)

### State Labor Violations:

- Back wages plus overtime (if applicable)
- Penalties: \$500-\$10,000 per violation (varies by state)
- Reputational damage and lawsuits

### Example:

If you misclassify a \$100,000 employee as a contractor for 2 years, you could owe: ~\$30,000 in back payroll taxes + \$5,000-\$40,000 in penalties + potential back wages and damages. Total exposure: \$35,000-\$70,000+.



## India-to-US Remote Worker Considerations

Many companies hire remote workers in India as contractors. Special considerations apply:

### Tax Treaties:

The US-India tax treaty allows Indian contractors to avoid US self-employment tax if they are tax residents of India. However, the contractor must file Form 8233 (Application for Exemption from Withholding) and provide an ITIN (Individual Taxpayer Identification Number) or equivalent Indian tax number.

### FCPA Compliance:

If your company has US subsidiaries or operations, the Foreign Corrupt Practices Act (FCPA) applies. Ensure your Indian contractors are compliant.

### Currency and Compliance:

Indian contractors must file Liberalized Remittance Scheme (LRS) forms and comply with India's Foreign Exchange Management Act (FEMA). Ensure you maintain proper documentation.

### Classification Risk:

Even for offshore contractors, be careful about over-controlling their work. The IRS may challenge classification based on behavioral control, especially if the contractor works full-time exclusively for your company.

#### Offshore Best Practice

AB7 Solutions handles contractor classification, tax compliance, and India-US worker requirements for clients. Our contractors are properly classified and compliant with both US and Indian tax authorities.



## C2H (Contract-to-Hire) Model Explained

The Contract-to-Hire model is popular for offshore hiring, especially from India. Here is how it works:

### Phase 1: Contract (Months 1-6)

Worker is hired as a 1099 contractor. The engagement defines:

- Specific project scope or trial period
- Monthly rate or project fee
- Conversion criteria (performance benchmarks, budget approval, etc.)
- Conversion date (typically 6-12 months)

### Phase 2: Conversion to Employment (Month 7+)

After the trial period, the contractor converts to W-2 employee status. This requires:

- Formal offer letter detailing salary, benefits, and position
- Tax withholding setup (W-4 form)
- Benefits enrollment (if applicable)
- Background check (if not done during contractor phase)

### Advantages:

- Reduces hiring risk by evaluating fit before permanent offer
- Allows worker to demonstrate performance
- Provides budget flexibility (contract vs. permanent headcount)
- Common practice for offshore hiring

### IRS Risk:

If a contractor is converted to employee, the IRS may look back at the initial contractor classification. Document that the contractor genuinely served a trial or project-based role, not an intentional misclassification.



## Common Misclassification Mistakes

Here are the most common errors that trigger IRS audits and state investigations:

5. Calling someone a contractor to avoid payroll taxes, even though they work full-time for you
6. Providing benefits (health insurance, PTO) to contractors, which indicates employee status
7. Directing how, when, and where the work is done (behavioral control indicates employee)
8. Hiring exclusively; not allowing contractors to work for other clients
9. Using contractor agreements with no real independence in practice
10. Failing to issue 1099-NECs to contractors earning over \$600
11. Misclassifying based on contractor preference, not legal requirements
12. Mixing contractors and employees in the same role (unequal treatment)

### Red Flags:

- Job title includes "employee" but classified as contractor
- Contractor works 40+ hours per week exclusively for one company
- Company owns or provides all tools and equipment
- Contractor cannot refuse work or substitute someone else
- Contractor receives training on company procedures



## Classification Decision Flowchart (Text Version)

Use this decision tree to determine proper classification:

### Start: Is this a new worker engagement?

YES: Does the worker have an end date or specific project scope?

- YES (Project-based): Consider contractor or C2H
- NO (Indefinite): Likely employee

Is your state California, New York, or Massachusetts (ABC Test states)?

- YES: Does the worker perform work OUTSIDE your usual business?

If YES to all three ABC factors: Contractor classification may survive

If NO to any ABC factor: Must classify as employee

Are you in a contractor-friendly state (Florida, Texas, etc.)?

- YES: Apply the IRS 20-Factor Test
- Factor list leans 10+ points to contractor: Can classify as contractor
- Factor list leans 10+ points to employee: Must classify as employee

When in doubt, classify as employee to avoid penalties.



## Classification Remediation Checklist

If you discover a misclassification, take these steps immediately:

### Immediate Actions (Days 1-7):

- ✓ Consult an employment attorney in the affected state
- ✓ Do not immediately reclassify (seek legal advice first)
- ✓ Gather all documentation of the worker's role and work arrangement
- ✓ Identify how long the worker has been misclassified
- ✓ Determine exposure (number of workers, duration, potential liability)

### Legal Compliance (Weeks 1-4):

- ✓ File Form SS-8 with IRS (optional but recommended for protection)
- ✓ Consider IRS Voluntary Disclosure Practice (VDP) if applicable
- ✓ Reclassify worker going forward (per legal advice)
- ✓ Issue corrected 1099-NEC or W-2 for the year
- ✓ Set up proper payroll withholding if converting to employee

### Long-term (Months 1-12):

- ✓ Audit other workers for similar misclassifications
- ✓ Implement classification policy and documentation
- ✓ Train HR and management on proper classification
- ✓ Review vendor and contractor agreements
- ✓ Maintain records for 6+ years of all classification decisions



## Creating a Classification Documentation Template

To defend your classification in an IRS audit, document your reasoning using this template:

Item	Finding	Evidence
Worker Name & Role		
Classification (Employee / Contractor / C2H)		
Effective Date		
State(s) of Work		
1. Control of Work		
2. Financial Control		
3. Relationship Type		
20-Factor Test Score	Employee: ___ Contractor: ___	
ABC Test Compliance (if CA/NY)	A (Control): ___ B (Scope): ___ C (Independence): ___	
Signed Agreement	Yes / No	Attach copy
Manager/HR Approval	Name: ___ Date: ___	



## Setup Checklist for New Contractor Engagement

When bringing on a new contractor, follow this checklist to ensure proper classification from the start:

### Before Engagement:

- ✓ Classify worker using 20-Factor Test or ABC Test (state-dependent)
- ✓ Document classification rationale and keep records
- ✓ Have legal review classification if in high-risk state
- ✓ Draft contractor agreement specifying: scope, duration, independence, IP rights
- ✓ Obtain W-9 form (not later than payment date)

### During Engagement:

- ✓ Limit behavioral control (contractor determines method of work)
- ✓ Do NOT provide training or detailed instruction
- ✓ Allow contractor to work for other clients (or document why not)
- ✓ Do NOT provide benefits
- ✓ Payments should be per project or monthly, not weekly salary
- ✓ Maintain distance: contractor provides own equipment/tools when possible

### End of Year:

- ✓ If \$600+: Issue Form 1099-NEC by January 31
- ✓ File 1099-NEC with IRS by February 28/March 31
- ✓ Keep copy for your records (6+ years)
- ✓ Report on contractor evaluation for next year

### Conversion (C2H):

- ✓ At conversion milestone: Transition from 1099 to W-2
- ✓ Issue final 1099-NEC for contractor period
- ✓ Offer formal employment with offer letter
- ✓ Set up tax withholding (W-4)
- ✓ Update benefits enrollment (health, retirement, etc.)

#### About AB7 Solutions

AB7 Solutions properly classifies all remote workers (employees, contractors, and C2H placements) and maintains full tax compliance documentation for US and India. We help companies avoid misclassification penalties and streamline global hiring.