

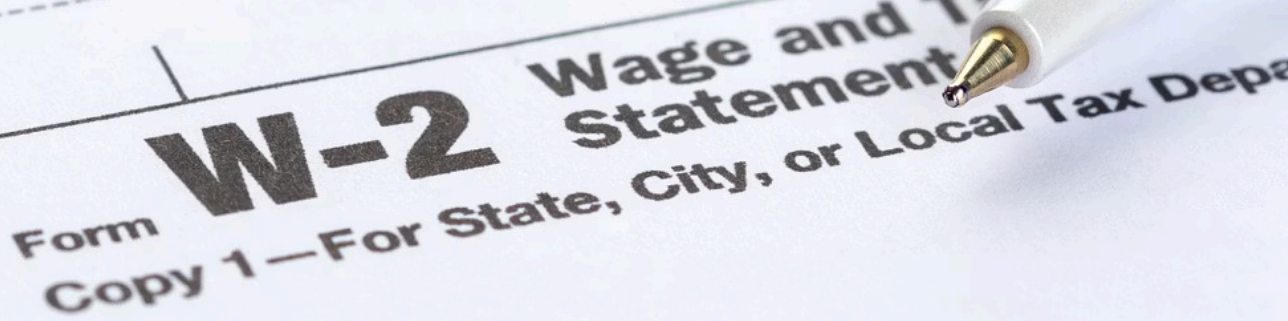
W-2 vs. 1099: Legal Criteria for Worker Classification

Scott Johnson is a Partner at Dunlap Bennett & Ludwig PLLC, where he focuses on management-side employment law and litigation, corporate transactions, government contracting, and outside general counsel services. Scott regularly advises employers on worker classification, independent contractor agreements, restrictive covenants, and multi-state compliance, with particular experience helping growing companies design classification frameworks that hold up under IRS and state agency scrutiny.

Worker classification issues surface across Scott's practice—in structuring new hiring relationships, in M&A due diligence where a target's contractor workforce creates reclassification risk, in government contracting where misclassification can trigger debarment, and in defending audit positions when the IRS or a state agency challenges an employer's classifications. This guide reflects that cross-practice perspective, treating classification not as a standalone tax question but as a business decision with implications for employment law, corporate transactions, and regulatory compliance.

Scott Johnson, Partner





Worker classification determines whether an individual is a W-2 employee or a 1099 independent contractor. The distinction governs tax withholding, payroll obligations, benefit eligibility, wage and hour protections, and liability exposure. The IRS applies a common-law test that weighs behavioral control, financial control, and relationship characteristics. States often apply stricter standards, including the ABC test. This guide maps the classification field, describes the tests, and frames the factors business leaders evaluate.

The Classification Question: What the Tests Measure

Classification turns on the degree of control and independence in the working relationship. Federal law, through IRS common-law rules, evaluates three categories: behavioral control, financial control, and the type of relationship. No single factor is dispositive. The totality of the relationship determines the outcome.

Behavioral control examines who directs how work is performed. Instructions on methods, timing, location, and sequence indicate employment. Training provided by the hiring entity suggests employee status. Financial control looks at who bears business risk. Independent contractors typically invest in tools, incur unreimbursed expenses, set their own rates, market to multiple clients, and face profit or loss. Employees receive wages with taxes withheld and do not bear business risk.

The relationship type considers permanency, benefits, and whether the work is integral to the business. Indefinite engagements delivering core services commonly signal employment. Project-based arrangements with defined deliverables favor contractor status. Written agreements help document intent but do not override the economic reality.

Behavioral Control: Instructions, Training, and Methods

Behavioral control measures the hiring entity's right to direct the worker's methods and schedule. If the organization dictates when, where, and how work is done, provides role-specific training, requires use of its premises or systems, and evaluates performance against detailed standards, those facts point toward W-2 status. If the worker chooses methods, timing, and sequence to deliver a result without detailed instructions, that aligns with independent contractor status.

Remote work does not eliminate behavioral control. Daily standups, mandatory time-tracking software, required approval for task changes, and prescribed workflows can all demonstrate control even when the worker is offsite. The question is whether the hiring entity retains the right to control the manner and means, not whether it exercises that right constantly.

Indicators of Behavioral Control (W-2)



Detailed instructions on how to perform tasks



Required training and onboarding programs



Set work hours or mandatory availability windows



Use of employer-provided premises, equipment, or systems



Supervision, evaluation, and performance reviews



Limited ability to delegate or subcontract work

Indicators of Independence (1099)



Worker determines methods and sequence



No required training; worker brings expertise



Flexible schedule set by the worker



Worker uses own tools and workspace



Minimal oversight; deliverable-focused relationship



Ability to hire assistants or delegate tasks

Financial Control: Investment, Expenses, and Business Risk

Financial control assesses who invests in the work, who bears costs, and who stands to profit or lose. Contractors commonly make significant investments in tools, software, licenses, or facilities. They incur unreimbursed business expenses and market their services to multiple clients. They set their own rates, invoice for completed work, and may earn more or less depending on efficiency and client volume.

Employees typically receive hourly wages or salary with taxes withheld. The employer provides tools, reimburses necessary expenses, and absorbs the cost of downtime or inefficiency.

Employees do not bear financial risk in the ordinary course of the relationship.

Indicators of Contractor Status



Unreimbursed expenses for tools, supplies, or travel



Investment in facilities, equipment, or specialized software



Opportunity for profit through efficient work or higher rate



Risk of loss if work is rejected or projects fail



Marketing and advertising to attract multiple clients



Invoicing and rate-setting authority

Indicators of Employee Status



Hourly or salaried compensation with tax withholding



Employer-provided tools, equipment, and workspace



Reimbursement of business expenses



Guaranteed wages regardless of productivity



Single client or primary economic dependence on one entity



No capital investment or business overhead

Relationship Type: Permanency, Benefits, and Integration

Relationship indicators include the expected duration, the provision of benefits, and whether the work is part of the hiring entity's regular business. An ongoing, indefinite relationship delivering services central to the company's operations commonly suggests employment. Health insurance, paid leave, retirement contributions, and other benefits are employee hallmarks.

A fixed-term project with a clear scope and deliverables, especially when the worker operates a separate business and provides similar services to other clients, favors contractor classification. Written contracts that specify deliverables, payment terms, and independence can support contractor status, but the economic reality controls over labels.

or foreign postal code, and telephone no.

		\$	Form 1099-MISC	Miscellaneous Information
		2 Royalties	(Rev. April 2025)	
		\$	For calendar year	
		3 Other income	4 Federal income tax withheld	Copy 1 For State Tax Department
		\$	\$	
PAYER'S TIN	RECIPIENT'S TIN	5 Fishing boat proceeds	6 Medical and health care payments	
		\$	\$	

IRS Common-Law Test and Federal Guidance

The IRS applies a common-law analysis rooted in three categories: behavioral control, financial control, and relationship type. IRS Publication 15-A provides the framework. The agency weighs all factors and the entire relationship; no single element is determinative. Form SS-8 allows a worker or hiring entity to request an IRS determination when the classification is unclear.

Under the Fair Labor Standards Act (FLSA), the Department of Labor (DOL) applies an “economic reality” test. The federal classification landscape shifted significantly in early 2026. On February 26, 2026, the DOL issued a Notice of Proposed Rulemaking to officially rescind the Biden administration’s 2024 six-factor rule (which the DOL stopped enforcing in May 2025). The 2026 proposed rule reinstates a framework that heavily prioritizes two “core factors”: the employer’s nature and degree of control over the work, and the worker’s opportunity for profit or loss.

Post-Chevron Landscape: Federal agency guidance is no longer the final word. Following the Supreme Court’s June 2024 decision in *Loper Bright Enterprises v. Raimondo*—which overturned Chevron deference—federal courts are no longer required to automatically defer to the DOL’s classification rules. This increases the likelihood of a patchwork of judicial interpretations, making it critical for businesses to rigorously document their independent contractor relationships rather than relying entirely on shifting agency regulations.

State wage and hour agencies also often apply their own tests, which may be stricter than federal standards.

Tax Withholding and Payroll Obligations

W-2 employees trigger withholding and payroll tax obligations. The employer withholds federal income tax, Social Security, and Medicare (FICA). The employer pays the employer share of FICA, federal unemployment tax (FUTA), and state unemployment insurance. Wages and withholding are reported on Form W-2, filed annually with the Social Security Administration and provided to the employee by January 31.

Independent contractors receive gross payments with no withholding. The hiring entity reports payments of \$600 or more on Form 1099-NEC, filed with the IRS and provided to the contractor by January 31. Contractors pay self-employment tax (the employee and employer shares of Social Security and Medicare) and make quarterly estimated tax payments. Contractors deduct ordinary and necessary business expenses on Schedule C.

Misclassification can trigger back taxes, penalties, and interest. If the IRS or a state agency reclassifies workers, the employer may owe unpaid withholding, the employer share of FICA and unemployment taxes, plus penalties for late filing and payment.

Benefits and Legal Protections

W-2 employees are eligible for employer-sponsored benefits when plan documents permit. Group health insurance, retirement plans, paid leave, and other benefits are common. Federal and state wage and hour laws—minimum wage, overtime, meal and rest breaks—apply to employees, not independent contractors. Employees are covered by unemployment insurance and workers' compensation. They may be protected by anti-discrimination, whistleblower, and wrongful termination statutes.

Independent contractors do not receive employer benefits. They are not covered by wage and hour laws, unemployment insurance, or workers' compensation in most jurisdictions. They are generally not protected by employment statutes, though some anti-discrimination laws have been extended to cover independent contractors in specific contexts.

Misclassifying an employee as a contractor can expose the employer to claims for unpaid overtime, denied benefits, and exclusion from protections. It can also create liability for the contractor's actions if control factors indicate an employment relationship.

Joint Employment and Staffing Relationships

Joint employment arises when two or more entities share sufficient control over a worker to be considered co-employers. This is most common in staffing agency arrangements, professional employer organizations (PEOs), and client-vendor relationships where the client company directs the worker's day-to-day tasks while the staffing firm handles payroll and benefits.

The DOL and NLRB have applied different joint employer standards in recent years, and the post-*Loper Bright* landscape means courts may independently evaluate these standards rather than deferring to agency rules. For employers using staffing arrangements, the practical risk is that a finding of joint employment makes the client company a co-employer—liable for wage and hour violations, discrimination claims, and NLRA obligations—even if the staffing firm is the W-2 employer of record. Written agreements with staffing firms should clearly allocate responsibilities, but as with contractor agreements, the actual working relationship controls over contractual labels.

State-Level Tests: The ABC Standard

Many states apply the ABC test for unemployment insurance, workers' compensation, or wage and hour law. Under the ABC test, a worker is presumed to be an employee unless the hiring entity proves all three prongs:

A	B	C
The worker is free from control and direction in performing the work, both under contract and in fact.	The work is performed outside the usual course of the hiring entity's business or outside all of its places of business.	The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

If any prong fails, the worker is an employee. Prong B is often the most restrictive. A software company hiring a software developer, or a delivery platform engaging drivers, commonly fails Prong B because the work is part of the company's usual business.

California, Massachusetts, New Jersey, and other states have adopted ABC tests with variations. Some apply the test only to certain statutes; others apply it broadly. Gig economy legislation in California (AB 5) and other states has carved out exemptions for specific occupations while tightening classification for others.

The IRS common-law test is more flexible than the ABC test. A worker who qualifies as an independent contractor under the IRS test may be classified as an employee under a state ABC test. Employers operating in ABC jurisdictions should apply the stricter state standard to avoid misclassification liability.

Virginia Worker Classification

Virginia generally follows the IRS common-law test for worker classification purposes. However, Virginia has its own misclassification enforcement framework under Va. Code § 58.1-1900 *et seq.*, which imposes penalties on employers that misclassify employees as independent contractors. Penalties include fines of up to \$1,000 per misclassified worker for a first offense, up to \$5,000 per worker for second offenses, and up to \$10,000 per worker plus potential debarment from public contracts for third and subsequent offenses.

Virginia's enforcement is particularly relevant for government contractors and businesses bidding on state or local contracts in the Northern Virginia market. The Virginia Department of Taxation, the Virginia Employment Commission, and the Virginia Workers' Compensation Commission can each investigate classification issues within their respective jurisdictions. Employers with Virginia-based workers should ensure their classification analysis addresses both federal and Virginia-specific requirements.

Safe Harbors and Relief

Section 530 of the Revenue Act of 1978 provides a critical safe harbor against IRS reclassification penalties, provided the employer meets three strict requirements: (i) a reasonable basis for the classification (e.g., judicial precedent, prior audit, or long-standing industry practice), (ii) consistent reporting (filing all required Forms 1099), and (iii) substantive consistency (treating all similar workers as contractors).

In January 2025, the IRS issued Revenue Procedure 2025-10, the first comprehensive update to Section 530 relief in 40 years. This critical update clarified that reporting consistency is evaluated strictly on a period-by-period basis, and it tightened the definition of a “substantially similar position” regarding job functions and supervision. Businesses relying on industry practice or precedent must ensure those standards existed at the time the classification decision was made.

Note: Revenue Procedure 2025-10 updates both VCSP procedures and Section 530 relief guidance. Because these are related but distinct mechanisms, employers should confirm with counsel which provisions apply to their specific situation. The characterizations in this guide are based on available IRS publications as of early 2026.

For businesses that discover misclassification but do not qualify for Section 530 relief, the IRS Voluntary Classification Settlement Program (VCSP) remains a valuable alternative. The VCSP allows eligible employers to voluntarily reclassify workers prospectively while paying only 10 percent of the employment tax liability for the most recent year, with no interest or penalties, provided they meet criteria such as having no current employment tax audit.

Forms and Reporting

Employers issue Form W-2 to employees and Form 1099-NEC to contractors. Both forms can go to the same person in the same year if the individual held distinct roles—for example, an employee of the company who also provided consulting services for a separate business unit under a contractor agreement. The substance of each engagement determines the correct form.

Form W-9 collects the contractor’s taxpayer identification number and certification. Employers should obtain a W-9 before paying a contractor to ensure accurate 1099-NEC reporting and to document that the payee is responsible for their own taxes.

Misclassification Risks and Enforcement

Federal and state agencies audit worker classification regularly. The IRS, Department of Labor, and state unemployment and labor departments coordinate enforcement in some jurisdictions. Patterns of misclassification in an industry or company often trigger targeted audits.

Penalties vary. The IRS may assess back payroll taxes, interest, and accuracy penalties. State agencies may impose fines, require retroactive unemployment contributions, and mandate payment of unpaid wages and overtime. Workers who sue for misclassification can recover damages, penalties, and attorney fees under state wage laws.



Contractor Agreements and Documentation

Written agreements define scope, deliverables, payment terms, intellectual property ownership, confidentiality, and termination. Agreements should reflect the economic reality of independence and avoid language that imposes employee-like control.

Contracts alone do not determine classification. Courts and agencies look to the actual working relationship. An agreement that labels the worker as an independent contractor but imposes set hours, detailed instructions, and exclusive availability will not withstand scrutiny.

Supporting documentation includes:

- **Business licenses, trade names, or entity formation documents**
- **Proof of separate business operations (website, marketing, other clients)**
- **Invoices submitted by the contractor**
- **Certificates of insurance**
- **Records showing the contractor's investment in tools and facilities**

Classification Decision Framework

A repeatable classification process reduces risk. Assess the role before hiring. Document the factors considered. Apply both the IRS common-law test and any applicable state test. Budget for the true cost of each classification option, including payroll taxes and benefits for W-2 roles or higher contract rates for 1099 roles.

1

Map the tasks, required skills, and integration into business operations.

2

Evaluate behavioral control: instructions, training, supervision, flexibility.

3

Evaluate financial control: expenses, investment, profit/loss risk, multiple clients.

4

Evaluate relationship type: duration, benefits, centrality to business.

5

Apply the IRS common-law test and any applicable state ABC test.

6

Document the analysis and retain the documentation.

7

Draft an agreement that reflects the classification and economic reality.

8

Review annually or when facts change.

When facts are mixed, lean toward W-2 classification or request an IRS determination via Form SS-8. Ambiguity favors the more protective classification.

Comparison Table: W-2 vs. 1099

Category	W-2 Employee	1099 Contractor	Notes
Tax withholding	Employer withholds income tax and FICA	No withholding; contractor pays estimated taxes	Contractors file quarterly payments
Payroll taxes	Employer pays FICA, FUTA, and state unemployment	Contractor pays self-employment tax	Misclassification triggers back taxes
Benefits	Eligible for employer plans	Not eligible; obtains own coverage	Plan terms vary
Expenses and tools	Employer provides or reimburses	Contractor pays and deducts on Schedule C	Ordinary and necessary expenses
Control	Employer directs methods and schedule	Contractor determines methods and timing	Key factor in all tests
Legal protections	Wage/hour, unemployment, workers' comp, anti-discrimination	Generally not covered; may have contract remedies	State laws vary

Industry Patterns and Edge Cases

Freelancers in creative fields—writers, designers, developers—commonly qualify as independent contractors when they maintain multiple clients, set project terms, and use their own tools. Gig platform drivers and delivery workers face classification disputes because platforms often impose routing, acceptance rates, and customer service standards that suggest control.

Remote workers are not automatically contractors. Remote employees who work set hours, use company systems, receive training, and integrate into teams are W-2 workers regardless of location. Staffing agencies and professional employer organizations (PEOs) can establish co-employment, making the agency the W-2 employer while the worker serves the client company.

Multi-state operations require applying both federal tests and the law of each state where the worker performs work. A contractor under the IRS test may be an employee under California's ABC test if the work is in California and fits the company's usual business.

Common Misconceptions

Labels do not control classification. Calling someone an independent contractor in a contract or having the worker sign an acknowledgment does not establish contractor status. The economic reality and actual working relationship govern.

A worker can be an independent contractor for one engagement and an employee for another, even with the same company, if the roles are truly separate and meet different tests. Length of engagement alone does not determine classification. Long-term contractors can remain contractors if independence is maintained.

State law can impose stricter standards than federal law. A determination that someone is a contractor under IRS rules does not insulate the employer from state claims under a stricter ABC test.

Documentation Best Practices

Maintain classification analysis worksheets for each role. Retain written agreements, statements of work, invoices, and proof of the contractor's separate business operations. Collect Form W-9 before first payment. File Forms 1099-NEC by the January 31 deadline.

For employees, document training, performance reviews, and integration into the organizational structure. Issue Form W-2 and retain payroll records as required by federal and state law.

Audit classification annually or when facts change. Role creep—where a contractor gradually takes on more employee-like duties—can shift classification over time.

FAQ

What is the difference between W-2 and 1099?

W-2 indicates employment. The employer withholds taxes, pays payroll taxes, and may provide benefits. The worker is subject to the employer's direction and control. 1099-NEC indicates an independent contractor relationship. No taxes are withheld; the contractor pays self-employment tax and makes estimated payments. The contractor operates independently, bears business risk, and typically serves multiple clients.

Who pays more taxes, W-2 or 1099?

The total tax burden is similar. W-2 employees have half of Social Security and Medicare paid by the employer; the employee share is withheld. Contractors pay both halves as self-employment tax but can deduct business expenses on Schedule C. The net tax depends on deductions, rate, and state taxes.

Why did my employer give me a 1099 instead of a W-2?

The employer likely classified the role as an independent contractor based on project scope, independence, use of your own tools, and business risk. If you believe the classification is incorrect—if the employer controlled your methods, schedule, and tools, and you worked like an employee—you can file Form SS-8 with the IRS or file a claim with your state labor agency.

Should I structure my compensation as W-2 or 1099?

The answer depends on your entity type and the nature of the working relationship. The classification must match the actual legal and economic relationship—it is not an elective choice. Business owners structuring their own compensation should work with a tax professional to model scenarios within the boundaries of IRS rules for reasonable compensation.

Can the same person receive both W-2 and 1099 from one company?

Yes, if the person holds two distinct roles. For example, an individual employed as a marketing manager (W-2) who also provides freelance graphic design services under a separate contract (1099-NEC) for a different business unit. The substance of each engagement determines the form. The roles must be genuinely separate in scope, control, and economic terms.

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About the Author

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Strategic Partnership for Legal Protection

This guide maps the behavioral-control, financial-control, and relationship factors that determine W-2 versus 1099 classification, the IRS common-law test, state ABC standards, safe-harbor provisions, and documentation requirements. Dunlap Bennett & Ludwig helps companies design classification frameworks, audit current relationships, draft agreements that reflect economic reality, and defend positions during agency audits or litigation.

If you are structuring hiring for growth, reclassifying workers to manage risk, responding to an audit, or navigating multi-state classification rules, our attorneys can help you build defensible processes and resolve disputes before they reach costly enforcement actions.



Dunlap Bennett & Ludwig is a veteran-owned law firm with offices across multiple states. Our privacy and business attorneys combine legal expertise with practical operational experience to help companies navigate workplace monitoring compliance while maintaining focus on their core business objectives.

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