

WE THRIVE COLLECTIVE

Freelancers & Your Business

What Service-Based Founders Need to Know

A practical compliance guide for service-based businesses that rely on freelancers. Covers classification risk, penalty exposure by business size, and what to do when a working relationship has outgrown its original structure.

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Overview

Freelancers are one of the smartest moves a growing service-based business can make. They give you access to specialized skills without the overhead of a full-time hire, and they flex with your workload in ways a fixed payroll can't.

They're also a real legal exposure when the working relationship isn't structured correctly.

The rules have shifted. Government agencies aren't just reading contracts anymore. They're looking at how freelancers are actually treated day in and day out. If someone is showing up like a full-time employee, working full-time hours, doing core business work, and sitting in on your internal meetings, regulators may classify them as one. The day-to-day reality is what regulators look at. The paperwork is secondary.

This guide covers the current regulatory landscape, how to assess freelancer relationships against compliance standards, and what structural options exist when a relationship needs to change. It's here to help you make informed decisions about workforce classification and risk.

The compliance exposure lives in unexamined freelancer relationships. Not in the contract. In the hours, the tenure, and how integrated someone has become, until the structure no longer holds up.

Why Freelancers Work for Service-Based Businesses

Service-based work doesn't move in a straight line. Client work ramps up, delivery seasons hit, and specialized needs come and go. A fully salaried team can't flex with that rhythm the way freelancers can. Accessing the right talent when the work calls for it, rather than maintaining a fixed headcount through slow seasons, is a sound business decision.

What Freelancers Provide	What That Means in Practice
Flexibility	You can scale up or pull back based on actual client demand, not projected need.
Speed	When a project is urgent, the right person can be brought in without a long hiring process.
Specialized Skills	Roles like copywriting, design, development, photography, or strategy can be filled for a project without a permanent hire.
Cost Control	No payroll taxes, benefits, or overhead for work that is temporary by nature.

The model holds when the relationship is genuinely independent. When it starts to look more like employment, the legal and financial picture changes, and the savings start running in reverse.

What Has Changed in 2026

1. The Contract Is No Longer the Point

The IRS and the U.S. Department of Labor have both shifted their focus. They used to spend most of their attention on what a contract said. Now they look at how the work actually runs. If you set someone's schedule, tell them how to do the work, give them your equipment, and have them show up in your business like any other team member, the government may treat that person as an employee regardless of what the paperwork says.

Classification follows the actual structure of the working relationship. The contract title is secondary. Hours worked, length of engagement, and how integrated someone has become in your operations are what regulators actually examine.

2. What the Government Actually Looks At

The Department of Labor uses an economic reality test to decide whether someone is a true freelancer. The questions are straightforward:

- Do you control when and how this person works, or do they set their own schedule and process?
- Does this person run their own business? Do they have other clients, their own tools, and real financial stake in their work?
- Is this person doing work that's central to what your business does every day, or is it a contained, defined project?
- Are you the only company this person works for, and has it been that way for a long time?

3. The Financial Stakes in 2026

Federal reporting requirements for freelancers have tightened. Misclassifying a worker can trigger back taxes, interest, and penalties that vary based on how long the situation has been in place and how many workers are involved. For a contractor who has been working full-time hours for a year or more, those numbers add up fast.

State-level enforcement has also increased, particularly in California, New York, and Illinois. The financial exposure is real regardless of your business size.

How to Read a Freelancer Relationship

When regulators look at a freelancer relationship, three things consistently determine the outcome. These are the questions worth bringing to any working arrangement you want to evaluate.

The Three Questions That Matter

Question	What It Measures	What Raises a Flag
Who controls the work?	Do you direct how, when, and with what tools the work gets done?	Mandating specific software, requiring daily check-ins, or dictating work hours.

Question	What It Measures	What Raises a Flag
Is this person financially tied to you?	Does most or all of this person's income come from your business?	Full-time hours with no other clients for six months or more.
Is there a defined end to this?	Is the relationship built around a project, or has it just kept going?	Engagements that keep getting extended with no clear finish line in sight.

Two Very Different Situations

A freelancer hired for a six-week project is a different situation than a freelancer who has been working 40 hours a week for 18 months. You need to know which category each person falls into.

Project-Based (Lower Risk)	Ongoing / Full-Time (Needs a Review)
Under 30 hours per week	30 or more hours per week
Clear end date or final deliverable	No defined end, just keeps going
Hired to produce a specific result	Regularly in your internal meetings
Has other clients outside of your business	Your business is their primary or only client
Uses their own equipment and software	Embedded in your daily operations
Specialized skill not needed full-time	Filling what functions as a permanent role

The 30-Hour Line

There is no hard number written into law. But 30 hours a week is where regulators start paying attention. At that point, the person is working as much as a full-time employee, contributing to core work the same way, and their situation starts to raise the three questions above in a serious way.

Crossing 30 hours doesn't mean you're automatically in violation. It means the relationship deserves a closer look. The goal is visibility, not panic.

When Multiple Factors Stack Up

A single factor on its own rarely triggers reclassification. Where it gets serious is when several stack up at the same time. If a freelancer checks most of these boxes, that relationship needs attention now.

Review immediately if you see these together: 30+ hours per week | With you for six months or more | Work is central to the business | Woven into team routines | You are their only or primary client

State Lines Change the Equation

Your home state matters, and so does where your contractor lives and works. Some states apply much stricter standards than others, and enforcement in those states is aggressive.

- California uses a test that makes it very difficult to classify someone as a freelancer if they do core business work.
- New York and Illinois have stricter rules around wages and how workers must be treated.
- Texas law is more flexible, but federal rules apply everywhere regardless of state.

The moment a contractor lives in a state with stricter laws, those state-level rules apply to that relationship, even if your business is based somewhere more flexible.

What Misclassification Actually Costs

Using freelancers saves money, and that's a legitimate business decision. The savings assume the relationship is legally sound. When it isn't, you don't just lose the savings. You owe back taxes, fines, and interest for every month the situation was wrong.

What You Save With a Freelancer	What You Owe If Misclassified
No payroll taxes	Back payroll taxes, plus interest
No health or retirement benefits	Government fines and penalties
Lower overhead costs	Workers' Compensation claims
Flexible contract terms	Legal fees to fight reclassification
No long-term headcount commitment	State-level fines that vary by jurisdiction

The left column is why freelancers make financial sense. The right column is what happens when the structure doesn't hold up. The specific penalties you face depend on the size of your business. Here is what each category looks like.

Penalties That Apply to Every Business (Regardless of Size)

Federal payroll tax liability applies to all employers. When a worker is reclassified, the IRS calculates what should have been withheld and paid. The amount owed depends on whether the IRS determines the misclassification was unintentional or willful.

Penalty Type	If Unintentional	If Willful
Income tax withholding	1.5% of wages paid	3% of wages paid
Employee FICA (Social Security + Medicare)	20% of what should have been withheld	40% of what should have been withheld
Employer FICA	100% of what was owed	100% of what was owed
Failure to file correct information returns (W-2s)	\$60 to \$310 per form, based on how late	\$630 per form or more

Interest accrues on top of all of the above from the date the taxes were originally due. State unemployment insurance, workers' compensation premiums, and state-level penalties stack on separately.

The longer a misclassified relationship goes unaddressed, the more months of unpaid taxes, interest, and fines accumulate. A situation that has been in place for two years costs significantly more than one caught at six months.

Additional Penalties for Large Employers (50 or More Full-Time Equivalent Employees)

Businesses that meet the federal threshold for large employer status under the Affordable Care Act face an additional layer of exposure when workers are misclassified. If a reclassified employee was not offered qualifying health coverage and they obtained subsidized coverage through the marketplace, the IRS can assess an Employer Shared Responsibility Payment.

There are two distinct penalties under ACA Section 4980H. Which one applies depends on whether you offered coverage at all and whether it met minimum standards.

ACA Penalty	When It Applies	Approximate Annual Amount Per Employee
Section 4980H(a)	You did not offer minimum essential coverage to at least 95% of full-time employees	Approximately \$2,900 to \$3,350 per full-time employee, minus the first 30. Adjusted annually by the IRS.

ACA Penalty	When It Applies	Approximate Annual Amount Per Employee
	and at least one obtained a marketplace subsidy.	
Section 4980H(b)	You offered coverage but it was unaffordable or did not meet minimum value standards, and at least one employee obtained a marketplace subsidy.	Approximately \$4,350 per full-time employee who received a subsidy. Adjusted annually by the IRS.

These penalties apply per affected employee per year. A misclassified contractor who worked full-time for two years and obtained marketplace coverage during that period can trigger penalties for both years. Confirm current penalty amounts with legal or benefits counsel, as the IRS adjusts these figures annually.

Not sure if you qualify as a large employer? The threshold is 50 full-time equivalent employees. Part-time hours count toward the calculation. If you are near that number or growing toward it, an employment attorney can help you assess your current status and exposure.

Four Ways to Handle a High-Risk Relationship

When a freelancer relationship has grown into something that looks more like employment, you have four options. None are automatic. The right one depends on the person, the role, and what your business actually needs going forward.

Option		What This Looks Like
Option 1: Hire Them as an Employee (W-2)	CLEANEST	Bring them on staff. This ends the classification risk entirely. It's the right call when someone has become a core, ongoing part of how your business operates.
Option 2: Use an Employer of Record (EOR)	LOW OVERHEAD	A third-party company takes on the legal role of employer. They handle payroll, taxes, and compliance. You keep directing the work, but the legal liability sits elsewhere.

Option		What This Looks Like
Option 3: Reset the Working Relationship	KEEPS IC STATUS	Rebuild the engagement around specific deliverables. Bring hours below 30 per week. Set a real end date. This restructures the relationship back to what a genuine freelance arrangement actually looks like.
Option 4: Document and Accept the Risk	RISK ACCEPTED	Keep the current setup, but have legal counsel put in writing that you've reviewed the situation and are choosing to accept the risk. Not a permanent solution, but it demonstrates you acted with awareness.

Where to Start

Step 1: Pull the Hours First

Pull weekly hours for every active freelancer and establish a baseline. Sort contractors into two groups: those working under 30 hours a week and those at 30 or above. That is where regulatory attention is likely to land.

Step 2: Check Tenure for High-Hour Contractors

For any contractor working 30 or more hours per week, length of service is the next variable that matters. Contractors who have been in that capacity for six months or longer represent the highest concentration of classification risk and need individual review.

Step 3: Set Internal Review Triggers

A simple set of internal thresholds lets you identify high-risk relationships before they become entrenched. Consider flagging for review:

- Any freelancer working 30 or more hours a week for four consecutive weeks
- Any freelancer reaching six months of continuous work with your business
- Any freelancer who no longer has other clients outside of your business
- Any freelancer attending your internal team meetings on a regular basis

These aren't reclassification triggers. They're review triggers. The purpose is to make sure high-risk relationships get documented attention, and that any decision to maintain, restructure, or convert them is made deliberately and on the record.

Five Things Worth Remembering

- 1. Classification follows how the working relationship actually runs**, not what the contract calls it.
 - 2. Hours, length of engagement, and how integrated someone is are the three things regulators actually measure.** All three matter together.
 - 3. Where a freelancer lives changes the risk.** Texas is more flexible. California, New York, and Illinois aren't.
 - 4. A 30-minute review today costs far less than a reclassification audit 18 months from now.** The math isn't close.
 - 5. The goal is using freelancers well**, with a structure that holds up and keeps the exposure out of the background.
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One Last Thing

Worker classification exposure builds quietly and tends to surface at the worst possible moment. It's also one of the more manageable compliance areas when someone is actually looking at it. The window to act before something becomes a problem is wider than most founders realize.

Most of the service-based founders I work with didn't know this was something they needed to pay attention to. Nobody hands you a freelancer compliance checklist when you hire your first VA or bring in a contractor for a launch. Now you have one.

If you want to talk through how to audit your current freelancer relationships, build internal review systems, or figure out the right structure for your business specifically, that's exactly the kind of work I do.

Start the conversation at we-thrive-collective.com/work-with-nicole

No pitch. No obligation. If there's alignment, we'll figure it out together.

This document does not constitute legal advice and is not a substitute for employment counsel. Any formal changes to worker classification should involve a qualified employment attorney.

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