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EMPLOYEE VS. CONTRACTOR:

The Complete Guide to International Worker Classification



WHAT WE DO

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Building a global team is one of the most exciting phases in the growth of a company. However, it also involves considerable research. You will need to answer a key question: Should I hire an employee or a contractor?

To stay on the right side of the law, reduce risk, avoid fines, and maintain compliance on an international scale, it's important to make sure you are classifying workers properly based on the labor and tax laws of the country where they are located.

Contractor or employee? How to make the right determination

Though the laws of every country are different, the following guidelines provide a general overview of factors that indicate a contractor/self-employed status:

- You do not exercise supervision, direction, or control over these workers. They have the ability to determine when, where, and how they work. While you may give instruction on the deliverables and specification for a project, you do not direct their daily work or set their schedules.
- They are free to provide services to other companies without your consent. They may or may not work for other companies – it is irrelevant to your engagement with them.
- They do not work for you full-time on an indefinite basis.
- The workers are paid a fixed price for the completion of certain tasks or projects and do not participate in any benefits programs.
- They are not required to perform the services personally and may appoint a substitute to perform the work.

When is a contractor considered an employee? International tax and HR advisors generally use the following parameters:

Does the individual:

- Work full-time for one company?
- Take management direction from that company?
- Have no other clients?
- Receive some employee benefits? (i.e., vacation days, stock options, car allowances, private health insurance, etc.)

If you answered yes to one or more of these questions about the hire you are hoping to make, the individual is likely an employee and there could be complications down the road if you engage the worker as an independent contractor. This is particularly true if the relationship with the contractor does not end on a positive note.

It should be noted that every case is different, and courts will look at all aspects of the relationship between the company and worker when determining whether the worker is properly classified. Below are some additional factors that courts often examine:

ADDITIONAL FACTORS FOR INTERNATIONAL WORKER CLASSIFICATION		
Contractor		Employee
Contractors perform work on a finite or project basis. There is a clear end to their project and contract.	Agreement	An employee generally works on an indefinite basis for the company.
Contractors are free to perform services to other companies without needing the permission of any company.	Other Activities	In an employment relationship, an individual may not be permitted to perform outside work without the express permission of the employer. However, it is possible for a person to have more than one part-time employment.
The individual is not required to perform the services personally and may appoint a substitute to perform the work.	Personal Service	The individual is required to provide services personally. In an employment relationship, there is no right for an employee to appoint a substitute.
Payment is a fixed price, made on an hourly, milestone, or project basis and is tied to completion of specific milestones or metrics.	Pay	Payment is made in the form of a salary and is paid as a fixed amount regardless of performance targets or completion of specific tasks.
Contractors are responsible for paying their own income taxes and any applicable employment taxes.	Taxes	The employer is responsible for their portion of the employee's taxes and social charges.
Contractors do not participate in any benefits programs the company offers. Contractors are generally not entitled to vacation days or sick pay.	Benefits	Employees may participate in benefits program offerings, such as pension, private medical insurance, car leasing, or other benefits. Employees are also entitled to vacation and sick pay, if applicable.
Contractors provide their own resources and equipment to complete their work.	Equipment	Employers are required to provide employees with the equipment and resources needed to perform their work. Employees are also reimbursed for work-related expenses.

Contractor		Employee
Contractors set their own working hours.	Schedule	Employees work within the working hours defined by their employer.
The individual is not sufficiently integrated into the company, and the work performed is not similar to work performed by employees. The work is often for one specific project, not for integral business operations. Contractors generally do not participate in company-wide meetings or events. Contractors are generally identified in any directories or email as an external contractor. Contractors will not have management or supervisory responsibilities.	Scope of Work/ Integration into Company	The individual is integrated into the company and performs work that is a part of everyday business operations. Employees participate in company-wide meetings, events, and their names appear on the internal phone/email directory. They have a company email address. Employees may also have management responsibilities over other employees.



One of the main reasons that companies hire contractors is because of the flexibility – they can quickly gain the expertise of a highly skilled professional without going through the process of establishing themselves as a legal employer in a new country.

One of the main reasons companies hire employees is because they are looking for professionals who will fully commit to their business long term, and an employer has the ability to direct the work of employees. Typically, full-time employees are going to be more invested in the success of the company, and they can help build out operations in a new country, hire others, and grow high-performing teams.

Both employees and contractors can play key roles for fast-growing international companies, but it's critical to make sure you classify them properly. If someone "should" be an employee according to local labor law, but the individual is classified as a contractor, that is where companies can run into problems.



Worker misclassification: how it happens

The story of worker misclassification almost always begins the same way: a first sales hire in Brazil, a fantastic programmer in Poland, a QC overseer of the third-party manufacturer in China.

Imagine this: Your company has decided that this year's business strategy will involve at least one international venture. This means you and your HR team will be responsible for facilitating the perfect hire once the decision has been made.

You begin to research what you will need to set up payroll for your international hire. After perusing countless websites with conflicting information, you begin to panic. You wonder how you will make this hire when you don't have an entity registered in-country.

With the pressure mounting, many HR professionals in companies small and large default to hiring the candidate as a contractor or consultant — "Let's just get the person on board and see."

If the individual is open to it, then this appears to solve several immediate problems. You also avoid spending time and money setting up business entities in countries where you aren't sure you'll hire more than one person or keep them on the team long term. It seems like a simple solution where everyone wins. Problem solved.

But is it?

It all depends on worker classification labor and tax laws in the country where your contractor is based. If the individual meets the legal definition of an employee but is classified as a contractor, you may only be exchanging one problem for another, or postponing the problem.



Worker misclassification risks

You may be tempted to dismiss the small risk of discovery and reclassification by the local authorities. But the chance of discovery is not necessarily the most significant risk. After all, how many authorities have time to investigate more than a small percentage of contractors? However, it's worth bearing in mind that some countries have the means to be more vigilant than others.

For instance, in Brazil, incoming payments made from a corporation to an individual are automatically flagged for the tax authorities' investigation. That is not to say that every payment will be investigated, but some are, and the means to track them are in place.

More granularly, outgoing payments from the Brazilian client to its international supplier are also tracked. If a match is discovered, the Brazilian client can be fined for working with a company that is hiring someone illegally. In the age of austerity measures and limited funds, local authorities are getting more sophisticated than ever about identifying tax opportunities.

Setting aside the risk of discovery by the tax authorities, the greater risk is what could happen should you part ways with a disgruntled contractor.

Suppose you decide to terminate your engagement with a contractor, and the negotiation does not go well. In that case, the more significant threat can be that the contractor decides to inform the authorities or sue the company directly for misclassification. The threat of action is often sufficient to elicit a significant payout to the contractor, which can run into the hundreds of thousands of dollars.

If such a case does go to the authorities, and they deem that the individual is an employee, here are some of the consequences you can expect:



It is the employer's responsibility to withhold and report income taxes in an employment relationship.

The employer is required to pay employer payroll taxes. If a tax assessment is made and your contractor is reclassified as an employee, the employee's fees are typically treated as net income. Employee income tax and the payroll tax are then assessed on top of that. The assessments can go back several years, including interest and penalties. Considering income tax rates of around 30 percent, and payroll taxes going from around 10 to 20 percent in Asia and up to 40 percent in some European countries, plus interest and penalties, the total assessment can be a substantial amount, with figures north of US\$250,000 not uncommon.



Terminating an employee is much more difficult than ending a relationship with a contractor.

In just about every jurisdiction other than the U.S., some form of notice period exists in labor law, severance pay may be required, and often an employer has to demonstrate a justified reason for terminating the employee. So, if the contractor is incorrectly classified, the individual could also claim unfair dismissal.



Worker misclassification can trigger potential corporate tax issues.

Once the tax authorities realize the company has improperly hired in-country, they may then assess that the company's activities have triggered Permanent Establishment or nexus and that they should have been following corporate law and paying local corporate taxes all along. Local tax authorities will document the legislation covering this in many jurisdictions.

The issue around classifying your workers is one of managing and understanding risk. How risk-tolerant is your company as plans are being made to hire contractors? Is it an early-stage startup, where the business case for having boots on the ground in a particular country is strong, and the decision is made to kick the can of contractor management down the road?

Or do you work for a public company with a policy that prohibits hiring contractors entirely? Does the reward outweigh the risk, or is it the other way around? These are the questions you'll need to answer as you consider your international hiring strategy.





Transitioning contractors to employees

As companies mature, there often comes the point where they decide that they must bring their contractor risk under control and hire these individuals as employees.

Contractors are often happy with the decision to switch to employee status because they receive some increase in benefits, even if that increase is through the payment of employer social security and other mandated benefits.

A full-time employment relationship also provides a level of job security that can increase engagement. There are greater protections in place for employees when companies make a commitment to hiring them full-time.

The bigger and more complex problem comes in setting an appropriate employee salary compared to the contractor fee. Contractors in transition tend to negotiate heavily for increased salaries because they may not have withheld taxes while they were contractors.

For those who did, self-employed taxes could result in a lower income tax bill. In any event, their net pay typically ends up lower as an employee than as a contractor – a situation that you will need to address with a fair amount of finesse. Striking a balance between too much and not enough is a delicate dance.

The best way to deal with the contractor to employee transition involves a detailed negotiation, including:

- Some small estimate of self-employed taxes.
- Additional benefits received as an employee.
- A general net-to-gross estimate to arrive at a new salary.



There is typically a tendency to overcompensate because you don't want to lose the valuable skills of workers who have proven their worth. Therefore, you will be tempted to agree to a final salary that is significantly more than the amount paid to a typical employee.

If your company is considering growing its operations in a particular country, this inflated salary can create challenging precedents for future hires. Plus, the extra employee salary and payroll tax cost may outweigh the apparent savings of those early days of hiring this individual as a contractor.

What are your options?

Hiring international workers doesn't have to be complicated, thanks to the Employer of Record (EOR).

An EOR helps companies get to market faster by offering a legal alternative to hiring directly. Your company can bypass entity setup, registration, and payroll tax deductions, plus the time and costs required to execute all of the above.

With compliant international entities already in place, an EOR takes care of payroll and meeting mandatory labor requirements. At the same time, your company manages and directs the individual on a day-to-day basis.

The employee receives local statutory benefits, is covered by all mandatory labor laws, and your company reduces its exposure to employment risk. Above all, an EOR reduces the exposure to worker misclassification risk and allows you to make a legal hire quickly.

If your company has decided that a contractor is better fitted for your needs, Globalization Partners can help you conduct a worker classification assessment and hire international contractors compliantly. In the future, as your company grows and the relationships with your contractors evolve, you can easily convert them to full-time employees, if required.

Through Globalization Partners, you can start and grow your international presence, with the added benefit of being able to hire both employees for your long-term growth and international contractors for short-term projects.

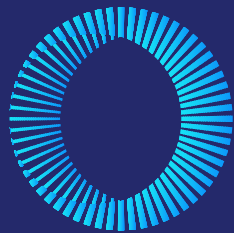


Hire anyone, anywhere – quickly and easily

Globalization Partners helps you scale your company in new regions without the burden of entity setup. You identify who you wish to hire, and we take on the risk and responsibility as the legal employer.

Not sure whether you want to hire a contractor or an employee?

We take you through a step-by-step assessment to guide you towards the compliant choice – the one that makes the most sense for your growing company.



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