



May 2009

## Employee Classification Issues For New Companies

There are several major issues facing all start-up companies relating to their workforce. This Newsletter shall provide a quick overview of three of these issues.

**Employee or Independent Contractor.** Many new companies want to classify their workers as independent contractors because they believe that having independent contractors will simplify payroll administration by not having to withhold federal and state income taxes and social security and medicare taxes, save money on employment related taxes, and that the worker will have less rights than an employee. However, it is important to understand that the courts and the Internal Revenue Service and Franchise Tax Board are not bound by the company's classification, and that there are substantial risks associated with a misclassification. These risks include tax penalties for failing to withhold taxes, and lawsuits by the worker for failure to pay overtime or provide employee health and welfare benefits. In an overall sense, the more control the company has over the day-to-day activities of the worker, the more likely the worker will be classified as an employee. If it is unclear as to whether a worker is an employee or an independent contractor, the company or the worker may file IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, and the IRS will review the facts and circumstances and officially determine the worker's status.

**Exempt or Non Exempt Employee.** New companies often try to classify their employees as "exempt" so that the company does not have to pay overtime compensation. However, merely labeling an employee as exempt or paying an employee a salary does not make the employee an exempt employee. In order to qualify as an exempt employee, the employee must qualify under the "executive" exemption, the "administrative" exemption, or the "computer-professional" exemption. These exemptions have both a duties requirement and a salary requirement. It is generally the duties requirement which is the issue for start-up companies. Under the executive exemption, the employee must spend more than one-half of his or her time in the management of the business and the employee must customarily direct the work of two or more other employees. In a new company with relatively few employees, not many employees will be covered by the executive exemption. Under the administrative exemption, the employee must primarily perform office work related to management policies or general business operations, must customarily exercise discretion and independent judgment, and must perform only under general supervision. Simply following established policies does not qualify. For new companies, not many office personnel will qualify. Failure to properly classify an employee may give rise to a claim for unpaid overtime, which may be made on behalf of all employees who have been incorrectly classified.

**At Will Employment.** New companies typically want their employees to be employed on an "at will" basis, meaning the company can terminate employment at any time with or without a reason. This allows a new company to make changes in its workforce without cost as circumstances demand. However, often, in order to attract a new employee, the company will provide for a specific term of employment in an offer letter or an employment agreement. This will negate the "at will" status of the employment relationship unless the offer letter or agreement specifically provides that the relationship is at will even though it has a specific term. The company also needs to avoid any oral promises that the employee will be employed by the company as long as he or she is doing a good job, which will prevent the company from being able to terminate employment without cause.

The classification of a worker as an employee or independent contractor, as exempt or non-exempt, and as "at will" or not "at will" has significant legal consequences, and a misclassification can result in substantial penalties and other consequences.

*This complimentary newsletter is intended to provide general information. Because of the complexities and constant changes in the law, it is important to seek professional advice before acting on any of the matters covered herein.*

**Citron & Deutsch is a boutique law firm whose practice includes entity and capital formation, management team building, employment issues, real estate matters, trademarks and copyrights, and succession and estate planning.**

**Please contact David R. Deutsch, Esq. for further information concerning matters in this Newsletter.**

**10866 Wilshire Blvd., Suite 970, Los Angeles, CA 90024 \* Tel 310-475-0321 \* Fax 310-475-1368 \* [www.candlaw.com](http://www.candlaw.com)**