

EMPLOYEE CLASSIFICATION: WHY IT MATTERS

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Introduction

Whether a sale of the business is imminent or not, Battery Ventures' portfolio companies should be thoughtful about how they classify workers.

Over the next ninety minutes, we will focus our attention on the following threshold questions, as well as the various and sometimes complex issues presented by worker classification.

- **Independent Contractor or Employee?**
- **If an Employee, Exempt or non-Exempt?**

Worker Classification: Employee or Independent Contractor?

- A person hired to perform services must be classified as an employee or an independent contractor.
- The U.S. Government Accountability Office found that businesses can save up to 30% of payroll costs classifying workers as independent contractors by avoiding unemployment insurance, workers' compensation, a variety of employment taxes, and the cost of withholding income taxes from paychecks. This has been labeled the "tax gap."

Employee or Independent Contractor?

- At the federal level, the applicable test generally is whether the contracting entity retains the right to control the manner in which work is performed.
- In some other states, like Massachusetts and California for example, tests are more stringent.
- Part-time temporary or even sporadic workers are not necessarily properly classified as independent contractors.

Employee or Independent Contractor?

- Mutually agreeing that a worker is an independent contractor, even in a written contract, is not determinative.
- Many state laws start with a “rebuttable presumption” that every worker is an employee.
- If a principal has the right to direct and control the manner and the means by which a worker performs work, he/she has likely been misclassified.

Worker Classification Crackdown

- Movement afoot at state and federal level to ferret out companies that misclassify workers as independent contractors.
- Recently enacted state laws, and joint task forces, pending federal legislation and the IRS Employment Taxes Audit (“tax gap”) initiative.
- Motivation is (1) to recapture lost tax revenue and (2) to level the playing field for businesses and (3) extend protections to entitled workers.

Consequences of Misclassifying Workers as Independent Contractors

- Misclassifying employees as independent contractors may subject an employer to:
 - IRS tax liabilities, including interest and penalties; these laws include damage multipliers plus interest and attorneys' fees.
 - Liability under the FLSA and state wage laws. (Damage multipliers, attorneys' fees.)
 - State unemployment and workers' compensation payment and premiums (and potential liability for workplace injuries).

Employee Classification: Exempt or Non-Exempt?

- Both federal and state laws require minimum wages and overtime to be paid to all “covered employees.” Covered employees are referred to as “non-exempt”; those not covered are referred to as “exempt.”
- Employers are also responsible for maintaining accurate time records for all non-exempt employees.
- If an employer fails to maintain time records in the mistaken belief that employees are exempt, the law will apply a “presumption” favoring the employees’ statements of the overtime worked.

Exempt or Non-Exempt?

- Exempt Employees. Most exemption issues concern whether employees are within one of the “white collar exemptions”: executive, administrative, professional or outside salesperson.
- Non-Exempt Employees. The law requires payment of minimum wage plus overtime wages at a rate of time and one-half the employee’s regular hourly rate for hours worked in excess of forty hours in one workweek.

White Collar Exemptions

- Executive
- Administrative
- Professional
- Computer employee
- Outside Sales

Minimum Salary Level

- Minimum salary level needed to qualify for the executive, administrative or professional exemptions is \$455/wk (\$23,660 per year)

The Salary Basis Test

General Rule:

- Employee must receive full salary for any week in which the employee performs any work;
- Not reduced because of variations in time worked or quality of work (no pay docking);
- Reducing vacation time or other paid leave is not a salary reduction.

Permissible Deductions

- Absence for One or More Full Days
 - Personal reasons
 - Sickness/disability if bona fide plan providing replacement income exists
 - Unpaid disciplinary suspension for violations of certain workplace conduct rules
- Good Faith Penalty for Infractions of Safety Rules of Major Significance
- Initial and Terminal Weeks of Employment
- Unpaid FMLA Leave

Examples of Impermissible Deductions

- Employer Occasioned Absence/Business Operating Requirements
 - Partial week shutdown
 - Business closed for inclement weather
 - Test: Is the employee “ready, willing, and able to work”?
- Jury Duty, Witness Court Appearance, Temporary Military Leave
 - Permissible to offset for payments received for service

Effect of Extra Pay on Salary Basis

- Extra Pay Based on Time Worked
 - Reasonable relationship between salary guarantee and total earnings
- Extra Pay Based on Commissions
 - No reasonable relationship required

Primary Duty

- Definition: “principal, main, major, or most important duty that the employee performs”
- Emphasis: “character of the employee’s job as a whole”
 - Amount of time: “useful guide” but not “sole test”
 - Relative importance of exempt duties
 - Freedom from direct supervision
 - Relative pay levels of nonexempt employees performing the same nonexempt work

Executive Employee Exemption

Elements:

- Primary duty is **management** of at least a department or subdivision;
- Customarily and regularly **directs the work of two or more full-time employees** (or equivalent); and
- Has **authority to hire or fire** other employees or recommendations are given particular weight

Administrative Employee Exemption

Elements:

- Primary duty is the performance of **office or non-manual work** directly related to the **management or general business operations** of the employer or the employer's customers
- Primary duty includes the **exercise of discretion and independent judgment** with respect to **matters of significance**

Professional Employee Exemption: Learned Professional

Elements:

- Primary duty must be the performance of work requiring **advanced knowledge**
- In a field of **science or learning**
- Customarily acquired by a prolonged course of **specialized intellectual instruction**

Creative Professional Exemption

Primary duty must be the performance of work requiring **invention, imagination, originality, or talent** in a recognized field of **artistic or creative endeavor**

Computer Employee Exemption

Elements:

- Salaried (\$455/week) or Hourly (\$27.63/hour)
- Systems analysts, programmers, or similar jobs with a primary duty of:
 - determining hardware, software, or system functional specifications;
 - designing, analyzing, or modifying computer systems or programs to satisfy design specifications;
 - designing or modifying programs for machine operating systems; or
 - a combination of these duties

Outside Sales Employee Exemption

Elements:

- Primary duty must be making sales or obtaining orders or contracts for services or for the use of facilities; and
- Customarily and regularly working away from the employer's place(s) of business

The Highly Compensated Test

- Total annual compensation \geq \$100,000
 - Includes salary, commissions, non-discretionary bonuses, but not board/lodging, fringe benefits
- Office or non-manual work
- Customarily and regularly perform at least one exempt duty
- Make-up payment & pro-rating permitted
 - One lump sum payment to reach \$100,000 level within one month
- Employer right to select measuring period; calendar year is default

Employee Misclassification: Litigation-Related Consequences

- Class actions on the rise
- Employee leverage at time of termination
- Proof of time worked in the absence of records
 - If employee shows uncompensated work and a basis for a reasonable inference (including estimates), burden shifts to employer to rebut
 - Alternative records
 - Contradictions in employee estimates
- Damages
 - Damages (2 or 3 years of back pay)
 - Damage multipliers
 - Interest
 - Attorneys' fees

Worker and Employee Misclassification: Transactional context

- Buyers look critically at classification issues
- Diligence focus
- Indemnification to protect against post-transaction claims by employees
- Purchase price may be affected
- May sour deal if faulty business model

Reducing Risk: Conducting a Classification Audit

- Identify problems
- Analyze compliance alternatives
- Communicate change
- Control costs through policy and workplace controls

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