Employment & labor issues (Part 2)

By Daniel A. Cotter | August 17, 2016

You have now reviewed the governing documents and have a good understanding of the company's mission and how it is organized. You can now turn to the staffing issues for your start-up.

LIMITED LIABILITY COMPANIES

Many start-ups are formed as limited liability companies ("LLCs"). Generally, the IRS and many state tax regulators consider members of LLCs to be investors and deem partners of LLCs to have no right to receive salaries for services provided by a partner in the official capacity of a partner. LLC members and partners are not considered employees by the IRS (See IRS Revenue Ruling 69-184 (members of partnership not treated as employees for tax purposes).) In limited circumstances, an LLC may pay a salary to members it classifies as employees if such employees are delegated very specific management functions.

You should review the members' and partners' employment status to make sure members and partners are treated in accordance with IRS guidance. (In May 2016, the IRS issued temporary regulations addressing self-employment tax treatment of partners in a partnership, available here, addressing employment treatment as well.) If you determine that the partners or members are being treated as employees when they should instead be treated as self-employed, you should discuss the situation internally and engage counsel or tax accounting advice if guidance is needed to sort through this complex area.

INDEPENDENT CONTRACTORS VS. EMPLOYEES

Your start-up may not have the funding to hire full-time workers, or may have decided to pay all personnel as independent contractors and report their payments on Form 1099. You will want to review the IRS guidance on the factors considered by the government in determining the status of a worker, contained in the IRS Publication 15-A-Employer's Supplemental Tax Guide available here.

In this publication and elsewhere, the IRS lists four categories of workers:

- independent contractors
- common-law employees
- statutory employees
- statutory nonemployees

In determining whether a worker is an independent contractor, the IRS and the United States Department of Labor (the "DOL") consider whether the organization has the right to control or direct the means and methods of accomplishing the result or only the right to control or direct the result of the work. If the latter, the person is likely to be considered an independent contractor. (For details on the factors the DOL considers, *see for example*, Fact Sheet #13: Am I an Employee?: Employment Relationship Under the Fair Labor Standards Act (FLSA), available here.)

In some instances, independent contractors are deemed by the IRS to be statutory employees. The examples in Publication 15-A include certain at home workers and certain sales people. You will need to carefully review how you have classified your workers and consider if they are properly categorized.

Recently, some local departments of labor and revenue regulators have addressed the issue of how certain start-ups/emerging companies are categorizing their workers. For example, in June

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2015, the California Labor Commissioner's Office issued a ruling in *Uber Technologies, Inc., A Delaware Corporation vs. Barbara Berwick, Case Number CGC-15-546378*, rejecting Uber's argument that its drivers were independent contractors, an argument that Uber successfully made in other jurisdictions. The Commissioner's Office addressed the various prongs of what constitutes an employee and found that Uber acted as an employer in many instances.

THE AFFORDABLE CARE ACT

To confuse this issue, the Affordable Care Act (the "ACA") requires employers with 50 or more "full-time equivalent workers" to offer health plans to employees who worked the minimum number of hours per week. The ACA does not explicitly define the terms "employer" or "employee," but through a series of statutory references, the definitions derive from those used in the Employee Retirement Income Security Act of 1974 ("ERISA"). Unfortunately, ERISA's definitions provide virtually no guidance. Justice David Souter, in *Nationwide Mutual Insurance Co. v. Darden*, 503 US 318, 323 (1992), stated for a unanimous Supreme Court:

ERISA's nominal definition of 'employee' as 'any individual employed by an employer,' 29 U.S.C. § 1002(6), is completely circular and explains nothing.

The *Darden* decision adopted a common-law test for determining who is an "employee" under ERISA:

> In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.
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> *Darden*, 503 U.S. at 323-24.

You should review this common-law test to determine whether and which of your workers may qualify for health benefits under the ACA, regardless of the classification you have assigned to your workers.

CONCLUSION

Your review of your employer's classifications and compensation practices will allow you to ensure that compensation and benefits are being treated appropriately and help avoid investigations by or disputes with departments of labor or revenue services. After your review, you may have matters to discuss with your management team.

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