

Workers Classified Right: Employees vs. Contractors

Misclassifying workers is one of the most common and costly mistakes small businesses make. This course breaks down the legal and tax distinctions between employees and independent contractors, helping you advise clients on proper classification, documentation, and compliance. With IRS scrutiny and state enforcement on the rise, getting this right matters more than ever. If you work with small to mid-sized businesses, this course gives you the tools to help clients avoid penalties and reduce exposure.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

[Start Course ↓](#)[Final Exam Copy ↓](#)

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the legal requirements for hiring and firing employees.

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

This course and test have been adapted from supplemental materials utilizing the partial text of Legal Guide for Starting and Running a Small Business, 19th Edition © 2026 by the Editors of Nolo. All rights reserved. Reprinted with permission from Nolo, which owns the copyrights.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Publication Date: January 2026

TABLE OF CONTENTS

CHAPTER

01

Employees And Independent Contractors 4

1.01 Hiring Employees 4

1.02 Job Applications..... 11

1.03 Background Checks 18

1.04 Wages And Hours 25

1.05 Termination Of Employment 32

1.06 Employers' Health Care Insurance Requirements Under Obamacare. 47

Test Your Knowledge..... 49

Final Exam Copy..... 65

Glossary..... 57

Index

Chapter 1: EMPLOYEES AND INDEPENDENT CONTRACTORS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the legal requirements for hiring and firing employees.

Many small businesses start as solo acts, with the business owner playing every role from executive decision maker to receptionist. At some point, however, you might need some help. You might be looking for temporary seasonal help (for example, someone to package and send your specialty food products during the holidays), expert assistance (a web designer to set up your website, for example), or even a team of employees (a sales force to make your product known to the world).

Other small businesses—such as new stores or restaurants—have employees right from the start. In fact, these businesses might have to hire a large group of employees before they can open their doors to the public.

No matter which group you fall into, you need to know the rules that govern how you treat employees and contractors. Employment is a very heavily regulated field, with numerous federal, state, and even local laws coming into play. This chapter provides basic information on your obligations when you become an employer. It also explains the rules relating to independent contractors, including how to avoid costly misclassification mistakes.

Resource

For an in-depth treatment of your legal obligations. For links to state and regional Department of Labor programs and information on state labor laws, including minimum wage, see the U.S. Department of Labor website at www.dol.gov.

HIRING EMPLOYEES

You can steer clear of legal peril when hiring employees by following the guidelines outlined below.

Avoid Illegal Discrimination

Federal and state laws prohibit all but the smallest employers from discriminating against an applicant or employee because of race, color, gender, religion, national origin, disability, citizenship status, or age (if the person is 40 years old or older). Also, many states and cities have laws

prohibiting employment discrimination based on marital status, sexual orientation, gender identity, and a variety of other characteristics.

But antidiscrimination laws don't dictate whom you must hire. You remain free to hire, promote, discipline, and fire employees and to set their salaries based on their skills, experience, performance, and reliability.

Some illegal practices should be obvious, such as advertising a job for people ages 20 to 30 only—which on its face violates age discrimination laws—or paying lower wages to women than men for the same work in violation of equal pay laws. But antidiscrimination laws also can bar employment practices that seem innocent but end up having a disproportionate and discriminatory impact on certain groups. For example, if you automatically disqualify any applicant who doesn't have a college degree, that might have a disproportionate impact on certain racial groups (depending on the demographics of the region where you do business). Unless it's a business necessity for employees to hold a degree, this type of requirement could be discriminatory.

To avoid violating antidiscrimination laws at the hiring stage:

- Advertise job openings in a variety of places so they come to the attention of diverse people.
- Determine the skills, education, and other attributes that are truly necessary to perform the job so that you don't impose requirements that unnecessarily exclude capable applicants. Avoid screening techniques that have an unfair impact on any group of applicants.

Respect the Applicant's Privacy Rights

Though it's wise to screen potential employees, a potential problem arises when mounting intensive background checks. Your attempt to assess applicants by gathering information about their past can conflict with their right to privacy. Before you send for high school or college transcripts and credit reports, you must obtain the applicant's written consent. If the applicant won't consent, you're free to drop that person from further consideration, as long as you follow that policy with all applicants.

Don't Promise Job Security

Most employees in the United States work "at will." This means that they are free to quit at any time, for any reason, and that you are free to fire them at any time, for any reason that isn't illegal. It's illegal to fire even an at-will employee for discriminatory reasons, in retaliation for complaining of a workplace safety violation, or in violation of public policy, for example.

At-will employment gives you a lot of leeway to make personnel decisions that you feel are right for your business. However, you can unwittingly lose the right to fire at will if you promise an employee or applicant job security, whether in an employee handbook, other written documents (such as an

offer letter or application for employment), or even a conversation or job interview. Promises like these could create an employment contract that limits your right to fire.

Employment at will is the “default” relationship between employer and employee, but it can be changed by contract. For example, let’s say you need to hire someone to sell your company’s software. You’re looking for a top-notch salesperson who already has an extensive network of potential clients, is willing to travel extensively, and can understand and demonstrate the software’s technical features. To land the right applicant, you might well have to offer a written contract promising that the person won’t be fired for a set period of time—a year or two, for example—absent serious misconduct. You might even propose this type of contract yourself, to make sure that the employee doesn’t quit right away, after you spend significant time and money on training.

Not all employment contracts are in writing, however. If you tell an employee, “I won’t fire you as long as you’re doing a good job,” or “I like to give new employees at least a year to get up to speed,” a court could interpret that as a contract that limits your right to fire at will. Statements like these are especially common in the hiring process when employers are trying to sell strong applicants on the benefits of working for their company. To avoid problems, don’t make any assurances or promises about job security. Make sure your application forms and offer letters clearly state that employment is at will, and have the applicant sign an acknowledgment to that effect.

Prevent Negligent Hiring Claims

You have a legal duty to protect your customers, clients, visitors, and the general public from injuries caused by employees who might harm others. When you hire someone for a position that might expose customers or others to danger, you must use special care in checking references and making other background checks. If someone gets hurt or has property stolen or damaged by an employee whose background you didn’t check carefully, you might face a lawsuit for negligent hiring.

Be especially vigilant when hiring maintenance workers, delivery drivers, and others whose jobs give them easy access to homes and apartments.

If you hire people for sensitive jobs, investigate their backgrounds as thoroughly as possible and look for any criminal convictions. Make sure any employee who will be driving is currently licensed and has a decent driving record. And where state laws require an occupational license—for asbestos removal, for example, or tending bar—check to see that the applicant is properly licensed.

Contact previous employers. Insist that the applicant explain any gaps in employment history. Consider turning over the prehire investigation to professionals with experience in screening job applicants.

Protect Against Unfair Competition

Employees sometimes leave to start a competing business or go to work for a competitor. Obviously, you needn't be too concerned about the employee you hire to scoop ice cream or the clerk you hire to work behind the counter at your dry cleaning shop. But employees who have access to inside information about product pricing or business expansion plans, for example, might pose competitive risks. The same goes for employees who handle valuable and hard-won customers—a salesperson, perhaps, who handles a \$200,000 account.

Consider asking new hires to sign agreements not to take or disclose trade secrets or other confidential information. Also, you might ask selected employees to sign covenants not to compete with your business.

Trade Secrets

Some business owners need to protect their unique assets from misuse—assets such as:

- A restaurant's recipe for a special salad dressing
- A heating and cooling company's list of 500 customers for whom it regularly provides maintenance, or
- A computer company's unique process for speedily assembling computer boards.

If they are treated as such, the recipe, customer list, and assembly process are all “trade secrets.” Other examples are an unpatented invention, engineering techniques, cost data, a formula, or a machine. To qualify for trade secret protection, the business information you seek to protect must meet two requirements.

The information must truly be secret. The information must not be freely available from other sources. If the recipe for a restaurant's award-winning custard tart can be found in a standard American cookbook or recreated by a competent chef, it isn't a trade secret. On the other hand, if the restaurant's chef found the recipe in a medieval French cookbook in a provincial museum, translated it, and figured out how to adapt it to currently available ingredients, it probably would be considered obscure enough to receive trade secret protection.

You must have protected the secrecy. You must show that you've taken steps to keep the information secret—for example, by:

- Keeping it in a secure place such as a locked cabinet
- Giving employees access to it on a need-to-know basis, and
- Having employees acknowledge in writing that the information is a trade secret.

Example

Sue works at Speedy Copy Shop. She has daily access to the list of larger accounts that are regularly billed more than \$2,000 per month. She quits to open her own shop. Before she does, she copies the list of major accounts. One of her first steps in getting her new business going is to try to get their business away from her former employer. Speedy sues Sue for infringing on its trade secret. At trial, Speedy shows that it keeps the list in a secure place, permits access only to selected employees who need the information, and has all employees—including Sue—sign nondisclosure agreements. In light of these precautions, the judge orders Sue not to contact the customers on the list and requires her to compensate Speedy for any profits she's already earned on those accounts.

Covenants Not to Compete

It's always disappointing and often quite costly when a high-level employee leaves your business and begins competing with you—especially if you've trained the employee and shared valuable inside information. Consider having high-level employees sign a covenant not to compete. In a typical covenant, the employee agrees not to start or work for a business that competes with yours for a specific time and within a specific distance from your established business.

The best time to secure a covenant not to compete is when you hire an employee. An employee who is already on the payroll might be more reluctant to sign anything—and you'll have less leverage to negotiate the agreement.

Battles over the legality of these agreements must usually be resolved in court. Judges are reluctant to deprive people of their right to earn a living, so the key to a legally enforceable covenant not to compete is to make its terms reasonable. Focus on three questions:

- **Is there a legitimate business reason for restricting the particular employee?** There probably is if you expect to spend significant time and money training a high-level employee and plan to trust that person with sensitive contacts or lucrative accounts.
- **Is the covenant reasonably limited in time?** Courts tend to favor short covenants—the shorter the better. A one-year covenant might be reasonable for a particular employee. A three-year limit might not be.
- **Is the covenant reasonably limited as to geographical scope?** For a local business, a 50-mile limit or one that excludes competition in a few counties might be reasonable. For a regional business, a limit spanning several states might be deemed reasonable.

Example

When Mariah hires Sydney to be the office manager for her profitable travel agency, she realizes that Sydney will have access to major corporate accounts and daily contact with the corporate managers who make travel arrangements. Mariah also knows that she'll spend considerable time in training Sydney and invest more than \$4,000 in specialized seminars that she'll require Sydney to attend. She has Sydney sign a covenant not to compete, in which Sydney promises that while working for Mariah and for two years afterward, she won't work for or own a travel agency within 50 miles of Mariah's agency. After six months, Sydney quits and starts a competing agency one mile from Mariah's. The judge enforces the covenant not to compete by issuing an injunction forbidding Sydney from operating her new business and by awarding damages to Mariah as well.

Caution!

Not all states honor noncompete agreements. Noncompete agreements can be difficult—or impossible—to enforce. In California, for example, courts virtually never enforce noncompete agreements, and other states enforce them only in very limited circumstances—for example, to protect an employer's trade secrets. Even in the states where they are enforced, it can be hard to overcome a judge's reluctance to interfere with an employee's ability to earn a living. One way to avoid this problem is to ask employees to sign a nonsolicitation agreement and nondisclosure agreement instead. Courts are more willing to enforce these agreements, which prevent former employees from taking your employees or using your company's confidential information. With these protections in place, you don't lose much by not having a noncompete agreement.

JOB DESCRIPTIONS

Write a job description for each position you're seeking to fill. Listing the skills and qualifications you're looking for in applicants will make the hiring process more objective. It will also give you ready standards to measure whether applicants are qualified—and which ones are most qualified—for the position.

A well-drafted job description should include:

- A summary, which briefly describes the most important aspects of the job
- A list of job functions, which provides a detailed description of duties
- A requirements section, which lists any education, certifications, licenses, and experience necessary to do the job, and
- A section for other information, where you can provide any other facts job applicants should know (for example, that the job has odd working hours or requires travel).

When you come up with your list of job functions, think carefully about whether each is essential to the job. The Americans with Disabilities Act (ADA) prohibits discrimination against applicants with disabilities, as long as they can perform the job's essential functions with or without a reasonable accommodation. This provision is intended to make sure people aren't excluded from a job simply because they can't perform some of the marginal duties associated with that position. For example, a receptionist who spends the day answering phones and greeting visitors at a front desk might also replace the large water bottles in the waiting room's machine when they're empty. But this probably isn't an essential function of the position: It takes only a couple of minutes a week, could easily be handled by someone else, and could well screen out applicants with disabilities.

JOB ADVERTISEMENTS

After you write a job description, summarize it in a job advertisement. Be careful because nuances in an ad can be used as evidence of discrimination against applicants of a particular gender, age, or marital status.

There are a number of semantic pitfalls to avoid in job ads.

Don't Use	Use
Salesman	Salesperson
College Student	Part-Time Worker
Handyman	General Repair Person
Gal Friday	Office Manager
Married Couple	Two-Person Job
Counter Girl	Retail Clerk
Waiter	Waitstaff
Young	Energetic

In any ad, stick to the job skills needed and the basic responsibilities. Some examples:

- “Fifty-unit apartment complex seeks experienced manager with general maintenance skills.”
- “Midsized manufacturing company has opening for accountant with tax experience to oversee interstate accounts.”
- “Cook trainee position available in new vegetarian restaurant. Flexible hours.”