July 22, 2015

On July 15, 2015, the Wage and Hour Division of the Department of Labor (the "DOL") issued a fifteen-page "Administrator's Interpretation" (the "Interpretation") on the appropriate classification of workers as employees and independent contractors under the Fair Labor Standards Act (the "FLSA"). The DOL claims that the Interpretation merely provides new guidance but does not change DOL policy (which would require official regulatory action). The Interpretation notes that improper classification of employees as independent contractors divests workers of overtime compensation, unemployment insurance, and workers' compensation coverage, and results in lower tax revenue.

The DOL uses the "economic realities" test to determine employee or contractor status. The economic realities test focuses on whether the worker is economically dependent on the employer or truly in business for himself or herself. The Interpretation concludes that a worker who is economically dependent on the employer is "suffered or permitted to work" according to the FLSA's definition of "employ"—even if the employer does not "control" the worker. The Interpretation acknowledges that the economic realities test results in *most* workers being classified as employees under the FLSA, but submits that the FLSA was intended to be liberally construed and provide broad coverage to workers.

The factors to be analyzed as part of the economic realities test are:

1. How integral is the work to the employer's business? (The work can be "integral" even if it is just integral to one component of the business and even if the worker's role is shared with many others,)
2. Does the worker have opportunity for profit or loss depending on his or her *managerial* skill (such as in hiring employees and purchasing supplies), rather than merely on his or her ability to take on additional work?
3. What is the relative investment of the worker and employer? (The focus is on whether the worker has invested in a *business*, not just in tools to do his or her work);
4. Does the work require special skills? (The focus is on managerial and business skills, not just skills in the trade);
5. How permanent is the relationship?
6. What degree of control is retained by the employer?

The factors are weighed and no single factor—including the "control" factor—is dispositive. The Interpretation downplays the "control" aspect, which is pivotal to the common law "control test" referenced in the Interpretation. The Interpretation states that the control factor should not overtake the other factors and all factors should be analyzed in the context of ultimately determining whether the worker is economically dependent on the employer or an independent business.

Note that the Internal Revenue Service (the "IRS") uses a different test for determining employee/independent contractor status. Until recently, the IRS used a 20-factor test, with the central focus being the control exerted over the worker. The IRS recently simplified its analysis to focus on 11 factors with the majority of the test focused on behavioral control (where, when, and how to do the work) and financial control (how business expenses, equipment, and payments are handled).

Although the DOL and IRS tests contain some overlapping factors, the tests will be reviewed through different lenses. The DOL will be reviewing the factors in light of the economic dependency of the worker, while the IRS will be reviewing the factors with a focus on the control exerted over the worker. It is plausible that these tests will lead to different conclusions on how various workers should be classified. The standards used to determine worker classification will also be different under various state laws. For example, determining whether a worker is an employee for unemployment tax and benefit purposes, and workers' compensation benefits, all issues governed under state law, will in some states be carried out under a different standard than DOL's, and could lead to a different result for those purposes.

Action steps for employers

The Interpretation sends a clear message that the DOL considers misclassification a significant problem.

Employers should anticipate increased scrutiny of worker classification and a focus on independent contractors in DOL audits of all types. To avoid liability employers should:

- Review the status and duties of all consultants/independent contractors to determine whether any of them should be classified as employees;
- Correct any potential misclassification going forward (note that in almost all cases it is safer to classify workers as employees —including as part time and temporary employees);
- Review independent contractor/consulting agreements to ensure they are drafted to maximize the likelihood that an auditor will view the relationship as an independent contractor relationship based on reading the agreement;
- Consult counsel regarding any difficult issues and regarding how to engage in the reclassification process if required.

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