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Retirement Spotlight

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# Department of Labor Changes "Employee vs. Contractor" Rule

The Department of Labor's Wage and Hour Division has once again released guidance on the definition of "employee." This October 2022 guidance, in the form of proposed regulations, applies primarily to determinations under the Fair Labor Standards Act (FLSA), but may help in other contexts, such as in determining whether a worker should be covered by a retirement or health plan. Although the new rules are not radically different from previous regulations, there are some important changes.

## Background

The guidance on whether a worker is an employee has developed over many years. The main purpose of the FLSA—passed in 1938—was to ensure that workers were fairly compensated. Nonexempt workers, for example, must receive the federal minimum wage and must be paid "time-and-a-half" for working more than 40 hours in a week. Of course, workers who are not considered *employees* cannot rely on this wage requirement.

**Pros and cons of worker classification.** Some employers have categorized workers as independent contractors to avoid certain expenses, such as overtime pay or workers compensation coverage. This tactic has led some to suggest expanding the definition of employee. Others, however, point to some benefits of allowing a freer hand to classify workers as contractors. For example, individuals might be more inclined to start and grow businesses if they were freed from some of the constraints that come with having employees. So a variety of competing interests have required the DOL to try to take a balanced approach toward defining who is an employee.

**The DOL's definition reversal.** The preamble to these new proposed regulations contains a detailed history of the federal definition of "employee". Over the past 70-plus years, there has been a wealth of material interpreting this term. Part of the complexity of this topic stems from the context in which "employee" is used. For instance, sometimes it is used in the context of the FLSA; but sometimes the term must be defined using the common law (such as where no clear statutory or regulatory definition exists). Over the years, various courts—including the U.S. Supreme Court—have addressed the term's meaning in different contexts and in numerous cases.

More recently, the DOL has wrestled with its own interpretation of the term. On January 7, 2021, the DOL published a final rule entitled "Independent Contractor Status Under the Fair Labor Standards Act." This "2021 IC Rule" attempted to address, among other things, a lack of focus in the multifactor balancing test, which we discuss below. This final rule was set to become effective on March 8, 2021. But in February 2021, the DOL proposed delaying the effective date based on numerous public comments and (presumably) on a change in the executive branch. Ultimately, despite procedural hurdles and a federal lawsuit, the DOL withdrew the 2021 IC Rule, stating that it would have had a

"confusing and disruptive effect" on workers and businesses alike because of its departure from longstanding judicial precedent. So the current proposed rule is the latest DOL attempt at clarifying the definition of "employee," while giving deference to well-established law.

## Overarching Framework

To better understand the importance of the DOL's reversal, it may help to point out some concepts that have been used for years in determining whether a worker should be considered an employee. Two concepts are particularly important. First, this question must be asked about workers: are they "economically dependent" on the business, or are they in business for themselves—as a matter of "economic reality"? Second, the worker's status must be determined using a totality-of-the-circumstances analysis. In other words, whether a worker is an employee or an independent contractor is not based on a simple formula. Multiple factors must be considered.

## The Multiple Factors Test

Text from the proposed regulation may help point out the importance of a sometimes fact-intensive analysis:

> §795.110 **Economic reality test to determine economic dependence.**
>
> (a) *Economic reality test.* (1) In order to determine economic dependence, multiple factors assessing the economic realities of the working relationship are used. These factors are tools or guides to conduct a totality-of-the-circumstances analysis. This means that the outcome of the analysis does not depend on isolated factors but rather upon the circumstances of the whole activity to answer the question of whether the worker is economically dependent of the employer for work or is in business for themself.

The proposed regulations next list the six economic reality factors that must be considered:

1) Opportunity for profit or loss depending on managerial skill
2) Investments by the worker and the employer
3) Degree of permanence of the work relationship
4) Nature and degree of control
5) Extent to which the work performed is an integral part of the employer's business
6) Skill and initiative

The text emphasizes that no one factor is necessarily dispositive, and that the weight each factor bears may depend on the facts and circumstances of the particular case. These six factors are also not exhaustive; additional factors may be considered.

**The 2021 IC Rule disrupted the longstanding rule.** The DOL's intention in the 2021 IC Rule was "to clarify the existing standard, not to radically transform it." Yet this prior rule elevated two of the factors above—degree of control an individual has over his or her work and the opportunity for individual profit or loss—as "core factors." The DOL asserted that the two core factors had "greater probative value" in determining a worker's economic dependence. So if both of these factors pointed toward either employee status or independent contractor status, the other factors may not need to be considered. Only if the two factors pointed in different directions would the other factors normally come into play.

**The new proposed regulations revert to the previous rule.** In rejecting its own earlier rule, the DOL now states that "[u]pon further review of judicial precedent, the Department is not aware of any court that has, as a general and fixed rule, elevated any one economic reality factor or subset of factors above others, and there is no statutory basis for such a predetermined weighting of the factors." In fact, the Supreme Court has stressed that employment status under the economic reality test turns on "the circumstances of the whole activity," rather than on "isolated factors." So despite its attempt to "clarify" the analysis in the 2021 IC Rule, the DOL now believes that restoring the original rule reflects legal precedent and the intention of the FLSA statute.

## Practical Effects

The FLSA "employee" definition is designed to prevent misclassification of workers, particularly when this affects compensation that is paid to workers. The DOL's current view is that the 2021 IC Rule could have led to *more* misclassification. In practice, the two different rules might not lead to different conclusions. But the new proposed rule at least returns to well-established practice and legal precedence.

This FLSA definition also applies to the Family and Medical Leave Act, the Age Discrimination in Employment Act, and the Americans with Disabilities Act. So employers and practitioners alike may need to become familiar with this rule when it becomes final.

But different standards may apply for determining “employee” versus “independent contractor” status in different contexts or under other laws. For retirement plans and other employee benefit plans covered by ERISA Title I, the term “employee” is defined as “any individual employed by the employer.” And because ERISA uses this circular definition, the practical definition for ERISA purposes has been determined by the courts. Still, courts may rely on well-reasoned and highly vetted regulations, such as the new proposed FLSA rule, to inform their analyses when crafting common law rulings.

## Stay Tuned

Determining whether a worker is an employee or an independent contractor is an important task for businesses and workers. It may mean the difference between getting paid for overtime work or not. It may dictate whether individuals may establish retirement plans for themselves. And it may affect the fundamental decision to start a business of one’s own. These new regulations may help businesses of all kinds better understand the factors that help classify workers as employees or independent contractors. Ascensus intends to review any changes to the rules once the final regulations are released. Visit ascensus.com for the latest developments.