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July 23, 2015

Department of Labor Says Most Workers Are Employees Under FLSA: Ultimate Test Is Economic Dependence

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On July 15, 2015, the Wage and Hour Division of the U.S. Department of Labor (DOL) issued Administrator's Interpretation No. 2015-1, adopting a very expansive interpretation of the definition of employees under the Fair Labor Standards Act (FLSA) under which many workers currently treated as independent contractors will need to be reclassified as employees. The Administrator's Interpretation identifies the issue of a worker's economic dependence as the most important factor in distinguishing between independent contractors and employees. The Administrator's Interpretation puts employers on notice that "the FLSA covers workers of an employer even if the employer does not exercise the requisite control over the workers, assuming the workers are economically dependent on the employer."

The DOL's test has as its foundation the FLSA's broad definition of "employ" as "to suffer or permit to work." The Administrator's Interpretation relies on a 1985 Supreme Court case, *Tony & Susan Alamo Found. v. Sec'y of Labor*, which articulated an "economic realities" test for employment under the FLSA. Although that case dealt with putative volunteers rather than independent contractors, the Administrator's Interpretation identifies the issue of a worker's economic dependence as the most important factor in distinguishing between independent contractors and employees. In rejecting the "common law control test" for independent contractors, the Administrator's Interpretation cites a series of judicial decisions that use a multi-factor "economic realities test" to determine whether a worker is in business for himself or herself or is economically dependent on the employer. According to the DOL, most workers will be employees under the "economic realities" test. In assessing a worker's status, employers should consider several factors, which include:

- The extent to which the work performed is an integral part of the employer's business;
- The worker's opportunity for profit or loss depending on his or her managerial skill;
- The extent of the relative investments of the employer and the worker;
- Whether the work performed requires special skills and initiative;
- The permanency of the relationship; and
- The degree of control exercised or retained by the employer.

The Administrator's Interpretation warns that no single factor is determinative, and no one factor—particularly the "control" factor—should be given undue weight. Moreover, the factors should not be applied mechanically or in a vacuum by tallying them up, but should be applied with an understanding that they are indicators of the broader concept of economic dependence. What matters is not the label the employer or worker gives the relationship, but the economic realities of the relationship. The DOL also acknowledged that courts may consider additional factors depending on the circumstances of the individual case. The factors are merely "tools" to aid in the assessment: "it is dependence that indicates employee status." Thus, individuals labeled independent contractors who work exclusively in support of a single customer for an extensive period will likely be deemed misclassified under this test and should instead be hired as employees of the business they support.

Integral Part of the Business

The Administrator's Interpretation explained that if work performed by a worker is integral to the employer's business, it is more likely that the worker is economically dependent on the employer. A true independent contractor's work, on the other hand, is unlikely to be integral to the employer's business. The DOL noted that work can be integral to the business even if the work is just one component of the business and/or the work is performed by hundreds or thousands of workers. Work can also be integral to the business if it is performed away from the employer's premises, at the worker's home, or on the premises of the employer's customers. As an example, the Administrator's Interpretation suggests that a software developer who develops customized software for a home construction company might be more easily classified as an independent contractor than a carpenter working for the same company.

Employers should thus be cautious of classifying workers that are integral to their businesses as independent contractors, even if those workers are integral to just a small part of the employer's business and even if those workers are given the freedom to work from home or offsite.

Worker's Opportunity for Profit or Loss

The Administrator's Interpretation also explained that the focus in determining whether a worker has an opportunity for profit or loss should be on how the worker's managerial skills affect that opportunity. Thus, decisions about hiring others, purchasing materials and equipment, advertising, renting space, and managing timetables are examples of managerial skill that can affect profit and loss. By contrast, a worker's decision to work more hours or take on more work "do[es] little to separate employees from independent contractors—both of whom are likely to earn more if they work more and if there is more work available."

Based on this factor, businesses increase the risk of misclassification claims if they enter into independent contractor agreements with individuals in which the compensation is tied to the hours worked or the amount of work they take on, or if the business restricts the putative independent contractor from using assistants to perform the work. Rather, businesses would be prudent to compensate independent contractors based on defined project completion milestones, leaving it to the independent contractor to make decisions affecting how efficiently or profitably he or she completes the deliverables.

Extent of Relative Investments

The Administrator's Interpretation also explained that the nature and extent of the relative investments of the employer and the worker should be considered in determining whether the worker is an independent contractor or an employee. A worker with no investment in the business or a relatively minor investment compared with the employer, such as an investment in tools and equipment, suggests that the worker may be economically dependent on the employer. Rather, the worker's investment must be "significant in nature and magnitude relative to the employer's investment in its overall business" to indicate independent contractor status. Moreover, the comparison should be to the employer's investment as a whole, not just to the employer's investment in the particular job performed by the worker or to only a piece of the employer's business. An investment that furthers the independent contractor's capacity to expand his or her business (e.g., investing in marketing and advertising), reduces his or her cost structure (e.g., purchasing bulk supplies or inventory), or extends the reach of the independent contractor's market (e.g., obtaining a vehicle suitable only for work use) can satisfy this factor.

Employers should thus be cautious of providing independent contractors with supplies, equipment or administrative support, as that could lead to a determination that the individual's investment in his or her business is negligible compared to the employer's. As part of their due diligence in determining how to classify a worker, employers may wish to require that any individual that requests to be paid as an independent contractor demonstrate some of the investments that the individual has made in establishing his or her own business.

Special Skills and Initiative Required

As explained in the Administrator's Interpretation, a worker's business skill, judgment, and initiative—rather than his or her technical skills—aids in determining whether a worker is economically dependent, but a specialized skill set is insufficient to classify a worker as an independent contractor rather than an employee. Rather, the focus for this factor should be on whether the worker exercises "business skills, judgment, or initiative." In other words, an individual who provides skilled labor in accordance with the instructions of an employer is more likely to be an employee.

Permanency of the Relationship

Under the test articulated in the Administrator's Interpretation, permanency or indefiniteness in a worker's relationship with the employer suggests that the worker is an employee. However, a lack of permanence or indefiniteness does not automatically suggest an independent contractor relationship, and the reason for the lack of permanence or indefiniteness should be carefully examined. Working for other employers or not relying on the employer as a primary source of income does not necessarily make the worker an independent contractor. If the lack of permanence or indefiniteness is due to "operational characteristics intrinsic to the industry," such as employers whose work is seasonal or who hire part-time workers or use staffing agencies, the worker is more likely to be an employee. However, if the worker's lack of

permanence or indefiniteness is due to the worker's "own business initiative," the worker is more likely to be an independent contractor.

Employers should thus be cautious of classifying long-term, full-time workers as independent contractors, even if the parties have entered into an independent contractor agreement. Employers should also be wary of classifying seasonal or temporary employees as independent contractors unless the worker's own business initiative controls when, where, and the rate at which he or she works.

Control Exercised or Retained by Employer

Finally, the Administrator's Interpretation explains that, as with the other economic realities factors, the employer's control over the work should be analyzed in light of the ultimate determination whether the worker is economically dependent on the employer or truly an independent contractor. To be an independent contractor, the worker must control meaningful aspects of the work and actually exercise that control. A lack of supervision is not particularly telling if the worker works from home or offsite. Similarly, an employer's lack of control over hours or a worker's flexible schedule is not necessarily indicative of independent contractor status. An employer's control over workers' schedules, dress and tasks are all indicative that the worker is an employee. The DOL cautioned, however, that the "control" factor should not play an oversized role in the analysis.

Employers should give up as much control as possible over the means by which independent contractors produce the agreed deliverables or work product but should also not rely solely on a lack of control or supervision over the worker to support independent contractor status. Rather, they need to examine whether even fairly self-directing workers are in fact economically dependent on the business.

Risks of Misclassification

Many employers have used the eleven-factor test that the Internal Revenue Service issues (in IRS Publication 15-A) to determine independent contractor status. Those eleven factors fall into three main categories: (i) control over the worker's conduct; (ii) control over the financial aspects of the worker's job; and (iii) other indicators of the nature of the working relationship. The Administrator's Interpretation does not change or supersede the IRS eleven-factor test because the DOL issued it as an interpretation of the FLSA's definition of employee, not of tax regulations. To the extent, however, that employers used the IRS test as a broadly applicable standard for distinguishing between employees and independent contractors, the IRS test can no longer serve that purpose. Now, employers will need to ensure that they have also evaluated each independent contractor position under the economic dependency standard, or they risk liability for a misclassification claim.

It is increasingly important for businesses to err on the side of caution in making classification determinations, as there can be substantial penalties for misclassifying employees as independent contractors. Intentionally or willfully misclassifying an employee as an independent contractor can result in liability by the employer for the full amount of income tax that should have been withheld (with an adjustment if the employee has paid or does pay part of the tax); the full amount of both the employer and employee shares for FICA (perhaps with an offset if the employee paid FICA self-employment taxes); and interest and penalties, computed on far larger amounts than in the case of an unintentional misclassification. In addition to back taxes, criminal and civil penalties may be issued.

Even for unintentional misclassification, the penalties can be large. Employers will be held responsible for payment of the employee's federal income tax withholding up to a cap of 1.5% of the employee's wages,

plus back FICA taxes (the full employer's share plus 20% of the employee's share), plus back unemployment taxes. If an employer has not filed information returns that were required, such as the Form 1099, the percentage amounts are doubled.

The employer can also be liable to the misclassified worker for back overtime for a two-year period (or for three years, if the misclassification is deemed willful), for the value of employee benefits denied to the worker, and for liquidated damages under the FLSA. Successful plaintiffs can recover their attorneys' fees. Significantly, the FLSA allows for individual liability for managers or executives who make compensation or classification decisions.

Challenges to independent contractor classification can arise from a number of sources, making the practical risk of liability from misclassification higher. Because the federal and state governments lose tax revenue and contributions to unemployment insurance when an employer misclassifies a worker as an independent contractor, a company can be subject to routine audits of its classification practices. Such audits are also prompted when a putative independent contractor files a claim for unemployment benefits after the end of a work assignment. In addition, the worker personally may bring a claim seeking the value of employee benefits or back overtime wages that he or she was denied because of misclassification as an independent contractor.

The Administrator's Interpretation sends a clear signal to employers to proceed carefully and conservatively before they agree to classify an individual worker as an independent contractor instead of as an employee. All employers would be well-advised to review their existing independent contractor agreements now and to consult with legal counsel before continuing any independent contractor relationships or entering into new independent contractor agreements—unless there is strong evidence that the independent contractor does not have a relationship of economic dependence with the employer.

If you have any questions about the content of this alert please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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