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U.S. Department of Labor Unveils Final Rule on Determining Independent Contractor Status

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Practices: Employment, Labor & Benefits

Executive Summary

- On January 9, 2024, the United States Department of Labor (the "DOL") released its long-awaited final rule (the "Final Rule") concerning when employers can classify workers as independent contractors rather than employees under federal law. This is the final version of the Employee or Independent Contractor Classification Under the Fair Labor Standards Act (FLSA), which the DOL proposed in October 2022.
- The Final Rule establishes a six-factor test for determining whether a worker is an employee or an independent contractor.
- The Final Rule differs significantly from prior DOL guidance and its rule governing independent contractors issued in 2021.
- The Final Rule was published in the Federal Register on January 10, 2024, and takes effect March 11, 2024.

RESCINDED 2021 INDEPENDENT CONTRACTOR RULE

The DOL issued the prior iteration of the worker classification rule in January 2021. The rule, entitled "Independent Contractor Status Under the Fair Labor Standards Act," endorsed an "economic realities" test to determine the nature of a worker's relationship with a business. That rule pointed to a list of non-exhaustive factors to be considered but sought to streamline the analysis by focusing on two "core factors" in the worker classification analysis: (1) the nature and degree of control over the work; and (2) the worker's opportunity for profit or loss. This was largely viewed as a business-friendly approach to the independent contractor standard.

THE FINAL RULE

As we previously reported, when the DOL issued its October 2022 proposed rule, it sought to repeal the 2021 rule and return to the six-factor analysis that examines the totality of the circumstances of the working relationship, presumably making it more challenging to classify workers as independent contractors. The Final Rule achieves this purpose with only minor variations from the proposed rule. Consistent with the DOL's longstanding position that the economic reality of the relationship between the worker and potential employer should be evaluated based on the "totality of the circumstances," the Final Rule returns to the six economic reality factors historically applied by both the DOL and federal courts.

The Final Rule applies the following six factors to analyze employee or independent contractor status under the FLSA:

1. **Worker Opportunity for Profit or Loss**
   This factor considers whether the worker has opportunities for profit or loss based on managerial skill (including initiative or business acumen or judgment) that affect the worker's economic success or failure in performing the work. The following facts, among others, can be relevant: whether the worker (1) determines or meaningfully negotiates their pay; (2) accepts or declines jobs or has power over timing; (3) advertises their business; and (4) makes decisions to hire others, purchase materials and equipment, and/or rent space. If a worker has no opportunity for a profit or loss, employee status is suggested.
2. **Investments by the Worker and Potential Employer**
   Worker investments that are capital or entrepreneurial in nature indicate independent contractor status, as they generally support an independent business and serve a business-like function (e.g., increasing the worker's ability to do different types of work, reducing costs, or extending market reach). Examples of worker costs that do not evidence capital or entrepreneurial investment, suggesting employee status, include: (1) tools/equipment to perform a specific job; (2) labor; and (3) costs the potential employer imposes unilaterally on the worker. If the worker is making similar investment types as the potential employer (even if smaller), independent contractor status is suggested.
3. **The Degree of Permanence of the Work Relationship**
   When the work relationship is indefinite in duration, continuous, or exclusive of work for other employers, employee status is suggested. When the work relationship is definite in duration, non-exclusive, project-based, or sporadic based on the worker being in business for themselves and marketing their services or labor to multiple entities, independent contractor status is suggested.
4. **The Nature and Degree of Control Over Performance of the Work and Working Relationship**
   This factor considers the potential employer's control, including reserved control, over the performance of the work and the economic aspects of the working relationship, i.e., whether the potential employer sets the worker's schedule, supervises performance, or explicitly limits the worker's ability to work for others; whether the potential employer uses technological means to supervise work performance (via a device or electronically), reserves the right to supervise/discipline the worker, or places demands/restrictions on the worker, which prevents them from working for others when they choose. This factor also considers whether the potential employer controls economic aspects of the working relationship, including control over prices or rates for services and the marketing of the services or products provided by the worker. Control is not indicated if a potential employer acts solely to comply with a specific, applicable federal, state, tribal, or local law or regulation.
5. **The Extent to Which the Work Performed is an Integral Part of the Potential Employer's Business**
   This factor measures whether the worker's function is integral to the business rather than whether any individual worker is integral to the business. When the work performed is critical, necessary, or central

to the potential employer's principal business, employee status is suggested. When the work performed is not critical, necessary, or central to the potential employer's principal business, independent contractor status is suggested.

6. **The Skill and Initiative of the Worker**
   The final factor considers whether the worker uses specialized skills to perform the work and whether those skills contribute to entrepreneurial initiative. If a worker uses specialized skills, this indicates independent contractor status. Employee status is indicated if the worker depends on potential employer training or does not use specialized skills. Where the worker brings specialized skills to the work relationship, this itself does not indicate independent contractor status because both employees and independent contractors may be skilled workers.

The Final Rule states that the foregoing six factors are to be applied equally, with no factor being afforded more weight than the other factors and no single factor being dispositive to the analysis. The factors also should not be considered in isolation. The Final Rule clarifies that, in some cases, one or more factors may be more probative than others, while in other cases one or more factors may be irrelevant. According to the DOL, this approach offers the flexibility required when applying the FLSA in the modern economy because, as these six factors are non-exhaustive, other considerations may arise in a given situation.

COMPARISON WITH PROPOSED RULE

The Final Rule largely tracks the proposed rule issued by the DOL on October 13, 2022. It uses the same six factors, but adjusts some details based on a review of more than 55,000 comments it received during the rulemaking period. There are five key changes between the proposed rule and Final Rule:

- **Legal Compliance:** The most important change is to factor four, the "nature and degree of control." The proposed rule stated that when a potential employer exercises control to comply with other laws or regulations, that control still indicates that the worker is an employee. The Final Rule, however, changes course. Under the Final Rule, the control necessary to comply with "specific" legal requirements does not necessarily indicate that the worker is an employee. Stated differently, businesses can take steps to comply with state, federal, tribal, or local laws without affecting the worker's classification. The Final Rule also states that if a potential employer goes beyond specific legal requirements for its own convenience, this additional control will affect the analysis.
- **Relative Investments:** The Final Rule also refines factor two, "relative investments." The proposed rule suggested that the DOL would compare the absolute investments by the worker and the potential employer. For instance, if the potential employer invested more than the worker, the worker was likely to be an employee. By contrast, the Final Rule clarifies that the DOL will not compare the investments on a dollar-for-dollar basis, nor will it consider the employer's absolute size. Instead, it will examine the *relative* investments to determine whether the worker is making "similar types of investments" that "suggest the worker is operating independently."
- **Tools and Equipment:** The Final Rule revises the DOL's approach to tools and equipment. The proposed rule stated that a worker is not an independent contractor merely because the worker pays for tools and equipment necessary to perform a job. For example, if a worker buys a hardhat and handsaw, the

investment in those tools does not make the worker an independent contractor. The Final Rule explains that this limitation applies to costs "unilaterally imposed" by the potential employer. So, if the potential employer requires the worker to buy the hardhat and handsaw, those costs do not make the worker more like an independent contractor.

- **Profit or Loss Opportunity:** The Final Rule also modifies the DOL's approach to profit or loss. The proposed rule stated that a worker does not have an "entrepreneurial" opportunity for profit or loss when the worker can earn more money simply by working more hours or taking more jobs. The Final Rule clarifies that limitation. It states that the worker's ability to earn more by working more is not entrepreneurial opportunity "when [the worker] is paid a fixed rate per hour or per job."
- **Specialized Skills:** Lastly, the Final Rule restricts the DOL's approach to the final factor, "specialized skills." It states that specialized skills by themselves do not indicate that the worker is an independent contractor. Both, "employees and independent contractors may be specialized workers." Thus, whether the worker uses specialized skills "in connection with business-like initiative" is most relevant for purposes of this factor.

KEY TAKEAWAYS

According to the DOL, the Final Rule is intended to "reduce the risk that employees are misclassified as independent contractors while providing a consistent approach for businesses that engage with individuals who are in business for themselves."

Whether the Final Rule will have the intended impact is unclear. Most federal circuit courts already have established legal tests for determining independent contractor status. Moreover, the U.S. Supreme Court in this term will be tasked with reconsidering the "Chevron" doctrine, in which courts grant considerable deference to certain federal agency regulations. The Court's eventual decisions in *Relentless, Inc. v. Department of Commerce* (No. 22-1219) and *Loper Bright Enterprises v. Raimondo* (No. 22-451) could sharply restrict the DOL's authority to enforce the Final Rule in the courts. Despite the pending decisions, DOL investigators may treat the new Final Rule as the controlling standard for audits and other compliance actions. Employers should therefore evaluate their existing and future worker relationships and independent contractor agreements and make necessary changes.

The Final Rule reinforces the DOL's pro-employee view of worker classification and may create classification complications for companies reliant on independent contractors, particularly for those in the gig economy. However, it is important to emphasize that the DOL's Final Rule only defines independent contractor status under the FLSA. The standard does not apply to other federal laws, including the National Labor Relations Act, or state wage and hour laws (or lawsuits alleging independent contractor misclassification under those statutes). Nor does the DOL's framework control the analysis in other legal contexts where a worker's independent contractor status may be determinative, such as liability under employment discrimination laws.

If you have any questions about this article or need any assistance evaluating the impact of the Final Rule on your business's operations, please contact Kevin S. Borozan or any other member of Masuda Funai's Employment, Labor and Benefits Group.

Masuda Funai is a full-service law firm with offices in Chicago, Detroit, Los Angeles, and Schaumburg.