



## Economic Realities Test: A Deep Dive into Employee vs. Independent Contractor

How does a business owner determine whether they've hired an independent contractor or an employee? The answer to this question is complex and often subject to substantial misinformation. It doesn't help that the Department of Labor (DOL) issued new guidelines in January 2021 by the Trump DOL, that were promptly called into question by the Biden DOL, and are officially rescinded and replaced by the department's new Employee or Independent Contractor Classification under the Fair Labor Standards Act rule, which takes effect March 11, 2024.

### Six Factor Test

So, who is properly an independent contractor, and how do business owners use the new rule to make that determination? The DOL provides a 6-point "economic realities" test to evaluate whether an individual can be classified as an independent contractor. However, much of this 'new' rule incorporates the pre-2021 legal landscape. Accordingly, there is little substantive change for employers who continued to apply the pre-2021 test to their analysis. The six factors identified by the DOL are as follows:

- Opportunity for Profit or Loss Depending on Managerial Skill;
- Investments by the Worker and the Potential Employer;
- Degree of Permanence of the Work Relationship;
- Nature and Degree of (the Potential Employer's) Control;
- Extent to Which the Work Performed is an Integral Part of the Potential Employer's Business; and

- Skill and Initiative (of the Potential Independent Contractor).


### Misclassifications Penalties

Classifying potential employees as independent contractors may seem attractive for payroll tax and legal liability considerations. Still, there is a substantial risk to the potential employer if the worker is misclassified, including tax, workers' compensation, unemployment compensation, and employee benefits to which the worker may be



entitled but was improperly denied. In addition to potential wage and hour law violations that can be extremely costly and difficult to resolve. At its most basic, the economic realities test is meant to limit the classification of independent contractors to those individuals/entities performing a skilled service for the business that the business cannot perform independently.

An excellent example of a traditional independent contractor relationship would be a business that hires an independent IT professional to respond to its internal IT issues as needed. In this case,



the IT professional likely has more than one client, is not dependent on any one of its clients for its success, performs a service that the client cannot perform on its own, and largely controls how the service is performed. As opposed to a business that hires an IT professional to provide 9-5 services, the engagement is ongoing, the IT professional does not have any other clients, and although the IT professional is providing a service that the business cannot on its own, the IT professional is entirely dependent on that business for its entire revenue. The degree to which the independent contractor is economically reliant on the hiring business largely guides whether the DOL will consider the relationship to be properly an independent contractor. In the second example above, the contractor economically depends on its one 'client.' Even if the contractor wants to be classified as such, an individual cannot waive their right to be classified as an employee, which will not protect the business owner if a misclassification is identified.

It is time well spent to periodically review your business's relationship with its independent contractors and service providers to ensure that your business remains compliant and avoids potential pitfalls. Consult with your CPM attorney or any member of our employment law team to assess whether your business contractors are truly independent.