Independent Contractor rules are about to change – again

Independent contractor rules are about to change – again. It may seem like just yesterday that the U.S. Department of Labor (DOL) tried to update its classification regulations under the Fair Labor Standards Act (FLSA). Those rules would have made it simpler and more attractive for employers to use independent contractors. They were scheduled to go into effect on March 8, 2021 but the then-incoming Biden administration put on the brakes. Then a federal court stepped in, ordering the rules effective. Now the DOL has issued updated proposed rules that reverse the reversal. Here's the lowdown for employers and what you'll need to know as these rules remain up in the air.

Using independent contractors versus employees.

Employers have two basic choices when it comes to getting work done — hire an employee or arrange for an independent contractor to do the work. Both approaches have their pros and cons.

Take taxes. Employers withhold income taxes from the pay due employees and send the money directly to the Internal Revenue Service (IRS) and other state and local taxing authorities. Independent contractors are responsible for their own tax payments. Plus, employers pay half of the federal Social Security taxes due from workers and send in the employee's share. Independent contractors are supposed to remit the entire 15% themselves.

Hire employees, and your organization is responsible for unemployment and workers' compensation insurance. Independent contractors pay those costs themselves. Ditto for equipment and tools. Plus, most employees are due overtime at time-and-a-half when working more than 40 hours per week. Independent contractors are paid based on their contract and don't get extra pay for extra hours. Then there are the benefits most employers provide their employees. Sick leave, vacation pay, and health insurance coverage are common benefits for employees. Independent contractors aren't paid when they don't work and arrange for their own health insurance coverage.

In addition, hiring employees represents a longer-term investment. Absent a business downturn, most organizations don't expect to discharge employees. But sometimes it makes more sense to contract with an independent contractor. You may have a short-term project with an end date and can't justify hiring an employee. Or, in times of uncertainty like today, the flexibility to ramp up and down as conditions change looks attractive. When the contract is up, there's no further obligation or unemployment compensation to pay.

Misclassification blues.

If you're sold on using independent contractors, you have to get the details right. It's not merely a matter of calling a worker independent and signing a contract. At the federal level, you have to make sure to follow DOL rules. That's where the FLSA comes into play. This federal law sets standards for who is classified as an employee and who can be an independent contractor. Those rules are spelled out in regulations.

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Generally, the less control you exert over the work being performed, the more likely the worker is properly classified as an independent contractor. But it's not simple. And the consequences of getting it wrong are substantial.

If DOL audits you — or a disgruntled independent contractor sues you — the penalties may include payment for all hours worked plus overtime, doubled. Plus you will have to pay the employer's share of the social security tax. Under the right circumstances, back pay and taxes can add up to hundreds of thousands of dollars or more.

Everything old is new again?

Currently, your organization can take advantage of the loosened classification rules that the Trump administration approved and a federal judge ordered put into effect. These rules use a five-factor "economic reality" test that focus on two of those five factors. Employers ask themselves what level of control they assert over the worker and whether the worker has an opportunity to operate at a gain or a loss.

Under this test, the less control you have over when and how the worker does the contracted job, the better. And the more you let the worker pick and buy his equipment and negotiate the contract price, the more likely he is in business for himself.

Before the Trump DOL's new rules, employers had to survive a fact-intensive evaluation if challenged on classifying a worker as independent. The prior rule weighed six factors with no one factor more important than the others. That made litigation expensive, time-consuming, and often induced a settlement.

On October 11, the Biden DOL released proposed new rules. These essentially revert to the pre-Trump rules and use a "totality of the circumstances" approach.

The factors to consider include:

- The contractor's skill set;
- How permanent or transient the contractor's relationship is with the organization using the services;
- The contractor's investment in equipment and materials; and
- Whether the work provided is an integral part of the organization's business.

Interested parties can comment on the proposed rules until December 13, 2022. Those comments will take DOL months to review. Finalization, with any modifications, is likely to happen in Spring 2023.

What should employers do?

The likelihood that these rules will take effect sometime in 2023 increased after the mid-term federal elections. For one, the Senate remains in Democrat hands while Republicans have taken control over the House of Representatives by a slim majority. That makes it unlikely that the proposed regulations could be halted by Congress under the Congressional Review Act (CRA).

The CRA allows Congress to review any new regulation before its effective date. Congress can pass a joint resolution rejecting the rule. That's unlikely with the current House/Senate split. Even if a joint resolution passes, President Biden could and likely would veto it. Congress could then only undo the regulations via the override process. That would require a 2/3 vote in both the Senate and the House — a highly unlikely event in a deeply divided Congress.

Bottom line: If DOL gives the final go-ahead, the old, complicated rules become the new, complicated rules.

Employers should assume that sometime in early to mid-2023, they will have to review all their independent contractor contracts.

Here's how to prepare:

- **Gather a list of all independent contractor agreements you currently have in place.** Look for clauses that allow modification or re-negotiation when regulations change. Also, be on the lookout for automatic renewal clauses and note the terms. These typically include a brief period of time prior to renewal to terminate or modify the agreement. You may want to halt automatic renewal at the first opportunity to facilitate changes if the regulations change.
- **Determine the effective date and expiration date for each.** You may find that you have some agreements that span several different sets of DOL rules. But because the current rules are more lenient than the prior rules, chances are the classification won't cause immediate problems.
- **Review the independent contractor's actual work as it has been performed to date.** What counts for proper classification is what's actually happening on the ground — not what the contract says should happen.
- **Look for signs that supervisors are treating the worker like one of the employees**. These include micro-managing the work as performed, and insisting the worker be present at specific times. The more the worker looks like an employee, the more likely the relationship will fail the "totality of the circumstances" test.
- **Using the "totality of the circumstances" approach, test each contract** to see if each likely would still properly classify the worker as an independent contractor. Be on the lookout for contract terms that encourage the worker to take on other clients — or at least don't prohibit her from doing so.
- **If, after following the above steps, you believe a worker may be misclassified, contract counsel.** He or she may be able to renegotiate the terms to comply with the anticipated regulations.
- **Once DOL announces that it will put the rules in effect, it will provide an effective date.** For a major change like this one, expect 60-90 days between the announcement and the effective date. That's enough time to come up with a compliant agreement.

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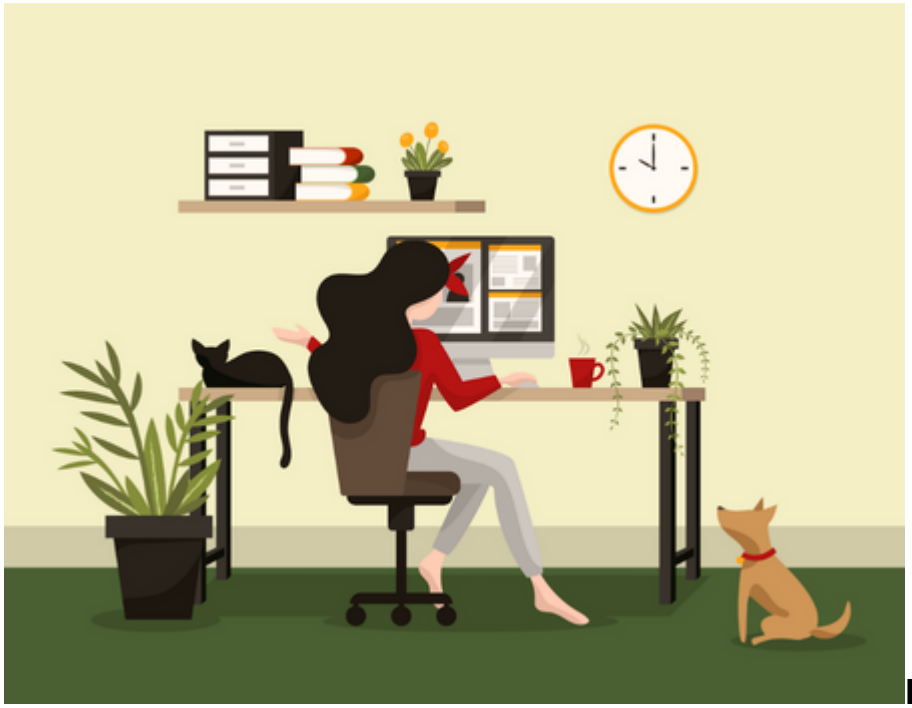

But wait, there’s more

The DOL regulations aren’t the only rules that apply to independent contractor agreements. A growing number of states have moved to encourage employment status over contractor status. One popular approach is to use the so-called ABC method. The ABC test uses just three factors.

To be classified as an independent contractor, a worker must:

- Be free from control or direction of their work;
- Perform work outside the usual course of business; and
- Be engaged in a trade, occupation, profession or business customarily considered independent.

This approach means that you have to leave to the worker the details of the work. Crucially, the work performed can’t be the type of work your business commonly does. This severely limits the ability to expand your work capacity during boom times with independent contractors. If you are a construction company that builds houses, you could not use independent drywall, plumbing, or electrical contractors even if you needed temporary help to construct additional houses during a robust building season. You could, however, contract for accounting or legal services.

States that use the ABC test include California, New Jersey, Massachusetts, and West Virginia. Pennsylvania is considering adopting the same approach.

Final note

Getting independent contractor status right is incredibly hard. Make sure you have trusted counsel that can draft effective and legal contracts. Most crucially, make sure he or she will update you on any changes to laws and regulations in all states where you operate.

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