Upcoming Federal Changes to Employee Classification and Potential Impacts on Community Action Agencies

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On March 11, 2024, a revision to the **Fair Labor Standards Act (FLSA) rule**, 29 C.F.R. § 795.110, takes effect and changes the way employers, including community action agencies (CAAs), classify workers as either employees or independent contractors. The Final Rule adopts a new "Economic Realities" test that emphasizes an individual's overall economic dependence on an employer for employee classification purposes. Application of the new test may result in shifts in worker classifications that could lead to both financial and administrative challenges for CAAs. However, the "Economic Realities" test's impact on CAAs will vary since some CAAs operate under stricter state wage and hour standards, which may mitigate the shift's effects.

New "Economic Realities" Test

The new "Economic Realities" test marks the latest development in an ongoing debate over worker classification under the FLSA. In recent years, shifting rules and legal battles have created uncertainty for employers. Under the previous test (the "2021 Rule"), two main factors dominated the classification decision: worker control (over their schedule, methods, and tools) and their profit/loss potential (the ability to increase earnings or face losses based on business decisions). The DOL adopted a new version of the "Economic Realities" test to align with existing judicial precedent and longstanding guidance prior to the 2021 Rule.

The "Economic Realities" test is a six-factor framework for assessing whether an employment relationship exists under the FLSA (**29 C.F.R. § 795.110**). No single factor is determinative. The goal of the test is to determine whether "as a matter of economic reality, the worker is economically dependent on the employer for work (and is thus an employee) …" or if the worker is in business for themself (and is thus an independent contractor).

These factors include:

1. **Opportunity for profit or loss:** Can the worker significantly control their income through entrepreneurial effort?
2. **Investment:** Does the worker invest significantly in equipment or tools compared to the employer?
3. **Permanence:** Is the relationship ongoing and indefinite, or temporary and project-based?
4. **Control:** Does the employer control how the work is performed and the worker's schedule?
5. **Integration:** Is the work an integral part of the employer's business?
6. **Skill and initiative:** Does the worker use specialized skills and independent judgment?

The DOL indicates that while the core "Economic Realities" test focuses on key factors, additional factors may be relevant in determining whether the worker is truly in business for themself or is economically dependent on the employer. Employers are directed to assess the totality of the circumstances within the employment relationship.

Illustrative Example of the "Economic Realities" Test

The example below illustrates the fact-intensive nature of the "Economic Realities" test.

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A CAA hires a local handywoman to perform landscaping and minor repair services. The worker does not (i) choose what she will work on, (ii) ask for additional work from other clients, (iii) have her own tools (rather, she uses tools provided by the CAA), (iv) advertise her services, or (v) try to reduce costs. The worker and the CAA agree that the worker is an independent contractor and will receive a 1099 Form at the end of the year for tax purposes.

The CAA must then assess each factor of the "Economic Realties" test within the circumstances, which may look like the following:

1. **Opportunity for profit or loss:** The handywoman appears to have limited opportunities for profit or loss. She doesn't seek additional clients or advertise, suggesting a lack of business initiative that could affect profitability and make her dependent on the CAA.
2. **Investment:** Since the handywoman doesn't use her own tools, her investments in the work are minimal. This factor also leans towards the worker being dependent on the CAA.
3. **Permanence:** While this example doesn't address duration of the work arrangement, ongoing work with a single entity can suggest a more permanent relationship than typical independent contracting.
4. **Control:** The CAA chooses what work is done and gives detailed instructions. This suggests employee status.
5. **Integration:** While landscaping and handywoman services might not be the core mission of the CAA, they are necessary to maintain the facilities and provide a suitable environment, making this work integral to the organization's operations.
6. **Skill and Initiative:** Using general handywoman skills is less indicative of independent business operations than applying specialized expertise to solve unique problems. This may further suggest employee status.

Based on the facts presented, the balance of factors weighs towards the handywoman likely being classified as an employee. She does not appear to engage in activities that are entrepreneurial in nature, e.g., advertising to grow her client base. Rather, the CAA appears to be her sole source of revenue. Her work is directed by the CAA and she uses the tools provided by the CAA. The work she performs is necessary for CAA operations and does not require specialized knowledge. The parties' agreement that the handywoman will be treated as an independent contractor is not dispositive or probative of the economic realities of the relationship. Rather, the nature of the relationship is critical. Even if a worker asks to be an independent contractor, the worker cannot waive their rights to FLSA protections.

The Economic Realities Test and its Potential Impact on CAAs

The "Economic Realities" test represents a significant shift in how worker classification is determined under the FLSA. Under this new approach, some workers previously classified as independent contractors might require reclassification as employees. For CAAs, who often rely on a mix of employees and contracted services, the shift could impact operations in several ways and result in:

- **Increased payroll tax expenses:** CAAs are responsible for paying both employer and employee portions of Social Security and Medicare taxes for employees and reclassified employees.
- **Benefits:** CAAs may need to offer benefits to some reclassified workers.
- **Overtime:** Reclassified non-exempt workers must be paid a higher rate for overtime hours worked. This can significantly increase labor costs.
- **Legal Risks and Penalties:** Misclassification carries the potential risk of backpay, penalties and other legal risks including the potential for costly litigation.

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- **Increased Administrative Burden:** CAAs may incur higher administrative costs associated with worker classification review and payroll and benefits management.
- **Revised Contracts:** CAAs must review contracts with existing contractors to ensure they align with the stricter classification standards of the "Economic Realities" test.
- **Reduced Staffing Flexibility:** CAAs may have less staffing flexibility if they can no longer classify certain workers as contractors.

Reconciling State and Federal Laws

The DOL's "Economic Realities" test sets the federal standard for worker classification. However, some states have stricter wage and hour laws than the federal FLSA. Importantly, under **29 U.S.C. § 218 ("Relation to other laws")**, the federal FLSA cannot supersede stronger state protections. Employers must follow the law that is most beneficial to employees, whether that's the federal FLSA, state wage and hour laws, or other regulations. The law most favorable to the employee is the one that establishes an employer/employee relationship.

While nonprofits, including nonprofit CAAs, are not exempt from federal FLSA coverage, certain nonprofit CAAs may be able to establish that they do not meet the criteria that would subject them to federal FLSA requirements. Nevertheless, because the federal FLSA coverage rules are fact-specific and broadly construed, the safest approach for nonprofit CAAs is to assume that the federal FLSA applies to all employees, and accurately classify each employee as exempt or non-exempt for purposes of compliance. For more information about the application of the federal FLSA to nonprofit CAAs, see **CAPLAW's Overview of FLSA Principles FAQ**.

Actions for CAAs

To comply with the FLSA and mitigate risk, CAAs should:

1. Work with an employment law attorney in their state to review existing independent contractor arrangements using the "Economic Realities" test;
2. Develop an action plan in consultation with qualified experts to protect your CAA in this evolving landscape; and
3. Maintain clear records of how the CAA reached its classification decisions.

Additional Resources for CAAs

Fact Sheet 13: Employee or Independent Contractor Classification Under the Fair Labor Standards Act (FLSA)

Federal Register: Employee or Independent Contractor Classification Under the Fair Labor Standards Act

Wages and the Fair Labor Standards Act

Fact Sheet #14A: Non-Profit Organizations and the Fair Labor Standards Act (FLSA)

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