

Distinguishing Employees from Independent Contractors Under California AB 5

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Determining whether someone working for you is an employee or an independent contractor used to be easy. If the person worked for your business a certain number of hours per week, they were an employee with rights to benefits and overtime pay (when applicable). If the person didn't meet those criteria, he or she was considered an independent contractor.

Back in 1987, the Internal Revenue Service (IRS) developed a list of 20 factors to examine in determining whether an employer-employee relationship exists. Based on case law and judicial rulings, the IRS determined that the degree of importance of each factor varied, depending on the occupation and context in which the services were performed.



But that all shifted last year here in the Golden State with the passing of California's Assembly Bill 5 (AB5), which was signed into law by Gov. Gavin Newsom in September 2019 and went into effect on Jan. 1, 2020. That bill classifies most workers as employees, placing the burden of proof for classifying workers as independent contractors on the hiring entity (*i.e., the small and medium size business, not-for-profit, or enterprise*).

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In essence, a worker is to be treated as an employee unless the business can prove otherwise. Another way to put it is that under AB5, it is California law – not businesses – that determines who is an independent contractor and who is not. It's a fairly rigorous law, and both business owners and workers are understandably confused by it.

The ABC Test

The California bill replaces the common law test (the Borello test described later in this post) with the so-called ABC test to determine whether a worker is an employee or an independent contractor in California. And if you're wondering why the test is named "ABC," it's because it features three parts – a Part A, a Part B, and a Part C.

For purposes of California employment laws, the test applies to those requiring minimum wage, overtime pay, unemployment insurance, workers' compensation insurance, and paid family leave. As an aside, AB5 does not change how out-of-state workers are classified.

Under the rule established by AB5, hiring entities are now required to classify workers as employees unless the person in question meets all the following conditions of the ABC test:

- Part A.** The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact;
- Part B.** The person performs work that is outside the usual course of the hiring entity's business; and
- Part C.** The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

Exceptions to AB5

certain occupations are exempt from the ABC test, including, among other:

- Licensed insurance agents.
- Certain licensed health care professionals.
- Registered securities broker-dealers and investment advisors.
- Direct sales salespersons.
- Real estate licensees.
- Commercial fishermen.
- Workers providing licensed barber or cosmetology services.
- Others performing work under a contract for professional services with another business entity, or pursuant to a subcontract in the construction industry.

Most occupations exempt from the ABC test, except real estate salespeople and repossessioners, must pass the Borello test, which is used to determine worker status before AB5 became effective.

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The Borello Test

The Supreme Court of California established the Borello test in 1998 for a court case known as *S.G. Borello & Sons, Inc. v. Dept. of Industrial Relations*. The test determined whether a worker can be classified as an independent contractor – including whether the hiring entity has all necessary control over the manner and means of accomplishing the work and its outcomes. However, such control need not be direct, actually exercised, or detailed. This factor must be considered along with other factors, which include the following:

1. Whether the worker performing services holds themselves out as being engaged in an occupation or business distinct from that of the employer.
2. Whether the work is a regular or integral part of the employer's business.
3. Whether the employer or the worker supplies the instrumentalities, tools, and the place for the worker doing the work.
4. Whether the worker has invested in the business, such as in the equipment or materials required by the nature of their work.
5. Whether the service provided requires a special skill.
6. The kind of occupation, and whether the work is usually done under the direction of the employer or by a specialist without supervision.
7. The worker's opportunity for profit or loss depending on their managerial skill.
8. The length of time for which the services are to be performed.
9. The degree of permanence of the working relationship.
10. The method of payment, whether by time or by the job.
11. Whether the worker hires their own employees.
12. Whether the employer has a right to fire at will or whether a termination gives rise to an action for breach of contract.
13. Whether or not the worker and the potential employer believe they are creating an employer-employee relationship (this may be relevant, but the legal determination of employment status is not based on whether the parties believe they have an employer-employee relationship)

Borello is referred to as a “multifactor” test because it requires consideration of all potentially relevant facts – no single factor controls the determination. Courts have emphasized different factors in the multifactor test according to the circumstances. For example, where the employer does not control the work details, an employer-employee relationship may be found if (1) the employer retains control over the operation as a whole, (2) the worker's duties are an integral part of the operation, and (3) the nature of the work makes detailed control unnecessary.

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Workers Subject Only to the Borello Test

Some workers are required only to satisfy the Borello test to be classified as independent contractors, including the following:

- Insurance brokers licensed by the Department of Insurance.
- Physicians, surgeons, dentists, podiatrists, psychologists, veterinarians licensed by the State of California.
- Lawyers, architects, engineers, private investigators, and accountants holding an active license from the State of California.
- Securities broker-dealers or investment advisors or their agents and representatives who are registered with the Securities and Exchange Commission or the Financial Industry Regulatory Authority or licensed by the State of California.
- Direct sales salespeople who are not paid by the hour and who have written IC contracts.
- Commercial fishermen working on an American vessel.

Workers Providing Professional Services

A worker providing various types of professional services is classified as an independent contractor only if she/he passes the Borello test *and* satisfies the following six criteria:

1. Maintains a business location, which may include the individual's residence, separate from the hiring entity.
2. Has a business license, in addition to any required professional licenses or permits to practice in their profession.
3. Has the ability to set or negotiate their own rates for the services performed.
4. Has the ability to set their own hours (outside of project completion dates and reasonable business hours).
5. Is customarily engaged in the same type of work performed under contract with one or more other hiring entities or holds themselves out to other potential customers as available to perform the same type of work.
6. Customarily and regularly exercises discretion and independent judgment in the performance of the services.

More specifically, the professional services exception applies to the following workers:

- Marketing professionals who perform original, creative work.
- Human resource administrators, provided that the contracted work is predominantly intellectual and varied.
- Travel agents.
- Graphic designers.
- Grant writers.

- Fine artists.
- Enrolled agents licensed by the United States Department of the Treasury to practice before the Internal Revenue Service.
- Payment processing agents through an independent sales organization.
- Photographers or photojournalists who do not license content submissions to the putative employer more than 35 times per year.
- Freelance writers, editors, or newspaper cartoonists who do not provide content submissions to the recognized employer more than 35 times per year.

A licensed esthetician, electrologist, manicurist, barber, or cosmetologist is considered an independent contractor provided they meet all of the following criteria:

- Sets their own rates, processes their own payments, and are paid directly by clients.
- Sets their own hours of work and have sole discretion to decide the number of clients and which clients for whom they provide services.
- Has their own book of business and schedules their own appointments.
- Maintains their own business license for the services offered to clients.
- If the individual is performing services at the location of the hiring entity, issues a Form 1099 to the salon or business owner from which they rent their business space.

Now, if you're a licensed manicurist in the state of California, or if you have a licensed manicurist working for you, the ABC test will apply starting Jan. 1, 2022.

Business-to-Business Service Providers

If a business service provider formed as a sole proprietorship, partnership, limited liability company (LLC), limited liability partnership (LLP), or corporation to provide services to another such business, under AB5, the determination of employee or independent contractor status is determined by the Borello test, only if the business service provider meets all of the following criteria:

- Is free from the control and direction of the contracting business entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
- Is providing services directly to the contracting business rather than to customers of the contracting business.
- Has a written contract to provide the services.
- Performs the work in a jurisdiction that requires the business service provider to have a business license or business tax registration, and the business service provider has the required business license or business tax registration.
- Maintains a business location that is separate from the business or work location of the contracting business.

- Is customarily engaged in an independently established business of the same nature as that involved in the work performed.
- Contracts with other businesses to provide the same or similar services and maintains a clientele without restrictions from the hiring entity.
- Advertises and holds itself out to the public as available to provide the same or similar services to other businesses.
- Procures its own tools, vehicles, and equipment to perform the services.
- Can negotiate its own rates.
- Can set its own hours and location of work consistent with the nature of the work.
- Is not performing the type of work for which a license from the Contractor's State License Board is required.

This exception is not service-specific. Any worker performing any type of service through a sole proprietorship, partnership, LLC, or corporation qualifies for this exception.

Construction Industry Subcontractors

In the construction industry, a subcontractor performing work for a contractor is exempt from the ABC test and qualifies as an independent contractor if they pass the Borello test and meet the following criteria:

- Number 1. Has a subcontract in writing with the contractor.
- Number 2. Is licensed by the State of California's Dept. of Consumer Affairs' Contractors State License Board and the work is within the scope of that license.
- Number 3. Has any required business license or business tax registration.
- Number 4. Maintains a business location separate from the business or work location of the contractor.
- Number 5. Has the authority to hire and to fire other persons to provide or to assist in providing the services.
- Number 6. Assumes financial responsibility for errors or omissions in labor or services as evidenced by insurance, legally authorized indemnity obligations, performance bonds, or warranties relating to the labor or services being provided.
- Number 7. Is customarily engaged in an independently established business of the same nature as that involved in the work performed.

The second criteria above (No. 2) does not apply to a subcontractor providing construction trucking services for which a contractor's license is not required, provided that all of the following criteria are satisfied:

- The subcontractor is a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership, or corporation.
- The subcontractor is registered with the Department of Industrial Relations as a

public works contractor pursuant, regardless of whether the subcontract involves public work.

- The subcontractor utilizes its own employees to perform the construction trucking services, unless the subcontractor is a sole proprietor who operates their own truck to perform the entire subcontract and holds a valid motor carrier permit.
- The subcontractor negotiates and contracts with, and is compensated directly by, the licensed contractor.

Any business entity that provides construction trucking services to a licensed contractor using more than one truck is deemed the employer for all drivers of those trucks, and nothing in AB5 prohibits an individual who owns their truck from working as an employee of a trucking company and utilizing that truck in the scope of that employment. An individual employee providing their own truck for use by an employer trucking company must be reimbursed by the trucking company for the reasonable expense incurred for the use of the employee-owned truck.

Businesses that Obtain Work through Referral Agencies

If a business entity formed as a sole proprietor, partnership, LLC, LLP, or corporation (known as a “service provider”) provides services to clients through a referral agency, whether or not the service provider is an employee of the referral agency, the determination (of whether the service provider is an employee of the referral agency) is governed by the Borello test, assuming the referral agency demonstrates that the service provider meets all of the following 10 factors:

- Factor 1. Is free from the control and direction of the referral agency in connection with the performance of the work for the client, both as a matter of contract and in fact.
- Factor 2. Holds any business license or tax registration required in the jurisdiction in which the service provider performed the work.
- Factor 3. Holds a state contractor’s license, if required by the nature of the services provided to the client.
- Factor 4. Delivers services to the client under service provider’s name, rather than under the name of the referral agency.
- Factor 5. Procures its own tools and supplies to perform the services.
- Factor 6. Is customarily engaged in an independently established business of the same nature as that involved in the work performed for the client.
- Factor 7. Maintains a clientele without any restrictions from the referral agency and is free to seek work elsewhere, including through a competing agency.
- Factor 8. Sets its own hours and terms of work and is free to accept or reject clients and contracts.

Factor 9. Sets its own rates for services performed, without deduction by the referral agency.

Factor 10. Is not penalized in any form for rejecting clients or contracts.

Real Estate Licensees

Simply stated, a real estate licensee is exempt from the ABC test. Determination of employee or independent contractor status generally is determined by the State of California's Business and Professions Code. If that Code is not applicable, then status is determined by:

- Section 650 of the state's Unemployment Insurance code for the purposes of unemployment insurance.
- Section 3200 for the purpose of workers' compensation.
- The Borello test for all other purposes in the state's Labor Code.

Other Exemptions

If all of this isn't confusing enough, here's some welcome relief. Other exemptions to the ABC test are provided for as follows:

- Licensed repossession agencies
- Individuals performing services pursuant to a contract between a motor club and a third party to provide motor club services utilizing the employees and vehicles of the third party.

So, there you have it. You now know how to determine whether a person working or performing work for your business or organization is doing so as an employee or as an independent contractor under California's AB5 law. And since that's a lot of information to take in, we here at Stees, Walker & Company, LLP strongly recommend consulting with a CPA on any questions you may have about any of this. Because at the end of the day, the cost associated with getting any of this wrong is too high to wager on.

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