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### **California Adopts New Test for Classifying Workers as Employees**

If your business has workers that you are classifying as independent contractors or you are currently operating as an independent contractor, please be aware that recent legislation in California may require that such workers (or you) be reclassified as employees under California law. Read on for more details:

#### **What has changed?**

The major piece of legislation governing changes in worker classification, California Assembly Bill 5 (“AB 5”), went into effect on January 1, 2020 and codifies a new 3-factor test (called the “ABC test”) for determining whether a worker can be treated as an independent contractor.

Under the new law, most workers are presumed to be employees unless all three factors of the ABC test are met. The factors are as follows:

- A. The worker is free from 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 (commonly known as the Borello “control test”);
- B. The worker performs work that is outside the usual course of the hiring entity’s business; and
- C. The worker is customarily engaged in an independently-established trade, occupation, or business of the same nature as the work performed.

#### **What if a worker doesn’t pass all three criteria of the ABC test?**

Of the three factors, the second one is the biggest change and can catch many hiring businesses off guard. If any of your workers are currently treated as independent contractors and are providing services that are within your business’s service lines, you may need to revisit each of their classifications.

If the ABC test is not passed, the worker is an employee for California purposes. This means that employers must ensure that these workers receive at least the minimum wage, workers’ compensation, unemployment insurance, paid sick leave, overtime, and paid family leave. This also means that workers previously operating as independent contractors could now lose out on business expense deductions on their income tax returns.

#### **Any good news?**

While the ABC test will cast a wider net on who is classified as an employee, AB 5 does provide for numerous exemptions for certain industries and professions, with more exemptions expected in the near future. Exempt occupations include the following:

- Licensed insurance brokers;
- Licensed physicians and surgeons, dentists, podiatrists, psychologists, and veterinarians, provided that the workers are not covered by a collective bargaining agreement;

- Licensed lawyers, architects, engineers, private investigators, and accountants;
- Registered securities broker-dealers, investment advisors, or their agents and advisors;
- A direct salesperson who performs in-person demonstrations and sales presentations of consumer products;
- Real estate licensees and repossession agents.

If an exemption applies, then the *Borello* test will continue to apply for purposes of determining whether a worker is an employee or an independent contractor.

### **AB 5 is a California law. How does this affect worker classification for federal purposes?**

As it currently stands, AB 5 has no impact on a worker's classification for federal purposes. The *Borello* test will continue to apply. Although this long-standing test has many factors of its own, its primary focus is on the hiring entity's right to control a worker's manner and means of accomplishing a job and the nature of the relationship between the hiring entity and the worker.

### **Does this mean a worker could potentially be classified as an employee for California and an independent contractor for federal?**

Unfortunately, yes, and it can get murky. In such cases, a worker would likely be issued a 1099 for federal purposes and a W-2 for California purposes, and the income reported on each form may differ. The worker can deduct business expenses for federal purposes, but is limited to unreimbursed employee expenses for California purposes. For federal purposes, the worker must pay self-employment tax, and the hiring entity does not have to pay any portion of the worker's Social Security and Medicare taxes. However, for California purposes, as an employer, the hiring entity must file quarterly payroll tax returns as well as remit State Disability Insurance tax and California income tax withholding. Payments to a California employee for sick leave, state disability, or fringe benefits that are excluded from the employee's California income might be taxed by the federal government.

### **What are the penalties for misclassification?**

Hiring entities who misclassify workers as independent contractors are liable for the unpaid withholding tax and payroll taxes in addition to any penalties and interest assessed by the EDD. Furthermore, the Labor Commissioner or a court can assess a civil penalty for willful misclassification of \$5,000 to \$15,000 for each misclassified individual. Such penalties increase to \$10,000 to \$25,000 for each misclassified individual if it is determined that the hiring entity has a "pattern and practice" of such misclassifications.

### **Where should I go for assistance and additional information if I have independent contractors?**

You may wish to consult with your labor attorney to review your independent contractor relationships, to determine the appropriateness of these classifications, and to assist you if re-classifications may be required to mitigate potential legal exposures to your business.