

## California Adopts ABC Test for Classifying Workers as Employees

*California Assembly Bill (AB) 5 (Ch. 19-296) codifies the California Supreme Court's ruling in the Dynamex Case.<sup>1</sup>*

Under California Assembly Bill 5 (AB 5), most workers are presumed to be an employee for purposes of the California Labor Code, the Unemployment Insurance Code, and for most wage orders of the Industrial Welfare Commission, unless a hiring entity satisfies a three-factor test, referred to as the ABC test.<sup>2</sup>

Under the ABC test, all three of these conditions must be met in order to treat the worker as an independent contractor:

- A: The worker 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 (the Borello "control test"<sup>3</sup>);
- 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.

If the ABC test cannot be successfully applied, California employers are required to treat the worker as an employee of the organization and ensure that the worker(s) receive at least the minimum wage, workers' compensation, unemployment insurance (if applicable), paid sick leave, overtime, and paid family leave.

### Impact on Federal Rules

The new California law has no effect on federal rules, though some would argue that it violates certain federal regulations and definitions of who is an independent contractor. However, treatment as an employee for state purposes is likely to make it more certain that the IRS may also consider a worker to be an employee. Most payroll and tax reporting systems also generally apply any worker classification decisions at both federal and state level, so California based employers may find that all employees, regardless of where they are located will be treated as employees, at least for the immediate future, until any legal challenges can be heard and the issue settled in the courts.

### Exemptions

*The legislation does provide for numerous exemptions to the application of the ABC test. If an exemption applies, then the standard for determining whether a worker is an employee or an independent contractor will continue to be the Borello right-to-control test. The exemptions are*

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<sup>1</sup> *Dynamex Operations West, Inc. v. Superior Court (2018)*

<sup>2</sup> *Labor Code §2750.3*

<sup>3</sup> *S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel. (1989) 48 Cal.3rd 342*

quite extensive so employers are advised to speak with their human resource representatives or legal counsel to see if they can take advantage of any applicable exemptions.

### **Effective dates**

The bill states that the application of the ABC test is declaratory of existing law with regard to most wage orders of the *Industrial Welfare Commission* and violations of the Labor Code relating to wage orders. Meaning it takes effect immediately. Unemployment compensation coverage (*properly classified churches and religious organizations remain exempt from this requirement*) must be provided starting January 1, 2020. Workers' compensation is not required for newly reclassified employees until July 1, 2020 however.

### **Reclassification to independent contractor prohibited**

The bill prohibits employers from reclassifying an individual who was an employee on January 1, 2019, to an independent contractor due to the bill's enactment. So even though a worker may qualify for an exemption, if they were treated as an employee as of January 1, 2019, they cannot be reclassified.

### **Specific Occupation Exemptions**

Workers engaged in the following occupations are exempt from the ABC test<sup>4</sup>:

- 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 as defined under UIC §650 (essentially a person who performs in-person demonstrations and sales presentations of consumer products);
- Real estate licensees and repossession agents;
- Until January 2021, Newspaper distributors working under contract with a newspaper publisher; and Newspaper carriers working under contract either with a newspaper publisher or newspaper distributor; and
- Until January 1, 2023, commercial fishermen (with certain exceptions under UIC §609)

### **Professional services exemption**

The Borello right-to-control test will still apply to contracts for professional services, whether provided by a sole proprietor or other business entity, if specified conditions are met.

Professional services are defined as:

- Enrolled Agents;
- Marketing services;
- Administrators of human resources;
- Travel agents;
- Graphic designers;
- Grant writers;
- Fine artists;
- Payment processing agents through an independent sales organization;

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<sup>4</sup> Labor Code §2750.3(b)

- Still photographers or photojournalists (this clause is not applicable to individuals who work on "motion pictures," which includes television, internet streaming theater, commercials, broadcast news, music videos, and live shows); and
- Freelance writers, editors, or newspaper cartoonists.

To qualify for the professional services exemption, the individual must:

- Maintain a business location (which may include the individual's residence) that is separate from the hiring entity. However, nothing prevents an individual from choosing to perform services at the location of the hiring entity;
- Obtain any required business and or professional license if work is performed on or after July 1, 2020;
- Have the ability to set or negotiate their own rates for services performed and to schedule their own hours outside of project completion dates and reasonable business hours;
- Be customarily engaged in the same type of work performed under contract with another hiring entity or hold themselves out to other potential customers for the same work; and
- Customarily and regularly exercise discretion and independent judgment in the performance of the services.

Note that Enrolled Agents will be subject to a different standard than attorneys and accountants to qualify for an exemption. All of these professionals must meet the Borello standards to qualify as an independent contractor. However, enrolled agents must also meet the additional tests listed here. Tax preparers (CRTPs) are not excluded at all and presumably would be employees under the ABC test.

### **Various salon workers**

The following licensed workers may qualify for the professional services exemption previously discussed, provided additional requirements are met: estheticians, electrologists, barbers, cosmetologists, and, until January 1, 2022, manicurists.

To qualify for the exemption, the worker must:

- Set their own rates, process their own payments, and be paid directly by clients;
- Set their own hours and have sole discretion over the number of clients and which clients they will see;
- Have their own book of business and schedule their own appointments;
- Maintain their own business license; and
- Issue a Form 1099 to the salon or business owner if the worker rents a space from the owner.

### **Business-to-business contracting exemption**

Also exempt from the ABC test standard are business entities (the "business service provider"), including sole proprietorships that contract to provide services to another such business (the "contracting business"), such as when a manufacturing plant hires an efficiency expert. In order to qualify for the exemption, the contract must be in writing, and the business service provider must:

- Be free from the control and direction of the contracting business entity, both under the contract for the performance of the work and in fact;

- Provide services to the contracting business rather than to customers of the contracting business;
- Have a required business license or tax registration if the work is performed in a jurisdiction that requires such;
- Maintain a business location that is separate from the business or work location of the contracting business;
- Be customarily engaged in an independently established business of the same nature as that involved in the work performed, contract with other businesses to provide the same or similar services, and maintain a clientele without restrictions from the hiring entity;
- Advertise and hold itself out to the public as available to provide the same or similar services;
- Provide its own tools, vehicles, and equipment to perform the services;
- Negotiate its own rates and set its own hours and location of work; and
- Not be performing the type of work for which a license from the Contractors State License Board (CSLB) is required, pursuant to B&PC §7000 et seq.

Because plumbers, electricians, etc., are required to be licensed, they would not qualify for the business-to-business exemption when a business hires them to come in and perform repairs. However, the exemption really wouldn't be necessary in such cases because these circumstances would likely satisfy the ABC test.

### **Construction subcontractor exemption**

The Borello standard would apply to classifying construction contractor/subcontractor relationships if the contract is in writing and the subcontractor:

- Is free from the control and direction of the contractor in connection with the performance of the work, both under the contract for the performance of the work and in fact;
- Is licensed by the California Contractors State License Board, and the work is within the scope of that license;
- Has a local business license or business tax registration if the subcontractor is domiciled in a jurisdiction that requires a license/registration;
- Maintains a business location that is separate from the business or work location of the contractor;
- Has the authority to hire and to fire other persons to provide or to assist in providing the services;
- 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; and
- Is customarily engaged in an independently established business of the same nature as that involved in the work performed.
- Until January 1, 2022, an exemption also governs construction trucking services. However, for work performed after January 1, 2020, any business entity that provides construction services to a licensed contractor utilizing more than one truck is the employer for all drivers of those trucks.

### **Referral agency exemption**

The Borello test, and not the ABC test, applies in determining the relationship between a service provider and a referral agency if the service provider:

- Has formed a business entity as a sole proprietor, partnership, LLC, limited liability partnership, or corporation;
- Is free from the control and direction of the referral agency as a matter of contract and fact;
- Has all required state or local business licenses/registrations;
- Delivers services to the client under the service provider's name, rather than under the name of the referral agency;
- Provides its own tools and supplies to perform the services;
- Is customarily engaged in an independently established business of the same nature as that involved in the work performed for the client;
- Maintains a clientele without any restrictions from the referral agency, and the service provider is free to seek work elsewhere, including through a competing agency;
- Sets its own hours and terms of work and is free to accept or reject clients and contracts;
- Sets its own rates for services performed, without deduction by the referral agency; and
- Is not penalized in any form for rejecting clients or contracts, unless the service provider accepts a client or contract and then fails to fulfill any of its contractual obligations.

A referral agency is a business that connects clients with service providers that provide the following services:

- Animal services related to daytime and nighttime pet care;
- Dog walking and grooming;
- Errands;
- Event planning;
- Furniture assembly;
- Graphic design;
- Home cleaning;
- Minor home repairs;
- Moving;
- Photography;
- Picture hanging;
- Pool cleaning;
- Tutoring; and
- Yard cleanup.

### **Motor club exemption**

The Borello test will continue to apply to the relationship between a motor club (e.g., AAA) and individuals performing services pursuant to a contract between the motor club and a third party to provide motor club services utilizing the employees and vehicles of the third party that is a separate and independent business from the motor club.

## **Impact on Nonprofits and Churches**

Churches, religious organizations, and other nonprofits operating in California are subject to ABC just like any other employer. Entities with independent contractors in California may need to re-determine whether contractors continue to qualify as such under the new rules, and consider establishing or revising formal policies and practices to minimize risk.

For example:

- Consult with appropriate legal and human resource professionals for assistance
- Create a systematic process for evaluating worker classification
- Avoid engaging independent contractors that provide services that are integral to the organization's normal course of business, or to augment current staff
- Avoid exercising control over independent contractors
- Verify that independent contractors are operating as an independent business
- Monitor for applicable changes to laws and regulations.

While not specifically exempt under the “professional services exemption,” individuals employed as ministers and pastors in a local church are likely to continue to be treated as such due to the reluctance of the courts to get involved in matters within the church that would be seen as impinging on their religious freedoms...the relationship between a minister and his/her church being a primary example. Nevertheless, religious organizations should begin immediately to work with their human resource experts and competent legal counsel to make any adjustments necessary to ensure all workers are correctly classified and paid.

*Sources:* *Spidell's October 2019 California Taxletter, AB 5 (Ch. 19-296)*  
<https://calmatters.org/economy/2019/09/whos-in-whos-out-of-ab-5/>

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## **DISCLAIMER**

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