

## Independent contractor versus employee

In September of 2019, Governor Newsom signed Assembly Bill (AB) 5 into law. The new law addresses the “employment status” of workers when the hiring entity claims the worker is an independent contractor and not an employee.

1. Q. What is AB 5 and what does it do?

A. AB 5 is a bill the Governor signed into law in September 2019 addressing employment status when a hiring entity claims that the person it hired is an independent contractor. AB 5 requires the application of the “ABC test” to determine if workers in California are employees or independent contractors for purposes of the Labor Code, the Unemployment Insurance Code, and the Industrial Welfare Commission (IWC) wage orders. The California Supreme Court first adopted the ABC test in *Dynamex Operations West, Inc. v. Superior Court* (2018) 4 Cal.5th 903. Among other things, AB 5 and later AB 2257 added a new article to the Labor Code addressing these issues (sections 2775-2787).

2. Q. What is the ABC test?

A. Under the ABC test, a worker is considered an employee and not an independent contractor, unless the hiring entity satisfies all three of the following conditions:

- 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 worker performs work that is outside the usual course of the hiring entity’s business; and
- The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

3. Q. How do you apply the ABC test to worker relationships?

A. Below is a summary of the California Supreme Court’s explanation of how to apply the ABC test.

**Part A: Is the worker free from the control and direction of the hiring entity in the performance of the work, both under the contract for the performance of the work and in fact?**

The hiring entity must establish that the worker is free of such control to satisfy part A of the ABC test. (*Dynamex*, 4 Cal.5th at 958.)

A worker who is subject, either as a matter of contractual right or in actual practice, to the type and degree of control a business typically exercises over employees would be considered an employee. (Id.)

Depending on the nature of the work and overall arrangement between the parties, a business need not control the precise manner or details of the work in order to be found to have maintained the necessary control that an employer ordinarily possesses over its employees. (Id.)

**PART B: Does the worker perform work that is outside the usual course of the hiring entity's business?**

The hiring entity must establish that the worker performs work that is outside the usual course of its business in order to satisfy part B of the ABC test. (Dynamex, 4 Cal.5th at 959.)

Contracted workers who provide services in a role comparable to that of an existing employee will likely be viewed as working in the usual course of the hiring entity's business. (Id.)

Examples where services are not part of the hiring entity's usual course of business:

- When a retail store hires an outside plumber to repair a leak in a bathroom on its premises.
- When retail store hires an outside electrician to install a new electrical line. (Id.)

Examples where services are part of the hiring entity's usual course of business:

- When a clothing manufacturing company hires work-at-home seamstresses to make dresses from cloth and patterns supplied by the company that will thereafter be sold by the company.
- When a bakery hires cake decorators to work on a regular basis on its custom-designed cakes. (Id. at 959-960.)

**PART C: Is the worker customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity?**

The hiring entity must prove that the worker is customarily and currently engaged in an independently established trade, occupation, or business. (Dynamex, 4 Cal.5th at 963.)

The hiring entity cannot unilaterally determine a worker's status simply by assigning the worker the label "independent contractor" or by requiring the worker, as a condition of hiring, to enter into a contract that designates the worker an independent contractor. (Dynamex, 4 Cal.5th at 962.)

Part C requires that the independent business operation actually be in existence at the time the work is performed. The fact that it could come into existence in the future is not sufficient. (See Garcia v. Border Transportation Group, LLC (2018) 28 Cal.App.5th 558, 574.)

An individual who independently has made the decision to go into business generally takes the usual steps to establish and promote that independent business. Examples of this include:

- Incorporation, licensure, advertisements;
- Routine offerings to provide the services of the independent business to the public or to a number of potential customers, and the like. (Dynamex, 4 Cal.5th at 962.)

***If an individual's work relies on a single employer, Part C is not met.*** For example, Part C was not satisfied where a taxi driver was required to hold a municipal permit that may only be used while that driver is employed by a specific taxi company. (See Garcia, 28 Cal.App.5th at 575.)

4. Q. Do AB 5 and Labor Code sections 2775 et seq. require use of the ABC test in all situations?

A. No. There are situations where the ABC test will not apply:

Sometimes the Legislature or the Industrial Welfare Commission has defined the employment relationship in a specific way. In such cases, the ABC test will not otherwise apply to establish employee status or employer liability. Rather, the specific language contained in the IWC wage orders, the Labor Code, or Unemployment Insurance Code will remain in effect.

Additionally, where a court determines the ABC test cannot apply for a reason other than an express exception, the Borello test, described in Question 5 below, will apply. For example, if a court were to determine in a particular case that the

ABC test is preempted by an applicable federal law, the Borello test would be used.

Finally, the ABC test may not apply for certain occupations and contracting relationships. See Question 7 below.

5. Q. What is the Borello test?

A. The California Supreme Court established the Borello test in *S.G. Borello & Sons, Inc. v. Dept. of Industrial Relations* (1989) 48 Cal.3d 341. The test relies upon multiple factors to make that determination, including whether the potential employer has all necessary control over the manner and means of accomplishing the result desired, although such control need not be direct, actually exercised or detailed. This factor, which is not dispositive, must be considered along with other factors, which include:

- Whether the worker performing services holds themselves out as being engaged in an occupation or business distinct from that of the employer;
- Whether the work is a regular or integral part of the employer's business;
- Whether the employer or the worker supplies the instrumentalities, tools, and the place for the worker doing the work;
- Whether the worker has invested in the business, such as in the equipment or materials required by their task;
- Whether the service provided requires a special skill;
- The kind of occupation, and whether the work is usually done under the direction of the employer or by a specialist without supervision;
- The worker's opportunity for profit or loss depending on their managerial skill;
- The length of time for which the services are to be performed;
- The degree of permanence of the working relationship;
- The method of payment, whether by time or by the job;
- Whether the worker hires their own employees;
- Whether the employer has a right to fire at will or whether a termination gives rise to an action for breach of contract; and
- 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 depending on 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. (*Yellow Cab Cooperative, Inc. v. Workers' Compensation Appeals Board* (1991) 226 Cal.App.3d 1288.)

As the Supreme Court has explained, Borello "emphasizes statutory purpose as the touchstone for deciding whether a particular category of workers should be considered employees rather than independent contractors for purposes of social welfare legislation." (*Dynamex*, 4 Cal.5th at 935.) The emphasis on statutory purpose "sets apart the Borello test for distinguishing employees from independent contractors from the [common law] standard . . . in which the control of details factor is given considerable weight." (*Id.*)

6. Q. How does the ABC test compare to the Borello test?

A. Both the Borello test and the ABC test assume that the worker is an employee and *the hiring entity must prove that the worker is an independent contractor.*

However, **the ABC test is designed to make it easier for both businesses and workers to determine in advance whether a worker is an independent contractor or an employee.** In other words, it is aimed at being more predictable than the multifactor approach used under Borello.

Unlike the ABC test — in which the inability of the hiring entity to demonstrate any part of the three-part test means that the worker is not an independent contractor — under the Borello test, no single factor determines whether a worker is an employee or an independent contractor. As described above in Question 5, courts consider all potentially relevant factors on a case-by-case basis in light of the nature of the work, the overall arrangement between the parties and the purpose of the law.

7. Q. Do AB 5 and Labor Code sections 2775 et seq. require use of the ABC test to determine if a worker is an independent contractor for all occupations in California?

A. No. While the ABC test is the applicable test for most workers, for some occupations and industries Labor Code sections 2775 et seq. apply the Borello multifactor test, described above. For some occupations, the Borello test applies without further requirements. However, for other occupations and industries, the Borello test applies instead of the ABC test only after the hiring entity satisfies other requirements first. Finally, for certain real estate licensees and repossession agencies, standards under the California Business and Professions Code will continue to apply.

To summarize:

Occupations where the Borello test applies instead of the ABC test under Labor Code sections 2775 et seq.:

- Certain occupations in connection with creating, marketing, promoting, or distributing sound recordings or musical compositions
- Certain licensed insurance agents, brokers, and persons who provide underwriting inspections, premium audits, risk management, or loss control work for the insurance and financial service industries
- Certain licensed physicians, surgeons, dentists, podiatrists, psychologists, or veterinarians
- Certain licensed attorneys, architects, landscape architects, engineers, private investigators and accountants
- Certain registered securities broker-dealers or investment advisers or their agents and representatives
- Certain direct salespersons
- Certain manufactured housing salespersons
- Certain licensed commercial fishers (only through December 31, 2022 unless extended by the Legislature)
- Certain newspaper distributors or carriers (only through December 31, 2021 unless extended by the Legislature)
- Certain persons engaged by an international exchange visitor program
- Certain competition judges
- Certain home inspectors, as defined in Section 7195 of the Business and Professions Code, and subject to the provisions of Chapter 9.3 (commencing with Section 7195) of Division 3 of that code.
- Occupations or contracting relationships where Labor Code sections 2775 et seq. requires that additional requirements must first be met in order to use the Borello test instead of the ABC test:
- Certain professional services contracts for marketing; human resources administration; travel agents; graphic design; grant writers; fine artists; enrolled agents licensed to practice before the IRS; payment processing agents; still photographers / photojournalists; videographers; photo editors to a digital content aggregator; freelance writers, translators, editors, copy editors, illustrators, or newspaper cartoonists; content contributors, advisors, producers, narrators, or cartographers for a journal, book, periodical, evaluation, other publication or educational, academic, or instructional work in any format or media; licensed barbers, cosmetologists, electrologists, estheticians, or manicurists (manicurists only)

through December 31, 2021); specialized performing arts Master Class Instructors, appraisers, registered professional foresters, and data aggregators, as defined.

Borello applies to determine whether the individual is an employee of the hiring entity if initial requirements are met.

- Relationships between two individuals working on a single engagement event, defined as a stand-alone non-recurring event in a single location, or a series of events in the same location no more than once a week. Borello applies if initial requirements are met.
- Certain individuals performing work under a subcontract in the construction industry, including construction trucking (with certain specific conditions applicable to construction trucking only through December 31, 2021). Borello and Labor Code section 2750.5 apply to determine whether the individual is an employee of the contractor if initial requirements are met.
- Certain service providers who are referred to customers through referral agencies to provide services including, but not limited to, graphic design, web design, photography, tutoring, consulting, youth sports coaching, caddying, wedding or event planning, services provided by wedding and event vendors, minor home repair, moving, errands, furniture assembly, animal services, dog walking, dog grooming, picture hanging, pool cleaning, yard cleanup, and interpreting. Borello applies to determine whether the service provider is an employee of the referral agency if initial requirements are met.

**The following services are excluded:** services provided in an industry designated as a high hazard industry, **janitorial**, delivery, courier, transportation, trucking, agricultural labor, retail, logging, in-home care, or construction services other than minor home repair.

Certain individuals performing services pursuant to a third party's contract with a motor club to provide motor club services. Borello applies to determine whether the individual is an employee of the motor club if initial requirements are met.

Certain bona fide business-to-business contracting relationships. Borello applies to determine whether the business providing services is an employee of the business contracting for the services if initial requirements are met.

For two specific industries, special rules under Labor Code section 2778(b) require examination under the Business and Professions Code:

- Certain real estate licensees, for whom the test of employee or independent contractor status is governed by section 10032(b) of the Business and Professions Code. (If that section is not applicable, then Borello is the applicable test for purposes of the Labor Code, except ABC will be the applicable test for purposes of workers' compensation as of July 1, 2020.)
- Certain repossession agencies, for which the determination of employee or independent contractor status is governed by Section 7500.2 of the Business and Professions Code.

The exemptions from the ABC test for certain industries, occupations, or contracting relationships may involve some complicated rules and criteria which are not set forth above. Employers and workers should seek independent advice and counsel if they have questions about the applicability of any exemption to their particular case.

8. Q. When do the changes from AB 5 become effective?

A. The law became effective January 1, 2020. However, different timeframes apply depending on the circumstances:

For purposes of IWC wage orders and violations of the Labor Code relating to wage orders: The ABC test was already in effect for these purposes (as explained in a Labor Commissioner's Office Opinion Letter) prior to 2020 due to the Dynamex Supreme Court decision. AB 5 is intended to codify — meaning write into the Labor Code — the ABC test from Dynamex, *which has been the law in California since the opinion was issued in 2018*.

Recognizing that the ABC test already applies to certain claims (wage order claims and Labor Code claims relating to wage orders) that pre-date January 1, 2020, section 2785 also provides that the exemptions from the test for certain occupations (see Question 7) apply to these claims. The hiring entity would not be required to use the ABC test with respect to these claims if it establishes that the job or occupation falls within one of the exemptions - including if the claim involves work performed before January 1, 2020.

For purposes of all other Labor Code provisions not relating to IWC wage orders:

**The ABC test must be used for these purposes beginning January 1, 2020** (unless an exemption from the test applies for certain occupations – see Question 7).

For purposes of the Unemployment Insurance Code, including determining eligibility for Unemployment Insurance, Disability Insurance, and Paid Family Leave benefits:

The ABC test must be used for purposes of the Unemployment Insurance Code beginning January 1, 2020. This change will affect how the Employment Development Department (“EDD”) determines eligibility for Unemployment Insurance, Disability Insurance, or Paid Family Leave benefits, which considers how much a worker earns as an employee during “base periods.” In making this determination, the EDD will use the ABC test to determine whether the worker is an employee or an independent contractor for work performed on or after January 1, 2020. (unless an exemption from the test applies for certain occupations — see Question 7).

**\*\* NOTE: Churches are normally not subject to State Disability Insurance (SDI) or Unemployment Insurance (UI)**

For more information on how the EDD uses base periods to determine eligibility for these benefits, please see How Unemployment Benefits Are Computed (DE 8714AB) or Calculating Disability Insurance Benefit Amounts (for Disability Insurance and Paid Family Leave benefits).

For purposes of Workers’ Compensation Insurance: The ABC test must be used for this purpose beginning July 1, 2020. This means that for a worker who experiences a compensable injury on or after this date, the ABC test will apply to determine whether the worker is an employee or independent contractor (unless an exemption from the test applies for certain occupations — see Question 7).

9. Q. Does AB 5 mean that workers will automatically be reclassified as employees instead of independent contractors?

A. **No. Labor Code section 2775 starts with an assumption that all workers are employees**, and provides the test that a hiring entity would have to satisfy to prove that the workers are independent contractors. Employers may wish to evaluate their working arrangements and ensure they are appropriately classifying their workers as required under the law, and workers may file a claim if they believe they have been misclassified (see Question 15).

10. Q. If a hiring entity has a worker sign an agreement stating that the worker is an independent contractor, does not make payroll deductions or withholdings for taxes or Social Security for the worker, and at the end of the year provides the worker with an IRS Form 1099 rather than a W-2, does this mean the worker is an independent contractor?

A. **No. Being labeled an independent contractor, being required to sign an agreement stating that one is an independent contractor, or being paid as an independent contractor (that is, without payroll deductions and with income reported**

by an IRS Form 1099 rather than a W-2), is not what determines employment status. The ABC test — or where appropriate, the Borello test or other standard under Labor Code sections 2775 et seq. (see Questions 2, 5, and 7 above) — are used to determine employment status. **An employer cannot change a person’s status from that of an employee to one of an independent contractor by requiring a written agreement to that effect or by giving them an IRS Form 1099 instead of a W-2.**

11. Q. Are there penalties for misclassifying workers as independent contractors?

A. Yes. In addition to penalties that may be assessed for wage violations associated with a worker being misclassified as an independent contractor, there are civil penalties for willful misclassification. Under Labor Code section 226.8, which prohibits the willful misclassification of individuals as independent contractors, **there are civil penalties of between \$5,000 and \$25,000 per violation.** Willful misclassification is defined as voluntarily and knowingly misclassifying an employee as an independent contractor.

12. Q. What difference does it make if a worker is an employee rather than an independent contractor?

A. California’s wage and hour laws (e.g., minimum wage, overtime, meal periods and rest breaks, etc.), workplace safety laws, and retaliation laws protect employees, but not independent contractors. Additionally, employees can go to state agencies such as the Labor Commissioner’s Office to seek enforcement of these laws, whereas independent contractors must resolve their disputes or enforce their rights under their contracts through other means.

13. Q. Do AB 5 and Labor Code sections 2775 et seq apply to public entities?

A. Yes. However, many provisions of the Labor Code and most sections of the IWC Wage Orders do not apply to public employees. (See, e.g., Johnson v. Arvin-Edison Water Storage District (2009) 174 Cal.App.4th 729.) AB 5 does not change that.

14. Q. Do AB 5 and Labor Code sections 2775 et seq. apply to volunteers and interns?

A. No. AB 5 and the ABC test apply to the question whether someone is an employee or an independent contractor. There are separate standards that apply to the question whether someone is an employee rather than a volunteer or intern. (Please see the Division of Labor Standards Enforcement Policy and Interpretations Manual and Opinion Letters for more information.)

**\*\* NOTE: A “volunteer” is a worker to provides services to an organization without compensation and who has “no expectation of receiving compensation” in any form. In other words, you cannot call a worker a “volunteer” and give that person “money equivalents” (prepaid debit cards, shopping cards, etc.) in exchange for his/her labor instead of actual cash.**

15. Q. What should workers do if their employer keeps them under independent contractor status when they think they should be considered an employee?

A. A worker can file one or more of the following:

- A wage claim with the Labor Commissioner’s Office
- A Report of Labor Law Violation with the Labor Commissioner’s Office for widespread violations affecting a group of workers
- A lawsuit in court

16. Q. Are there protections if a worker is retaliated against because the worker complains about being misclassified and losing out on employee rights like being paid overtime?

A. Yes. Workers who face discrimination or retaliation in any manner whatsoever — for example, if the employer fires a worker because they complain about being classified as an independent contractor or not being paid overtime, or because the worker filed a claim or told the employer that they intend to file a claim with the Labor Commissioner — can file a discrimination/retaliation complaint with the Labor Commissioner’s Office. However, it is important to note that the Labor Commissioner does not have jurisdiction over most workers who are in fact independent contractors. The worker can also file a lawsuit in court against the employer instead of filing a complaint first with the Labor Commissioner’s Office.

17. Q. Is there a grace period for employers to get into compliance with their payroll tax obligations after the effective date of AB 5?

A. No. Employers must pay any payroll taxes that are due based on the employees they have as of January 1, 2020. If employers are not yet registered with EDD as an employing unit, they are encouraged to register and begin filing and paying their taxes (based on established due dates per calendar quarter) utilizing EDD’s online e-Services for Business.

18. Q. How are employment status determinations made by EDD for purposes of Unemployment Insurance or State Disability Insurance benefits?

A. EDD may make employment determinations through an employment tax audit or through determining a claim for Unemployment Insurance (UI) or State

Disability Insurance (SDI) benefits. For work performed prior to January 1, 2020, employment status will be determined by the existing provisions of Unemployment Insurance Code section 621(b), which requires EDD to use the Borello test. For work performed on or after January 1, 2020, EDD will determine employment status based on the tests provided in AB 5.

19. Q. Do existing statutory exclusions to employment under the Unemployment Insurance Code remain in effect after the passage of AB 5?

A. The Unemployment Insurance Code excludes certain types of services from the Code's definition of employment, which affects who is eligible for Unemployment Insurance benefits. These exclusions remain in effect after AB 5.

20. Q. What risks do employers face under the Unemployment Insurance Code for not properly classifying employees?

A. If EDD finds that workers are misclassified as independent contractor(s) when they should be classified as employee(s), employers face significant risks related to failing to comply with their obligations under the Unemployment Insurance Code. **These risks include under-paying their taxes and having to pay their employees' share of payroll taxes, both of which may result in incurring penalties and interest.**

21. Q. What are the tax implications if a worker is classified as an independent contractor for federal tax purposes and employee for California tax purposes?

A. The Franchise Tax Board, the state entity that administers personal income and franchise tax, has provided guidance on this question its webpage.

22. Q. Can workers be considered employees under California law if they are not considered employees under federal law?

A. Yes. Workers may be considered employees and have protections under California law, even if they are determined not to be employees under federal law. This is because *the tests used to determine employee status under California law differ from the tests used under federal law*, such as the federal Fair Labor Standards Act (FLSA).

For more information, please visit the Labor & Workforce Development Agency Employment Status Portal.

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