# Employee or Independent Contractor?
## The rules have changed… Has your business?

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**"A Day that will Live in Infamy" for California Employers**

For decades, California courts have applied a complex, multi-factor test to determine whether a worker who was paid as an independent contractor was properly classified as such. No more. On April 30, 2018, the prerequisites changed dramatically in the landmark California Supreme Court case *Dynamex Operations West, Inc.*

**AB5 Slams the Door for Employers**

While Dynamex was a 2018 court decision, the statute known as AB5 has slammed the door and codified the three-factor test of *Dynamex* into the Labor Code, beginning in 2020. That 2020 effective date for AB5 has been rendered irrelevant by *Vasquez v. Jan-Pro Franchising, Inc.*, which has held that *Dynamex* is to be applied retroactively since the beginning of time. The general statute of limitations for wage and hour claims under the Labor Code is 3 years.

Fortunately, AB5 did exempt a few professions if certain other tests are met (see last page).

**Text from *Dynamex* and AB5:**

In order for a worker to be truly an "independent contractor", they must meet all three tests below:

***(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,*

***(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 that involved the work provided.*

## Explanation and Examples

**A)** The individual has the right to control, and discretion as to the manner of performance of the contract for services, but not the means by which the work is accomplished;
*Example: Hiring an outside I.T. consultant to integrate your office computers as a network would favor contractor status, but specifically telling them how to do the work renders that worker as an employee.*

**B)** The individual performs services in an occupation or business distinct from that of the principal (not part of your regular business);
*Example: an outside bookkeeper who does accounting work for a plumbing company favors contractor status, but a plumber who works for that same company must be an employee.*

**C)** The individual is customarily engaged in an independently established trade or business;
*Example: a management consultant offers advice to various businesses on how they can become more profitable, but does not actually perform the services that regular company employees do. Management consultants typically work as freelancers and not as employees.*

***The worker needs to meet all three of the above tests to properly be classified as an independent contractor. Fail just one and the worker must be an employee.***

## Cumulative Penalties for Misclassification:

1) No Workers' Compensation Insurance + DLSE visit = Citation / Stop Order.
2) Violation of Stop Order is a criminal misdemeanor.
3) SB 459 penalties of $5,000 per misclassified worker if willful.
4) Payment of back taxes (employer's and employee's taxes).
5) Reimburse employee's medical expenses if injured.
6) Do you have the cash in the bank for all this?

## Employers: What does all this mean to you?

- Consult an employment law attorney before classifying any worker as an independent contractor. Don't merely rely upon your tax preparer, as the IRS' federal test is easier to meet than California's more restrictive A-B-C test.
- A contract with your workers cannot re-write California's laws.

# Frequently Asked Questions

About Classifying Workers as Independent Contractors

***Q:*** ***My outside sales rep works from home and maintains their own schedule. Can they be an independent contractor?***

A: Not anymore. This worker fails the "B" prong of the A-B-C test, in that your sales reps are providing services that your business performs (every company sells its own services in one way or another).

***Q:*** ***What if I'm paying a corporation or LLC?***

A: The *Dynamex* case and AB5 address payments to individual workers (which would include those who merely use a fictitious busines name), but not payments to separate legal entities. Payments to corporations can be contractor payments, since the corporation is a separate legal and taxable entity from the individual (and corporations legally cannot be on payroll). Payments to single-member LLCs are a bit less clear as the member is still taxed as a sole proprietorship.

In either case, the worker's business entity must be independently established before you plan to hire them. Telling a worker: *"Go set up your own corporation so I can pay you as a contractor"* would likely be held as a fraudulent subterfuge and the worker declared to be an employee by the DLSE or EDD.

***Q:*** ***Is the Dynamex case retroactive?***

A: YES. On January 14, 2021, the California Supreme Court held in *Vazquez v. Jan-Pro Franchising Int'l Inc.* that the A-B-C test in *Dynamex* is retroactive. However, as a practical matter, the businesses that are now properly classifying their workers are probably off the radar of the DLSE and EDD. Those agencies are more focused on current violators than previous ones. If you have not yet complied, do so now to minimize ongoing liability.

***Q:*** ***Our accounting firm hires independent contractors at tax time. OK?***

A: Under *Dynamex*, NO. Under AB5, maybe. The previous tests under *S.G. Borello & Sons* for classification as an independent contractor will apply to whether a licensed CPA or EA can qualify. Non-licensed bookkeepers and other accounting staff must still be on payroll.

***Q:*** ***I'm a licensed CLSB contractor. How does Dynamex or AB5 affect me?***

A: Not much. Contractor have always been held to a higher standard of classification than most other businesses. Every worker on a job site must either be either: a) a licensed contractor; or b) an employee of a licensed contractor. Unlicensed independent sub-contractors have not been permitted on a job site for many years. Contractors should never hire a sub as an independent contractor without first verifying their CSLB license status, and should also verify the sub-contractor's workers are properly classified as well.

***Q:*** ***Can't I just make my workers partners / shareholders / members to avoid paying them as employees?***

A: As a general rule, NO. When two or more people co-found a business, have equal ownership, equal management control, and contribute equally to the capital investment, the DLSE generally doesn't get involved with wage claims. However, when companies start passing out token percentages of equity ownership in an attempt to subvert California's Labor Code, except the DLSE to disregard such token ownership. The test of what constitutes a true "business partner" is not merely a numerical percentage of equity, but also how much capital they have invested and to what degree they participate in the management of the company. On a separate note, it's generally a bad idea to give up equity in your company without a solid written buy-back agreement in place. When you terminate an employee, you don't want them owning a piece of equity in perpetuity.

***Q:*** ***What about the "business-to-business" exemption in AB5?***

A: There is a narrow exemption in AB5 for businesses that contract with other business providers for services. There are many factors, but the big ones are:

- The provider is doing the service for the business and not the customers of the business. So, a webmaster could meet this test if the payor was not in the web-development business.
- A contract has been made in writing. This is a requirement but does not wipe away other factors.
- The business services provider is properly licensed, if required.
- Providers maintain a separate physical location from the payor.
- The provider publicly markets themselves as being available to provide services to other businesses for related services. Translation, if the provider does not have a website to advertise their services, this test will probably fail.

***Q: What licensed professions are exempt under AB5?***

A: The list of exemptions in AB5 are changing, as some listed below will expire before others and more may be added later. For those licensed professionals that are exempt from the A-B-C test of AB5, they must still meet the *Borello* factors (or some variant of them) in order to qualify. This often includes having a business license, a separate business address, and setting their own rates. As of the original AB5 statute, and later AB2257, the exemptions include:

1) Insurance broker.
2) Physician, dentist, podiatrist, or veterinarian.
3) Lawyer, architect, engineer, private investigator, or CPA - Enrolled Agent.
4) Securities broker-dealer.
5) Commercial fisherman.
6) Travel agent.
7) Real estate brokers and salespeople (includes mortgage and business brokers).
8) Repossession agents.
9) CSLB licensed contractors working as subs (but not unlicensed workers).
10) Esthetician, Electrologist, Manicurist, Barber, or Cosmetologist.

Some unlicensed professions may be exempt under narrow circumstances:

11) Direct salesperson or yacht broker per §650 of the Unemployment Insurance Code *(note: this is very narrow and does not cover most regular salespeople).*
12) Marketing consultants, provided the work is creative in nature.
13) Human Resource administrator.
14) Graphic designer, grant or freelance writer, and fine artist.
15) Photographer or photojournalist *(less than 35 submissions per year per outlet).*
16) Construction trucking services.
17) Pet sitters.
18) Tutors *(private, not those contracted by schools)*