WORKER CLASSIFICATION AND AB 5 FREQUENTLY ASKED QUESTIONS

There have been recent changes to California law addressing worker classification, including the signing into law in September 2019 of Assembly Bill 5 (AB 5). AB 5, which goes into effect on January 1, 2020, may impact whether workers are treated as employees or as independent contractors under California law. Although these FAQs provide some information about AB 5, you are encouraged to visit the website of the California Labor and Workforce Development Agency, which contains information from various state entities to help workers, employers, and hiring entities understand AB 5 and other California worker classification laws, including their rights and obligations: https://www.labor.ca.gov/employmentstatus/.

Worker classification has tax implications and this is nothing new. There are different tax reporting and filing requirements for workers classified as employees or independent contractors. These frequently asked questions are designed to help workers achieve tax compliance by minimizing errors in preparing tax returns, paying the correct amount of tax, and filing accurate tax returns.

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

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 added a new section to the Labor Code addressing these issues (section 2750.3).

2. What is the ABC test?

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:

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 as that involved in the work performed.

3. How do you apply the ABC test to worker relationships?
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 a retail store hires an outside electrician to install a new electrical line.

- 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.

**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* (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:
  o Incorporation, licensure, advertisements;
  o Routine offerings to provide the services of the independent business to the public or to a number of potential customers, and the like.

• 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. **Do AB 5 and Labor Code section 2750.3 require use of the ABC test in all situations?**

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.
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:

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 their task;
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; and
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 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 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. How does the ABC test compare to the Borello test?

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. Do AB 5 and Labor Code section 2750.3 require use of the ABC test to determine if a worker is an independent contractor for all occupations in California?

No. While the ABC test is the applicable test for most workers, for some jobs and industries Labor Code section 2750.3 applies 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 section 2750.3:**

- Certain licensed insurance agents and brokers
- Certain licensed physicians, surgeons, dentists, podiatrists, psychologists, or veterinarians
- Certain licensed attorneys, architects, engineers, private investigators and accountants
- Certain registered securities broker-dealers or investment advisers or their agents and representatives
- Certain direct salespersons
- Certain licensed commercial fishermen (only through December 31, 2022 unless extended by the Legislature)
- Certain newspaper distributors or carriers (only through December 31, 2020 unless extended by the Legislature)

**Occupations or contracting relationships where Labor Code section 2750.3 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; freelance writers, editors, or newspaper cartoonists; licensed barbers, cosmetologists, electrologists, estheticians, or manicurists (manicurists only through December 31, 2021). *Borello* applies to determine whether the individual is an employee of the hiring entity 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 graphic design, photography, tutoring, event planning, minor home repair, moving, home cleaning, errands, furniture assembly, animal services, dog walking, dog grooming, web design, picture hanging, pool cleaning or yard cleanup. *Borello* applies to determine whether the service provider is an employee of the referral agency if initial requirements are met.

- 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 2750.3 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. **Is the determination of whether a worker is an employee or independent contractor under AB 5 relevant for California income tax purposes?**

Yes. The determination of whether a worker is an employee or independent contractor under AB 5 is relevant for California income tax purposes.

9. **What are the tax implications if a worker is classified as an employee for both federal and California tax purposes?**

If a worker is classified as an employee for federal and California tax purposes, they would receive a W-2, which would report their wages. For W-2 employees, all of wages, compensation, fringe benefits (unless otherwise excluded), and other compensation from the employer is included on the W-2. Employees are generally not entitled to deduct any of the costs of being an employee, such as the cost of a car to get to work, unrequired office supplies, etc. However, employees may be able to deduct some unreimbursed employee business expenses required by the employer, such as uniforms.

In addition, the employee's W-2 reports the employee's withholdings for federal income taxes and the employee's share of Social Security taxes and Medicare taxes. Furthermore, employers also remit and pay the employer's portion of the Social Security and Medicare tax liability. In California, employees are also generally subject to withholding for State Disability Insurance tax and California Personal Income Tax. Employers must withhold these amounts from employees and must also pay the Unemployment Insurance Tax and the Employment Training Tax.

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

If a worker is classified as an independent contractor for federal and California tax purposes, they may receive a 1099-K or a 1099-MISC from a hiring entity which would report payments being made to the worker, dependent on the type of payments received and/or the amount of the payments.

The information provided on a 1099-K generally includes the gross amount received from third party transactions (which includes gig platform transactions), the number of the payments received, and any federal or state income tax withholding where the worker did not provide taxpayer ID number. Whereas, the information provided on a
1099-MISC includes detailed income information, including, rents, royalties, other income, and nonemployee compensation. Unlike an employee, an independent contractor is considered self-employed and is able to take deductions for ordinary and necessary business expenses for items such as:

- Travel
- Vehicle expenses
- Bad debts
- Depreciation
- Interest
- Rent
- Pension plans
- State and local taxes
- The Self-Employment Tax
- Property, sales, excise, and fuel taxes
- Home office deduction (with limitations)

Since the worker is not an employee, there is no withholding requirement on the hiring entity for Social Security or Medicare. However, the worker must pay the federal Self-Employment Tax, which accounts for Social Security taxes and Medicare taxes. In addition, for California purposes, the worker may elect to pay California unemployment insurance, but it is not required.

For more information about business expense deductions, please see FTB Publication 984, relating to Business Expenses (revised 3/2017) at https://www.ftb.ca.gov/forms/misc/984.html.

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

As detailed above, a worker classified as an independent contractor for federal tax purposes would likely receive a 1099-K or a 1099-MISC for federal purposes. A worker classified as an employee for California tax purposes would receive a W-2. As a result, the income reported on the 1099-K or 1099-MISC may be different than the amount on a W-2 since the items of income and how that income is reported may be different.

A worker that is an independent contractor for federal purposes would be entitled to deduct their business expenses, as described above, however as a California employee, the worker would be limited to unreimbursed business expenses. For example, if a worker uses a vehicle in their business, they may be able to depreciate the vehicle and deduct maintenance against their business income for federal purposes. However, for California tax purposes, they would not be entitled to those deductions.

In addition, hiring entities that are considered employers in California would be required to pay state disability insurance tax and California personal income tax withholding, however would not be required to pay a portion of the worker’s Social Security and Medicare taxes. Whereas, for federal purposes, the worker would be required to pay
the self-employment tax without any contribution from the hiring entity. It is important to note the worker is allowed to take a deduction for the self-employment tax for federal purposes, but would not be able to take the deduction for California purposes.

Payments that are required to be made to a worker under California's classification as an employee, such as sick leave or state disability, or fringe benefits which are excluded from an employee's income, may be considered to be taxable by the federal government.

In addition, it is important to note that several deductions and credits are available to California employers.

12. If an employer treats a worker as an independent contractor for federal purposes, and an employee for California under AB 5, what is the proper way for the worker to report their income on their California Form 540?

A California resident taxpayer, who is an employee for California tax purposes, is required to report income from all sources, including wage income, on their Form 540.

13. If a hiring entity issues a Form 1099 to a worker, are they required to file a separate Form 1099 with the Franchise Tax Board?

Although AB 5 may have an impact on who is required to file a Form 1099, it did not change the reporting requirements for Form 1099s. A hiring entity does not have to file the IRS Form 1099-MISC or 1099-K separately with the Franchise Tax Board if they file the IRS Form 1099-MISC or 1099-K through the Internal Revenue Code Federal/State Filing Program. The Internal Revenue Service will forward the Form to the Franchise Tax Board.

14. If the worker is issued a W-2 reporting earnings because the worker is an employee under California law, and a Form 1099-K or 1099-MISC reporting the same earnings because the worker is an independent contractor under federal law, should the payor file a Form 1099-K or 1099-MISC showing zero income to the Franchise Tax Board?

The payor is not required to file the Form 1099-K or 1099-MISC with California and would file the form with the Internal Revenue Service. The payor would be required to report information on the Form 1099-K or 1099-MISC in accordance with the federal Form 1099 filing requirements.

15. Will California follow the federal pension plan qualification rules through automatic conformity regardless of its determination if a worker is an employee or independent contractor?

Sections 401 through 424 of the Internal Revenue Code provide rules regarding deferred compensation plans, included the qualification rules regarding employer
provided pension plans. California, pursuant to Section 17501 of the Revenue and Taxation Code, automatically conforms to Sections 401 through 424 of the Internal Revenue Code and any modifications to those code sections. Thus, California would follow the federal determination if a pension plan is a qualified plan. Therefore, if a pension plan is a qualified plan under the Internal Revenue Code, the pension plan would be considered a qualified plan for the purposes of the Revenue and Taxation Code.

16. Are various benefits included in income for California tax purposes?

Unemployment Compensation Benefits

Unemployment compensation benefits are not included in the recipient’s income under California law. Section 17083 of the Revenue and Taxation Code states that Section 85 of the Internal Revenue Code, relating to unemployment compensation, shall not apply.

Social Security Benefits

California provides an exclusion from income for Social Security benefits. Section 17087 of the Revenue and Taxation Code states, “Section 86 of the Internal Revenue Code, relating to Social Security and Tier 1 Railroad Retirement Benefits, shall not apply.”

Medical and Dental Benefits

State

Generally, you can deduct the amount of your medical and dental expenses that is more than 7.5% of federal AGI.

California generally conforms to federal law related to the treatment of employer provided coverage under accident or health plans and amounts received through accident or health insurance with some exceptions.

However, self-employed individuals can deduct the amount paid for health insurance, including all Medicare parts from gross income.

Social Security, Medicare, State Disability Insurance, Federal and State Income Taxes paid by an Employer

If an employer pays the employee’s share of Social Security, Medicare, or State Disability Insurance without deducting the amounts from their wages, these payments generally should be included on the Form W-2, and should be reported by the employee as taxable income on their personal income tax returns.

Amounts deducted from employee's wages for State Disability Insurance and state income tax would be considered paid by the employee. These amounts would be deductible as business expenses for Schedule C filers/independent contractors to the extent those state taxes are considered deductible at the federal level.
For more information on AB 5, go to the California Labor and Workforce Development Agency's website at https://www.labor.ca.gov/employmentstatus/.