



JORGE PERAZZO, CPA
ACCOUNTANCY CORPORATION

RE: Independent Contractors

Dear Client:

In 2019, the Governor signed AB 5. Under AB 5, most workers are presumed to be employees for both labor and payroll tax purposes unless the business (hiring entity) satisfies a three-factor test, referred to as the ABC test. This means that many workers previously classified as independent contractors are now employees under California law and you must withhold California income and payroll taxes, and meet California's minimum wage and overtime requirements.

However, as discussed below, AB 5 provides numerous exemptions from the ABC test, and AB 2257, enacted in 2020, significantly expands on the number of available exemptions. AB 2257 also applies the ABC test for purposes of determining an employee for personal income tax purposes. In addition, Proposition 22, which was passed by the voters in the November 2020 election, makes an independent contractor carve-out for certain app-based drivers (for example, Uber, Lyft, and Doordash), but requires the companies that contract with these drivers to provide additional benefits to the workers.

The ABC test

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, commonly known as the **Borello** "control test" (*S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.* (1989) 48 Cal.3rd 342);
- 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.

The ABC test means, for example, that a hospital who hires nurses to work in specialized areas, such as an anesthesia nurse or neonatal nurse, may not treat the nurse as an independent contractor if those nurses are filling in for or working alongside employee-nurses. While physicians have their own specific exemption from AB 5, the same treatment would apply to other medical services, as well as consulting services, some portions of the entertainment industry, and many personal service workers.

A previous court case, **Borello**, will continue to apply. Many workers have been treated as independent contractors rather than employees, even using the **Borello** test. The difference now, is that AB 5 is putting the issue in the forefront and many businesses have not been properly classifying workers. We will see an increase in audits by the state in this area.

Exemptions

While applying the ABC test to workers will result in many more workers being classified as employees, the legislation provides for numerous exemptions to the application of the ABC test. The exemptions are complicated, and very specific. However, the exemptions do not mean workers are automatically independent contractors.



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If an exemption applies, you are still required to apply the traditional tests to determine if a worker is an employee or an independent contractor. Under these traditional tests, the “B” part of the ABC test will still be considered, but it is not a make-or-break factor.

Penalties could apply

Be aware that California law includes severe financial penalties for willfully treating an employee as an independent contractor.

The penalties, which are in addition to other assessments, penalties, or fines, are:

- \$5,000 to \$15,000 for each violation (a single misclassified individual); and
- \$10,000 to \$25,000 for each violation if the Labor Commissioner, or a court, determines there is a “pattern and practice” of these violations.
- (Labor Code §226.8)

With the exception of an attorney or other employee of the business, these penalties also apply to your tax professional or any paid person who advises you to incorrectly treat a worker as an independent contractor. This means that you may be required to obtain a legal opinion if there is a question as to the classification of employees and as a non-attorney, I cannot provide this advice.

Important points

There are three important points to understand:

1. Forming or operating as a corporation or an LLC is not a work-around. The corporation or LLC will be ignored if the worker does not meet the ABC test, and the worker who owns the entity will still be an employee of the payor;
2. In many cases the worker may still be an independent contractor for federal purposes if the “A” and “C” test apply. This is an area that we must discuss in detail; and
3. The effective date of the law is January 1, 2020, but could be applied retroactively, so time is of the essence.

The law is extremely complex with many unanswered questions. We continue to research and educate ourselves and are available to consult with you regarding this new issue as well as any other tax-related matters.

Sincerely,

Jorge Perazzo CPA Accountancy Corporation

PS – New Form 1099-NEC must be used for independent contractors for payments made in 2020. Only payments for independent contractors use this form – all others still use Form 1099-MISC.