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Assembly Bill 5: Problem or Solution for Construction Contractors?

Assembly Bill 5. To great fanfare, Governor Gavin Newsom signed into law California Assembly Bill 5, codified as Labor Code §2750.3 and effective as of January 1, 2020 ("AB5").[1] AB5 codified the main thrust of *Dynamex v. Superior Court (2018)* 4 Cal.5th 903 ("***Dynamex***") in §2750.3(a): requiring the hiring entity to demonstrate that the worker is correctly classified as an independent contractor, and not an employee, under the ***Dynamex*** "ABC" test:

(A) The person 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 person performs work that is outside the usual course of the hiring entity's business.
(C) The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.[2]

Stated Legislative Intent: Enshrining Dynamex. The Legislature made a specific point of declaring that AB5 was enshrining ***Dynamex*** in California law, in order to protect workers from the predations of hiring entities:

- "[T]he Court [in Dynamex] cited the harm to misclassified workers who lose significant workplace protections, the unfairness to employers who must compete with companies that misclassify, and the loss to the state of needed revenue from companies that use misclassification to avoid [financial and legal] obligations …."
- "The misclassification of workers as independent contractors has been a significant factor in the erosion of the middle class and the rise in income inequality."
- "It is the intent of the Legislature in enacting this act to include provisions that would codify the decision of the California Supreme Court in Dynamex and would clarify the decision's application in state law."
- "It is also the intent of the Legislature in enacting this act to ensure workers who are currently exploited by being misclassified as independent contractors instead of recognized as employees have the basic rights and protections they deserve under the law …"
- "By codifying the California Supreme Court's landmark, unanimous Dynamex decision, this act restores these important protections to potentially several million workers who have been denied these basic workplace rights that all employees are entitled to under the law."[3]

Actual Result: Reversing Dynamex. However, AB5 did nothing to protect exploited workers or restore workplace rights, because ***Dynamex*** ABC test had already done so. Why then was AB5 necessary? That necessity lies in the vast array of worker classes exempted from ***Dynamex*** by AB5. Contrary to the Legislature's moral grandstanding about AB5 enshrining ***Dynamex***, AB5 actually reversed ***Dynamex*** for a broad class of entrepreneurial and professional workers! The focus of this article is the sixth of eight exempt classes: subcontractors in the construction industry.

Why is Independent Contractor Status Important? High-income subcontractors have immense financial incentive to maintain their own independent contractor status, particularly in light of the huge tax savings available ($12,500 and up annually) under the S corporation business structure.[4] Employee status requires

the subcontractor to work as an individual, rather than as a contracting S corporation, eliminating ALL of those tax benefits.

General contractors also face substantial financial harm if their subcontractors are reclassified as employees. Labor Code §226.8 imposes serious penalties ($5,000 to $25,000 per violation) for hiring entities that willfully misclassify workers as independent contractors and can result in CSLB disciplinary action. Contractors also are personally liable for misclassified workers' unpaid (and unwithheld) taxes.[5] Similarly, the IRS can force any person with authority to sign checks for the hiring entity to pay personally the required (but unwithheld and unpaid) tax.[6]

Construction Subcontractor Exemption. Labor Code §2750.3(f) states that ***Dynamex*** does not apply to "the relationship between a contractor and an individual performing work pursuant to a subcontract in the construction industry…." This exemption requires meeting four tests. First, the contractor (the hiring entity) must demonstrate that all the following (abbreviated) criteria are satisfied:

(1) The subcontract is in writing;
(2) The subcontractor is licensed by the CSLB and its subcontracted work is within the scope of that license;
(3) The subcontractor has the required business license or business tax registration (if applicable);
(4) The subcontractor maintains a separate business location from the hiring contractor;
(5) The subcontractor has the authority to hire and fire its own staff for work under the subcontract.
(6) The subcontractor is financially responsible for its mistakes via insurance, performance bond, warranties, or indemnity language in the written contract; and
(7) The subcontractor customarily engages in an independent business providing the same type of work.[7]
(8) Subcontractors providing "construction trucking services" for which no CSLB license is required, have an additional set of rules, but currently can only use the subcontractor exemption through December 31. 2021. PLEASE NOTE that the entirety of AB5 is currently unenforceable against the motor carrier industry, and California government appeals to revive enforcement are unlikely to succeed.[8]

Next, "satisfactory proof" must be available to show that **(a)** the subcontractor can control its work such that the result of its work is the primary factor bargained for in the subcontract; and **(b)** its independent contractor status is bona fide and not a subterfuge to avoid employee status. Evidence that helps establish "bona fide" contractor status includes "the presence of cumulative factors" such as:

(1) substantial investment (other than time) in the business;
(2) holding itself out to be in business for itself;
(3) bargaining on price based on the project completed rather than time spent;
(4) control over the time and place of work;
(5) supplying its own tools and equipment that otherwise are generally supplied by employers;
(6) hiring its own employees;
(7) performing work outside the usual course of the hiring contractor's business;
(8) performing work that requires a particular skill;
(9) holding a CLSB license;
(10) the intent by the parties that the work relationship is of an independent contractor status; or
(11) the hiring contractor cannot fire the subcontractor "at will" without being liable for breach of contract.[9]

Finally, the contractor-subcontractor relationship must also pass the six-part test set forth in *Borello v. Department of Industrial Relations* (1989) 48 Cal.3d 341 ("***Borello***"). ***Borello*** is a 30-year-old case, one of many California cases addressing the difference between independent contractors and employees. Here is the ***Borello*** six-part test, verbatim:

> "Each service arrangement must be evaluated on its facts, and the dispositive circumstances may vary from case to case. We also note the six-factor test developed by other jurisdictions which determine independent contractorship in light of the remedial purposes of the legislation. Besides the 'right to control the work,' the factors include (1) the alleged employee's opportunity for profit or loss depending on his managerial skill; (2) the alleged employee's investment in equipment or materials required for his task, or his employment of helpers; (3) whether the service rendered requires a special skill; (4) the degree of permanence of the working relationship; and (5) whether the service rendered is an integral part of the alleged employer's business. (citation.) As can be seen, there are many points of individual similarity between these guidelines and our own traditional Restatement tests. (citations.) We find that all are logically pertinent to the inherently difficult determination whether a provider of service is an employee or an excluded independent contractor…."[10]

Legislative Intent Matters. The ***Borello*** requirement, that "the six-factor test … [shall] determine independent contractorship in light of the remedial purposes of the legislation," matches up nicely with the ***Dynamex*** requirement that the "underlying legislative intent and objective of the statutory scheme at issue" must be considered when applying the ABC test. AB5's statement of legislative intent makes "exploited workers" the intended beneficiaries of AB5, but by doing so AB5 finesses our non-exploited independent subcontractors out of AB5's intended beneficiary class! That, in turn, makes it easier for these subcontractors to be classified as independent contractors.

Different IRS Rules. Please remember that the Internal Revenue Service is not bound by California law, and still could reclassify subcontractors as employees for federal tax purposes. There is a longstanding Federal three-part test for determining independent contractor status similar to the ABC test, but focusing on behavioral control, financial control, and type of relationship.[11] Also, the "economic substance doctrine" requires that a transaction's structure (in this case, as a construction subcontractor agreement) cannot be strictly tax-based; there must be another substantial business purpose *and* a meaningful change or difference in the parties' economic position to support that choice.[12] If economic substance cannot be established, the IRS can impose a 40% underpayment penalty on the taxpayer, even if the taxpayer was not negligent in making that misclassification.[13]

How to Demonstrate Independent Contractor Status? By reviving ***Borello***, AB5 requires that "each service arrangement must be evaluated on its facts, and the dispositive circumstances may vary from case to case." Also, recall that AB5 (unlike ***Borello***) shifts the burden of proof to the hiring contractor to demonstrate the subcontractor is correctly classified as an independent contractor. This tells me that each construction subcontract must be tailored to the specific facts of the subcontractor's situation.

I am also concerned about AB5's requirement that the hiring contractor must "demonstrate" that the required exemption factors are present. Does that mean only upon government investigation, or in the discovery phase during a lawsuit? My reading of AB5 would permit many California government agencies to require additional filings demonstrating that the subcontractor qualifies for the exemption.

Given the high stakes involved, it is my opinion that the subcontractor relationship must be memorialized in a writing that **(A)** describes the subcontractor's particular circumstances in detail; **(B)** applies those circumstances to each applicable IRS rule and AB5 test under the construction subcontractor exemption; and **(C)** explains how treating the subcontractor as an independent contractor under those circumstances also are consistent with the underlying legislative intent of AB5 and applicable IRS rules.

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Endnotes:

[1] Chapter 296, Statutes of 2019.

[2] Labor Code §2750.3(a)(1)

[3] AB5, Section 1(c)-(e), inclusive

[4] Please see my May 2018 article in Santa Barbara Lawyer, Huge Tax $avings for S Corporations, for details.

[5] Unemployment Insurance Code §1735

[6] 26 United States Code §6672(a)

[7] Labor Code §2750.3(f)

[8] A federal judge issued an injunction on December 31, 2019, and a California judge ruled on January 8, 2020, each preventing California from enforcing any part of AB5 against the motor carrier industry. In both cases, the judge considered that regulation of the motor carrier industry is the sole province of federal law, thereby preempting any state attempt at further regulation. California is likely to appeal these rulings, but in my opinion this "federal preemption" argument will prevail in the end.

[9] Labor Code §2750.5

[10] 48 Cal. 3d 341, 354-355

[11] IRS Publication 15-A, pages 7-10 (2019)

[12] 26 United States Code §7701(o)

[13] 26 United States Code §6662(i)