Assembly Bill 5

Problem or Solution for Entrepreneurial and Professional Workers?

Exemption No. 5

Business-to-Business Contracts

By Robert W. Olson, Jr.

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"). AB5 banned reclassification of existing employees retroactive to January 1, 2019, if reclassification was "due to this measure's enactment." AB5 also 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.

Stated Legislative Intent: Enshrine Dynamex. The Legislature made a specific point of declaring that AB5 was enacted to enshrine ***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."

Actual Result: Reverse Dynamex

However, AB5 does nothing whatsoever to protect exploited workers or restore their basic workplace rights, because ***Dynamex*** already had done so by establishing the ABC test on April 30, 2018. 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!

There are 6 basic exempt classes, each of which has its own set of non-***Dynamex*** qualification rules:

- pre-existing statutorily exempt workers,
- certain top-tier licensed professionals,
- certain other "professional service" providers,
- licensed real estate agents and repossession agencies,
- business-to-business ("B2B") contracting, and
- subcontractors in the construction industry.

Each of these classes has its own set of very specific conditions to meet its particular exemption. For example, "professional services" in the third exemption is defined as contracts for marketing, HR administration, or graphic design; and services from travel agents, grant writers, fine artists, enrolled agents, payment processing agents, and licensed skin/nail/hair consultants. Professional services from photographers, freelance writers, editors and newspaper cartoonists also qualify, but only if that worker does not sell an "item of content" to the hiring publication more than 35 times per year. The rules are not intuitive and seem quite arbitrary, so a close reading of AB5 is *essential* before deciding that a particular worker qualifies for an exemption.

Why is Independent Contractor Status Important?

High-income entrepreneurs and professionals have immense financial incentive to maintain independent contractor status, particularly in light of the huge tax savings available ($12,500 and up annually) under the S corporation business structure. Employee status requires the worker to work as an individual, rather than as a contracting S corporation, eliminating ALL of those tax benefits.

Hiring entities also face substantial financial harm if their independent contractors are reclassified as employees. Labor Code §226.8 imposes serious penalties ($5,000 and up per violation) for hiring entities that willfully misclassify workers as independent contractors, and hiring entities are personally liable for misclassified workers' unpaid (and unwithheld) taxes. 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.

Business to Business Contracting

In order to limit the length of this article, I will limit my discussion to (arguably) the broadest applicable exemption: B2B contracting.

Labor Code §2750.3(e) states that ***Dynamex*** does not apply to a "bona fide business-to-business contracting relationship." This exemption requires meeting three tests. First, the B2B exemption applies only to the service provider (the worker) itself, not to the service provider's workers; those workers must be treated as employees for the service provider. Next, the contracting business (the hiring entity) has to demonstrate that all of the following (abbreviated) criteria are satisfied:

- **(A)** The service provider is free from the control and direction of the contracting business in connection with the performance of the work.
- **(B)** The service provider provides services directly to the contracting business rather than to its customers.
- **(C)** The contract is in writing.
- **(D)** The service provider has the required business license or business tax registration (if applicable).
- **(E)** The service provider maintains a separate business location from the contracting business.
- **(F)** The service provider customarily engages in an independent business providing the same type of work.
- **(G)** The service provider actually contracts with other businesses to provide its services to its own clients.
- **(H)** The service provider advertises and holds itself out to the public as available to provide its services.
- **(I)** The service provider provides its own tools, vehicles, and equipment.
- **(J)** The service provider can negotiate its own rates.
- **(K)** Consistent with the nature of the work, the service provider can set its own hours and place of work.
- **(L)** The service provider is not performing work that requires a license from the Contractor's State License Board.

Finally, the service arrangement between the parties must also pass the test set forth in *Borello v. Department of Industrial Relations* (1989) 48 Cal.3d 341 ("***Borello***").

Remember Borello?

Borello was decided 30 years ago! Why did AB5 dig up *that* case? My opinion is that the Legislature was fully aware of its political situation. It needed to reverse ***Dynamex*** for entrepreneurial and professional workers to avoid crashing the California economy. However, it also needed to keep that reversal quiet, to avoid offending its political supporters. Therefore, some watered-down test had to be substituted for the ***Dynamex*** test for these favored worker classes, without actually providing the details of that watered-down test. Citing a Supreme Court case, that few people would actually read, fit the bill.

Borello is (was) one of many California cases addressing the difference between independent contractors and employees. ***Borello*** and *Yellow Cab v. Workers Compensation Appeals Board* (1991) 226 Cal.App.3d 1288 ("**Yellow Cab**") were both cited in ***Dynamex***, although the ***Dynamex*** ABC test effectively endorsed the three-part test in ***Yellow Cab*** over the six-factor test in ***Borello***. Now that ***Borello*** is back in play, let's look at its 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. 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 ...."

Remember Legislative Intent?

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 these non-exploited entrepreneurial and professional clients out of AB5's intended beneficiary class! That, in turn, makes it far easier to demonstrate that these upper-class workers are properly classified as independent contractors.

Different IRS Rules

Please remember that the Internal Revenue Service is not bound by California law, and still could reclassify these workers 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. Also, the "economic substance doctrine" requires that the transaction structure (in this case, as a B2B independent contractor agreement) cannot be strictly tax-based; there must be another substantial business purpose *and* a meaningful change in the parties' economic position to support that choice. If economic substance is not established, on audit the IRS can impose a 40% underpayment penalty on the taxpayer, even if the taxpayer was not negligent in making that misclassification.

How to Demonstrate Independent Contractor Status?

By reviving ***Borello***, AB5 notes that "each [B2B] 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 entity to demonstrate the service provider is correctly classified as an independent contractor. This tells me that each B2B contract must be tailored to the specific facts of the service provider's situation. The B2B exemption appears to be the most complicated, requiring the worker to pass at least 25 separate tests. (Attorneys are only required to pass 11 tests under AB5 – 12, if you count the Bar Exam.)

If the parties need to demonstrate that the service provider is an independent contractor, it is my opinion that the parties' working relationship must be memorialized in a writing that **(A)** describes the service provider's particular circumstances in detail; **(B)** applies those circumstances to each applicable IRS rule and AB5 test under the B2B exemption; and **(C)** explains how treating the service provider as an independent contractor under those circumstances also are consistent with the underlying legislative intent of AB5 and applicable IRS rules. ■

Robert W. Olson, Jr., has been a California licensed attorney since 1984. His practice includes mergers and acquisitions; corporate, business and commercial real estate law; estate planning; and related tax considerations. ***Mr. Olson's website and email are www.trans.dental and rwo@transdental.com.***

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Probate

Legislation introduced this year in the State Assembly brings to California the concept of a valid electronic will – i.e. a will that's created and stored in an electronic format. Several other states already have legislation that recognizes the validity of an electronic will.

AB 1667, introduced by Miguel Santiago (D-Los Angeles), was approved unanimously by the Assembly and referred to the Senate Judiciary Committee, where it has yet to receive a hearing. It may still be heard, when the second year of this legislative session begins in January 2020.

"With this evolving technology growing in popularity every day," the American Bar Association stated in an October 2018 article, "the question is no longer if all states will allow for wills and trusts to be created and passed electronically, but when." ■

Kendall VanConas is managing partner at Arnold LaRochelle Mathews VanConas & Zirbel LLP (A to Z Law). She is an AV-rated attorney and a California State Bar Certified Specialist in Estate Planning, Trust and Probate Law. A to Z Law is based in Oxnard, California, at 300 Esplanade Drive, Suite 2100. For more information, visit atozlaw.com or call 805-988-9886. The contents of this article are accurate as of Santa Barbara Lawyer's *publication deadline for this issue. Laws may have changed by publication date.*