ROBERT W. OLSON, JR.
A PROFESSIONAL CORPORATION

PHONE: 888.963.1120
FACSIMILE: 855.963.1120
LOCAL PHONE: 805.963.1120

ATTORNEY AND COUNSELOR AT LAW
21 EAST CARRILLO STREET #240
SANTA BARBARA, CA 93101

WEB: trans.dental
ZOOM: 805-963-1120
EMAIL: RWO@transdental.com

Contractor or Employee?
California Licensed Health Care Professionals

Assembly Bill 5 & Assembly Bill 2257. In 2019, to great fanfare, Governor Gavin Newsom signed into law California Assembly Bill 5, effective January 1, 2020 ("AB5").[1] AB5 has since been "revised and recast" by Assembly Bill 2257, effective September 4, 2020.[2] AB2257 codifies the main thrust of *Dynamex v. Superior Court (2018)* 4 Cal.5th 903 ("***Dynamex***") in Labor Code §§2775-2787.[3] Both the original and recodified law generally requires 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.[4]

Stated Legislative Intent: Enshrining Dynamex. The Legislature made a specific point of declaring that AB5 was enshrining ***Dynamex*** in California law 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."[5]

Actual Result: Reversing Dynamex. However, neither AB5 nor AB2257 did anything to protect exploited workers or restore workplace rights, because the ***Dynamex*** ABC test had already done so. Why then are AB5 and AB 2257 even necessary? That necessity lies in the vast array of worker classes exempted from ***Dynamex*** through AB5 and AB 2257. Contrary to the Legislature's moral grandstanding about enshrining ***Dynamex***, AB5 actually reversed ***Dynamex*** for a broad class of entrepreneurial and professional workers, and AB2257 expanded that reversal to vast new classes of workers, primarily for those who provide services to print and digital publishers and aggregators, and the entertainment industry. Notably, neither AB5 nor AB2257 considered extending those exemptions to app-based transportation and delivery drivers … which is why Proposition 22 ended up on California ballot on November 3, 2020.[6] The focus of this article is the second of eight exempt classes: top-tier health care professionals.

Why is Independent Contractor Status Important? High-income professionals 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.[7] Employee status requires the health care professional to work as an individual, rather than as a contracting S corporation, eliminating ALL of those tax benefits.

Hiring entities (the businesses hiring the health care professional) also face substantial financial harm if their health care professionals 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 hiring entities are personally liable for misclassified workers' unpaid (and unwithheld) taxes.[8] 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.[9]

Top-Tier Health Care Professional Exemption. One of the exemptions provided by AB 2257 is for top-tier health care professionals. This exemption requires meeting three tests. The first test is that the worker must be "physician and surgeon, dentist, podiatrist, psychologist, or veterinarian licensed by the State of California … performing professional or medical services provided to or by a health care entity, including an entity organized as a sole proprietorship, partnership, or professional corporation…."[10] The second test is that the working relationship must pass the six-part test set forth in *Borello v. Department of Industrial Relations* (1989) 48 Cal.3d 341 ("***Borello***"). [11]

Why the Borello Case? ***Borello*** was decided over 30 years ago, and is (was) one of many California cases taking different approaches for discerning the difference between independent contractors and employees. So why did AB5 and AB2257 choose that case? My opinion is that the Legislature was fully aware of the delicate balance it needed to achieve. It needed to reverse ***Dynamex*** for broad range of workers to avoid upending large portions of the California economy, but it also needed to keep that reversal quiet to avoid offending certain political supporters. Therefore, some watered-down test had to be substituted for ***Dynamex*** for these favored worker classes, without actually providing the details of that watered-down test. Citing a distant Supreme Court case that few voters would actually read fit the (assembly) bill. 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. (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…."[12]

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 AB5's statement of legislative intent that makes "exploited workers" the intended beneficiaries of AB5 (and by extension AB2257). By doing so AB5 finesses these non-exploited independent contractor health care professionals out of AB5's intended beneficiary class! That, in turn, makes it easier for these health care professionals to be classified as independent contractors. AB2257 didn't address legislative intent other than to add exemptions for overlooked

classes of workers, but it also didn't change any of AB5's rules for doctors and dentists. Therefore, I believe that AB5's legislative intent, to protect exploited workers, remains intact.

Different IRS Rules. Please remember that the Internal Revenue Service is not bound by California law, and still could reclassify health care professionals 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.[13]

Also, the "economic substance doctrine" requires that a transaction's structure (in this case, as an independent contractor 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.[14] 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.[15]

How to Demonstrate Independent Contractor Status? By reviving ***Borello***, AB2557 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 entity to demonstrate the health care professional is correctly classified as an independent contractor. This tells me that each independent contractor agreement must be tailored to the specific facts of the health care professional's situation.

Given the high stakes involved, it is my opinion that the working relationship must be memorialized in a writing that **(A)** describes the health care professional's particular circumstances in detail; **(B)** applies those circumstances to each applicable IRS rule and ***Borello*** test under the licensed health care professional exemption; and **(C)** explains how treating the health care professional as an independent contractor under those circumstances also are consistent with the underlying legislative intent of AB5, AB2557 and applicable IRS rules.

Robert W. Olson, Jr., has been a California licensed attorney since 1984. His practice includes professional practice transitions (purchases, sales, partnerships, and associations); corporate, business and commercial real estate law; estate planning; and related tax considerations.

Endnotes:

[1] Chapter 296, Statutes of 2019.

[2] Chapter 38, Statutes of 2020.

[3] AB5 was "revised and recast" by Assembly Bill 2257. AB2257 repealed Labor Code §2750.3 but restates it with expanded exemptions in new code sections. All references in this article now will refer to the new code sections now in effect.

[4] Labor Code §2775(b)(1)

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

[6] Proposition 22, the App-Based Drivers as Contractors and Labor Policies Initiative.

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

[8] Unemployment Insurance Code §1735

[9] 26 United States Code §6672(a)

[10] Labor Code §2783(b)(2)

[11] Labor Code §2783

[12] 48 Cal. 3d 341, 354-355

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

[14] 26 United States Code §7701(o)

[15] 26 United States Code §6662(i)