

Risks to the use of Independent Contractors with AB5

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It was thought by our California state legislators that the passage of Assembly Bill 5 that went into effect January 1st of this year would result in businesses reclassifying their independent contractors that are not truly independent to employees with benefits. They believe this new law will bring in new employment and income taxes into the state coffers as well as provide benefits like paid sick days, healthcare benefits and overtime pay. The results so far have not shown this to be the case. Many businesses are cutting back on the use of Independent Contractors for fear of the potential increased costs associated with employment taxes and benefits. AB5 has created confusion in the overall classification process as it would be inappropriate to treat a worker as an Independent Contractor for federal purposes and as an employee for state purposes.

The new California requirements under AB5 for a worker to qualify as an independent contractor and not be subjected to employment taxes and benefits are the ABC tests. As of January 1st, the California worker must now meet all three of these factors: A) Be free from control and direction of the hiring business, B) Be performing work that is outside the usual jobs performed within the hiring business, and C) The worker must be customarily engaged in an independently established trade, occupation or business in line with the type of work being performed.

The first test has been a longstanding test by the IRS. It is based upon behavioral, financial and relationship control. The real change in the ABC test is test B. Many of the California



businesses that hire Independent Contractors are hiring these workers in positions that are within the businesses' normal scope of work. This will be the factor that most companies will have the most difficulty getting around. The final test C requires the worker to be in a line of business that typically is independent. The IRS defines Independent Contractors as "doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, stenographers, or auctioneers who are in an independent trade, business, or profession in which they offer their services to the general public."

Everyone knows that Uber and Lyft are heavily fighting AB5. With the 2017 Tax Act, there are no longer federal income tax deductions available for employees whereas these expenses are 100% deductible by Independent Contractors. With AB5s forced treatment of these Uber drivers as employees, 100% of the workers' costs for maintaining their cars are completely lost for federal tax purposes.

The AB5 law was introduced to reduce the misclassification of workers as Independent Contractors where no true business to business relationship existed. These were the facts in the California Supreme Court Dynamex case. The company, a nationwide same-day courier service, where prior to 2004 all drivers were classified as employees and in 2004 the company converted the drivers from employees to Independent Contractors as a cost savings measure. One driver, three months after leaving the company, filed a lawsuit claiming misclassification of its workers. This led to the Dynamex decision in April of 2018 and laid the groundwork for the current AB5. The over-reach of the new AB5 law will hurt the legitimate Independent Contractors that have been doing business successfully for years and years and may now be in jeopardy of not meeting the new ABC standards. The key now is for businesses operating in California to make sure that all hired independent contractors meet all the requirements of the newly enacted AB5 or at least prepared to defend against a challenge.