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AB 5, California's Gig-Work Law, Could Mean Inconsistent Federal and State Tax Treatment for Workers

On Sept. 18, 2019, Governor Gavin Newsom signed Assembly Bill No. 5 (AB 5) into law in California. The landmark legislation, which came into effect Jan. 1, 2020, promises to significantly expand the number of workers treated as employees for state tax and labor purposes. Although the legislation was aimed at participants in the "gig economy" (i.e., freelancers) it has much broader application. Early estimates suggest that as many as one million workers in California will be affected by this legislation. Moreover, for some businesses, it may result in workers having an inconsistent treatment for federal and state purposes.

Under the prior law, California's Employment Development Department (EDD) and courts would apply an 11-factor analysis from *S.G. Borello & Sons, Inc. v. Department of Industrial Relations* to determine whether a worker should be classified as a worker or independent contractor. AB 5 codifies the three-part test for determining independent contractor status as established in *Dynamex Operations West, Inc. v. Superior Court*. Under this test (referred to as the "ABC Test"), a worker is presumed to be an employee unless the hiring entity can establish three factors:

(A) The individual is free from the control and direction of the hiring entity in connection with the performance of work;

(B) The individual performs work that is outside the usual course of the hiring entity's business; and

(C) The individual is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

AB 5 exempts specific licensed professionals including physicians, dentists, podiatrists, psychologists, veterinarians, insurance brokers, lawyers, architects, engineers, private investigators, accountants, registered securities brokers or investment advisors, and direct salespeople from the new test. AB 5 also exempts individuals providing professional services who can establish that they: (i) maintain a business location separate from the hiring firm (including a home office); (ii) have a business license in addition to any required professional license; (iii) have the right to negotiate their own rate for the services provided; (iv) set their own hours; (v) provide or hold themselves out to provide the same services to other hiring entities; and (vi) exercise discretion and independent judgment over the services they provide. The exemption applies only for the purposes of the ABC Test. These workers will still be subject to the 11-factor analysis under *Borello*. The legislation gives the state the right to sue companies that violate the law.

The distinction between employees and independent contractors is an important one for state and federal tax purposes. From the employer's perspective, if a worker is classified as an employee, the employer is responsible for: (i) income tax withholding on the state and federal level; (ii) withholding the employee's share of payroll taxes on the federal level; (iii) paying the employer's share of payroll taxes on the federal level; and (iv) paying state disability, unemployment insurance and state employee training tax. The failure to properly withhold or remit payroll taxes can result in substantial tax, penalties, and interest on the state and federal level. The reclassification may also affect the worker's tax situation because their income will be subject to withholding, and they will no longer be able to deduct their personal business expenses.

It remains to be seen how the EDD and courts will enforce AB 5. Multiple lawsuits have already been filed to invalidate the law. On Dec. 31, 2019, a federal judge in the Southern District of California issued a temporary restraining order against the implementation of AB 5 in the trucking industry in *California Trucking Association, et al. v. Becerra*. In this time of uncertainty, employers will have to decide whether to change their worker classification voluntarily or wait until the EDD enforces the provision. At the federal level, there are mechanisms in place that may minimize the effect of a worker classification issue: (i) Section 530 relief and (ii) the Voluntary Classification Settlement Program. These programs are not available to address California state law issues, so employers have less certainty about what their California exposure will be. Moreover, because AB 5 does not alter the federal standards, employers will have to decide whether they treat workers inconsistently for state and federal purposes or whether they make a reclassification on the federal level as well. Non-California businesses that rely on California independent contractors will also have to evaluate how AB 5 affects them.

California has raised the stakes on the worker classification issue. Other states such as New York and Washington are considering similar legislation. If your business relies on independent contractors to perform services, legal counsel can help examine your independent contractor relationships and determine your potential exposure under AB 5.

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