



## **AB5: Proper Classification of Employee vs. Independent Contractor**

When hiring workers, properly classifying them as employees or independent contractors has considerable significance for both the workers and businesses, including nonprofits. Assembly Bill 5 (“AB5”), effective January 1, 2020, solidifies the three-factor “ABC test” as the standard for identifying whether a worker should be classified as an employee or independent contractor for purposes of California wage orders, the California Labor Code, the California Unemployment Insurance Code, the California Fair Employment and Housing Act (FEHA), and Workers’ Compensation policies. This bulletin will review the difference between an employee and independent contractor, how to properly apply the ABC test to worker classification, exceptions to the rule, and implications for nonprofits and small businesses.

***This publication provides general guidance only and should not be construed as legal advice.*** The law on the topics discussed in this publication is highly context-specific. If your organization needs legal assistance, or if you have further questions about these topics, please contact Public Counsel’s Community Development Project at (213) 385-2977, ext. 200. The Community Development Project provides free legal assistance to qualifying low-income entrepreneurs and qualifying nonprofit organizations that share our mission of serving low-income communities and addressing issues of poverty within Los Angeles County.

### **Employees**

If a worker is classified as an employee, the employer typically has greater control over the way the worker performs their job and the worker is protected by applicable labor laws and regulations. The employer that hires the worker bears the responsibility of:

- Paying/withholding state and federal payroll taxes, such as unemployment, Social Security, and federal and state income taxes;
- Providing the worker with the tools necessary to complete the job and/or reimbursing employees for business expenses.
- Providing workers’ compensation insurance; and
- Complying with numerous state and federal statutes and regulations governing the wages, hours, and working conditions of employees.

### **Independent Contractors**

If a worker is classified as an independent contractor, the business that hires the worker typically has less control over the way the worker performs their job; the business does not bear any of the costs or responsibilities to the worker that would be owed to an employee; and the worker is not entitled to many of the benefits of labor laws.

### **ABC Test**

The three-factor ABC test is the standard for identifying whether a worker should be classified as an employee or independent contractor. The decision to be an independent contractor is not one that can be made unilaterally by the hiring entity or the worker, or be assigned through a contract entered into by the hiring entity and worker. Under the ABC test, there is a presumption that a worker is an employee, and the burden is on the entity seeking to classify a worker as an independent contractor to establish that the classification is proper.

In order for a hiring entity to establish that a worker is an independent contractor, the entity must show each of the following three conditions. If they cannot establish they meet all three of the conditions, the hiring entity should consider classifying the worker as an employee:

**(1) The worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of work and in fact.**

- The hiring entity must show that the worker is free of such control.
- The worker would be considered an employee if they are subject to the type and degree of control a business typically exercises over employees.
- A business does not need to actually control the precise manner or details of work in order to be found to have maintained the necessary control that an employer ordinarily possesses over its employees for the worker to be considered an employee.

**(2) The worker performs work that is outside the usual course of the hiring entity's business.**

- The hiring entity must show that the worker performs work that is outside the usual course of its business.
- Workers who are contracted to provide services in a role comparable to that of existing employees will likely be viewed as performing work in the usual course of business.
- Examples where services fall outside of the hiring entity's usual course of business include:
  - When a retail store hires an outside plumber to repair a bathroom leak on its premises;
  - When a retail store hires an outside electrician to install an electrical line.
- Examples where services fall inside the entity's usual course of business include:
  - When a clothing company hires work-at-home seamstresses to make dresses from patterns provided by the company.
  - When a bakery hires cake decorators to work on a regular basis on its custom-designed cakes.

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

- The hiring entity must show that the worker is engaged in an independently established trade, occupation, or business.
- The decision to be an independent contractor is not one that can be made unilaterally by the hiring entity or the worker, or be assigned through a contract entered into by the hiring entity and worker.
- True independent contractors take steps to establish and promote their independent business, such as through incorporation, advertisements, or offering their services to the public or a number of potential customers.
- The fact that a business has not prohibited or prevented a worker from engaging in an independent business is not sufficient to establish that the worker has independently made the decision to go into business for themselves.
- The work carried out by the worker cannot rely on a single hiring entity.

## Exceptions

Although the ABC test is applicable to most workers, state law exempts certain occupations, industries, or contracting relationships. If a worker falls within one of the defined exemptions, classification may instead be determined by a different test (the *Borello* test) or a combination of tests that considers a wider range of factors that often makes it easier for a hiring entity to establish a worker's status as an independent contractor. Additionally, while app-based gig workers are currently not exempt from the ABC test due to the court ruling that Proposition 22, which exempted app-based transportation and delivery companies from AB5, is unconstitutional, there may be further developments in this area.

For a list of occupations exempted from the ABC test, please see question seven of the California Department of Industrial Relations Independent contractor versus employee FAQs [here](#). Due to the

complicated nature of the rules and criteria exempting certain occupations from the ABC test, we recommend consulting an attorney to understand the applicability of these exemptions.

### **Implications for Nonprofits and Small Businesses**

AB5 has broad implications for all entities that hire workers, including nonprofits and small businesses. Application of the ABC test may result in workers who were previously considered independent contractors now being classified as employees for the purposes of California wage orders, the Labor Code, the Unemployment Insurance Code, the FEHA, and Workers' Compensation policies. Among other things, this may trigger various employer responsibilities such as payment of payroll taxes and overtime and provision of meal and rest periods. In light of this, any entities that treat workers as independent contractors should conduct a thorough review and reevaluation of their worker classifications under the ABC test. In addition, we recommend that entities ensure that persons making classification decisions on the entity's behalf are apprised of, and apply, the ABC test to avoid potential penalties for misclassification such as assessments for wage violations as well as civil penalties for willful misclassification.

### **Relevant publications:**

- [State of CA - Independent Contractor vs. Employee](#)
- [State of CA - Frequently Asked Questions on AB5](#)
- [State of CA - Wage Orders](#)