



Dear E&M Tax Service Client:

As many of you already know in 2019, the Governor signed AB 5. Under AB 5, most workers are presumed to be employees for both labor and payroll tax purposes unless the business (hiring entity) satisfies a three-factor test, referred to as the ABC test. This means that many workers previously classified as independent contractors are now employees under California law and you must withhold California income and payroll taxes, and meet California's minimum wage and overtime requirements.

In order for E&M to handle the preparation and filing for your companies 1099's you must certify you have followed the rules in paying out your workers. E&M can provide you information about the ABC Test and exemptions of the ABC test, but will not be advising you on the classification of workers.

#### **What is the The ABC test**

Under the ABC test, **all three of these conditions must be met** in order to treat the worker as an independent contractor:

- A. The worker 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, commonly known as the *Borello* "control test" (*S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.* (1989) 48 Cal.3rd 342);
- B. The worker performs work that is outside the usual course of the hiring entity's business; and
- C. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

#### **Some Exemptions Are**

Applying the ABC test to workers will result in many more workers being classified as employees, the legislation provides for numerous exemptions to the application of the ABC test. The exemptions are complicated, and very specific. However, the exemptions do not mean workers are automatically independent contractors. We will provide a separate PDF of common exemptions.

#### **What happens if you do not follow the rules?? PENALTIES**

Be aware that California law includes severe financial penalties for willfully treating an employee as an independent contractor.

The penalties, which are in addition to other assessments, penalties, or fines, are:

- \$5,000 to \$15,000 for each violation (a single misclassified individual); and
  - \$10,000 to \$25,000 for each violation if the Labor Commissioner, or a court, determines there is a "pattern and practice" of these violations.
  - (Labor Code §226.8)
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With the exception of an attorney or other employee of the business, these penalties also apply to your tax professional or any paid person who advises you to incorrectly treat a worker as an independent contractor. This means that you may be required to obtain a legal opinion if there is a question as to the classification of employees and as a non-attorney, I cannot provide this advice.

### **Important points**

There are two important points to understand:

1. Forming or operating as a corporation or an LLC is not a work-around. The corporation or LLC will be ignored if the worker does not meet the ABC test, and the worker who owns the entity will still be an employee of the payor;
2. The effective date of the law is January 1, 2020, but could be applied retroactively, so time is of the essence.

The law is extremely complex with many unanswered questions. We continue to research and educate ourselves and are available to consult with you regarding this new issue as well as any other tax-related matters.

Sincerely,

E&M Tax Services, Inc.

**I understand the rules and legislation regarding hiring independent contractors and am confirming that the 1099's that I am requesting to be prepared by E&M Tax Services, Inc. are based on my classification of each contractor as the hiring entity. My determination of these said contractors were not based upon advice from E&M Tax Services, Inc., but solely my understanding of the AB5 Law and my determination of their employment status.**

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Name of Company/Individual issuing 1099's

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Representing Officer/Responsible Individual

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Date

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### Exemptions from the ABC Test

(If a worker meets the criteria for any of these exemptions, use the *Borello* test to determine if the worker is an independent contractor.)

**Note:** Refer to statute for specific definitions of applicable terms.

Exemption	Qualifying workers/industries	Other qualifying criteria
<p>Specific occupations exemption  (Labor Code §2783)</p>	<ul style="list-style-type: none"> <li>• Competition judges (e.g., amateur umpires/referees);</li> <li>• Landscape architects;</li> <li>• Licensed insurance brokers;</li> <li>• Licensed physicians, surgeons, dentists, podiatrists, psychologists, and veterinarians;</li> <li>• Manufactured housing sales people;</li> <li>• Until January 1, 2022, newspaper distributors working for newspaper publishers and newspaper carriers;</li> <li>• Persons involved in international exchange visitors program; and</li> <li>• Persons who provide underwriting inspections, premium audits, risk management, or loss control work for insurance/ financial industry</li> </ul>	<p>None</p>
<p>Professional services exemption  (Labor Code §2778)</p>	<ul style="list-style-type: none"> <li>• Content contributors, advisors, producers, narrators, or cartographers for various publications or educational work;</li> <li>• Digital content aggregators;</li> <li>• Enrolled agents;</li> <li>• Fine artists;</li> <li>• Freelance writers, editors, or newspaper cartoonists;</li> <li>• Grant writers;</li> <li>• Graphic designers;</li> <li>• Human resources administrators;</li> <li>• Marketing services;</li> <li>• Registered professional foresters;</li> <li>• Salon workers: barbers, cosmetologists, electrologists, estheticians, and until January 1, 2022, manicurists;</li> <li>• Still photographers, photo editors, and photojournalists;</li> <li>• Translators, copy editors, illustrators;</li> <li>• Travel agents; and</li> <li>• Videographers</li> </ul> <p>Other professions not subject to general qualifying criteria listed in the next column:</p> <ul style="list-style-type: none"> <li>• Home inspectors;</li> <li>• Real estate licensees under B&amp;PC §10037 and UIC §8300; and</li> <li>• Repossession agents</li> </ul>	<p>To qualify for the exemption, the service provider must meet the following general criteria:</p> <ul style="list-style-type: none"> <li>• Maintain a separate business location;</li> <li>• Obtain required business and/or professional licenses;</li> <li>• Have ability to set/negotiate own rates and hours;</li> <li>• Be customarily engaged in same type of work contracted for or hold themselves out as being available to other potential customers; and</li> <li>• Regularly exercise discretion and independent judgment in their work</li> </ul> <p>In addition to general criteria listed above, to qualify for exemption, professions listed in bold must meet the following criteria (<b>Note:</b> 35 submission cap per putative employer is repealed):</p> <ul style="list-style-type: none"> <li>• Be working under a written contract that specifies the rate of pay, intellectual property rights (inapplicable to photographers, photojournalists, videographers, or photo editors; and obligation to pay by a defined time;</li> <li>• Not be directly replacing an employee;</li> <li>• Not be primarily performing the work at the hiring entity’s business location; and</li> <li>• Be free to work for more than one company</li> </ul>

*(continued)*

**Exemptions from the ABC Test (continued)**

<b>Exemption</b>	<b>Qualifying workers/industries</b>	<b>Other qualifying criteria</b>
Professional services exemption <i>(continued)</i>		<p>In addition to general qualifying criteria listed above, to qualify for the exemption, salon workers must:</p> <ul style="list-style-type: none"> <li>• Set their own rates, process their own payments, and be paid directly by clients;</li> <li>• Set their own hours and clientele;</li> <li>• Have their own book of business and schedule own appointments;</li> <li>• Maintain their own business license; and</li> <li>• Issue a Form 1099 to salon owner if they rent the space</li> </ul>
Business-to-business contracting exemption  (Labor Code §2776)	Any business (other than construction businesses discussed below) that contracts with another business to provide services	<p>A written contract is required and the business service provider must:</p> <ul style="list-style-type: none"> <li>• Be free from control and direction of contracting business;</li> <li>• Provide services to the contracting business directly rather than to customers of the contracting business unless the service provider provides the service to the customer's customers under the service provider's name and only if the service provider regularly contracts with other businesses;</li> <li>• Have required licenses/tax registrations;</li> <li>• Maintain a separate business location (can be provider's home);</li> <li>• Be customarily engaged in independently established business providing similar/same services and can contract with other businesses to provide services without restriction from hiring entity;</li> <li>• Advertise its services;</li> <li>• Consistent with nature of work, provide its own tools, vehicles, and equipment, not including any proprietary materials that may be necessary to perform the contracted services; and</li> <li>• Negotiate its own rates, hours, and location of work</li> </ul>
Construction subcontractor exemption  (Labor Code §2781)	Subcontractors working for contractors	<p>To qualify, the contract must be in writing and the subcontractor must:</p> <ul style="list-style-type: none"> <li>• Be licensed by California Contractor's License Board and work must be within scope of license;</li> <li>• Have required business licenses/registrations;</li> <li>• Maintain a separate business location from contractor;</li> </ul>

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Exemptions from the ABC Test <i>(continued)</i>		
Exemption	Qualifying workers/industries	Other qualifying criteria
Construction subcontractor exemption <i>(continued)</i>		<ul style="list-style-type: none"> <li>• Be free to hire/fire workers;</li> <li>• Assume financial responsibility for errors and omissions; and</li> <li>• Be customarily engaged in independently established business providing similar work</li> </ul> <p>Special rules apply to construction trucking industry (Labor Code §2781(h))</p>
Referral agency exemption  (Labor Code §2777)	<p>Allows almost all types of services contracted through a referral agency to qualify for the exemption, including an “illustrative” listing of the following services:</p> <ul style="list-style-type: none"> <li>• Animal boarding and daycare services;</li> <li>• Caddying;</li> <li>• Consulting;</li> <li>• Dog walking and grooming;</li> <li>• Errands;</li> <li>• Event planning;</li> <li>• Furniture assembly;</li> <li>• Graphic design;</li> <li>• Home cleaning;</li> <li>• Interpreting services;</li> <li>• Minor home repairs;</li> <li>• Moving;</li> <li>• Photography;</li> <li>• Picture hanging;</li> <li>• Pool cleaning;</li> <li>• Tutoring;</li> <li>• Wedding planning, wedding and event vendors;</li> <li>• Yard cleaning; and</li> <li>• Youth sports coaching</li> </ul> <p>The following industries are specifically excluded from eligibility: high hazard industries and janitorial, delivery, courier, transportation, trucking, agricultural labor, retail, logging, in-home care, or construction services other than minor home repair</p>	<p>To qualify, the service provider must:</p> <ul style="list-style-type: none"> <li>• Have formed a business entity (including sole proprietor);</li> <li>• Be free from referral agencies control and direction;</li> <li>• Have all required state and local business and professional licenses/registrations;</li> <li>• Deliver services to client under provider’s name;</li> <li>• Provide own tools and supplies;</li> <li>• Be customarily engaged in, or was previously engaged in, an independently established similar or related business as the services provided;</li> <li>• Not be restricted by referral agency regarding clientele or working for other or competing agencies;</li> <li>• Set own hours/terms of work directly with client and be free to accept/reject clients/contracts;</li> <li>• Set own rates, without deduction by referral agency; and</li> <li>• Not be penalized for rejecting clients/contracts unless fails to comply with contractual obligations after accepting client/contract</li> </ul>
Music industry workers  (Labor Code §2780)	<ul style="list-style-type: none"> <li>• Independent radio promoters;</li> <li>• Musical engineers and mixers;</li> <li>• Musicians engaged in the creation of sound recording;</li> <li>• Photographers working on recording photo shoots, album covers, and other publicity;</li> <li>• Record producers and directors;</li> <li>• Recording artists and their managers;</li> </ul>	<p>Any union contract takes precedent as to whether a worker is an employee or independent contractor</p> <p style="text-align: right;"><i>(continued)</i></p>

**Exemptions from the ABC Test *(continued)***

<b>Exemption</b>	<b>Qualifying workers/industries</b>	<b>Other qualifying criteria</b>
Music industry workers <i>(continued)</i>	<ul style="list-style-type: none"> <li>• Songwriters, lyricists, composers, and proofers;</li> <li>• Vocalists; and</li> <li>• Any other individual engaged to render any creative, production, marketing, or independent music publicist services related primarily to the creation, marketing, promotion, or distribution of sound recordings or musical compositions</li> </ul>	Musicians and musical groups are also exempt if they perform at a single engagement live performance (as defined), excluding events as part of the tour, unless the musical group: <ul style="list-style-type: none"> <li>• Is performing:                             <ul style="list-style-type: none"> <li>○ As a symphony orchestra;</li> <li>○ At a theme or amusement park;</li> <li>○ In a musical theater production; or</li> <li>○ At a festival that sells more than 18,000 tickets per day; or</li> </ul> </li> <li>• Is an event headliner for a performance taking place in a venue location with more than 1,500 attendees</li> </ul>
Performance artists  (Labor Code §2780(c))	Performance artists, which includes, but is not limited to: <ul style="list-style-type: none"> <li>• Comedians;</li> <li>• Improvisation artists;</li> <li>• Magicians;</li> <li>• Mimes;</li> <li>• Puppeteers; and</li> <li>• Storytellers</li> </ul> <p>Inapplicable if artist is performing in a theatrical production or is a musician</p>	To qualify, the worker must: <ul style="list-style-type: none"> <li>• Be free from the control and direction of the hiring entity;</li> <li>• Retain intellectual property rights;</li> <li>• Set their terms of work and have ability to set/negotiate rates; and</li> <li>• Be free to accept or reject each individual performance engagement without penalty</li> </ul> <p>Any union contract takes precedent as to whether a worker is an employee or independent contractor</p>
Single engagement exemption  (Labor Code §2782)	Any individuals (acting as either sole proprietors or a business entity) who contracts with one another to provide services at the location of a single engagement event <p>Industries specifically excluded: high hazard industries and janitorial, delivery, courier, transportation, trucking, agricultural labor, retail, logging, in-home care, or construction services other than minor home repair</p>	To qualify: <ul style="list-style-type: none"> <li>• Individual must be free from control and direction from the data aggregator with respect to feedback substance and content;</li> <li>• Consideration paid must be at least equivalent to minimum wage;</li> <li>• Individual must exercise independent judgment/discretion in the type of feedback provided; and</li> <li>• Individual must be able to reject feedback requests without penalty</li> </ul>

### ✦ Quick Law: The *Borello* test

The *Borello* test has been the law of the land in California since 1989. (*S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.* (1989) 48 Cal.3rd 342) The principal factor of the *Borello* test is “whether the person to whom services is rendered has the right to control the manner and means of accomplishing the result desired.” Strong evidence of control is the principal’s right to discharge the worker at will, without cause.

If the principal has the right to control the services performed by the worker, whether or not that right is exercised, an employer-employee relationship exists. The primary right of direction and control is discussed in 22 Cal. Code Regs. §4304-1. If it cannot be determined whether the principal has the right to control the manner and means of accomplishing a desired result, the following factors should be examined (22 Cal. Code Regs. §4304-1):

1. Whether the one performing the services is engaged in a separately established occupation or business;
2. The kind of occupation, with reference to whether, in the locality, the work is done under the direction of a principal without supervision;
3. The skill required in performing the services and accomplishing the desired result;
4. Whether the principal or the person providing the services supplies the instrumentalities, tools, and the place of work for the person doing the work;
5. The length of time for which the services are performed to determine whether the performance is an isolated event or continuous in nature;
6. The method of payment, whether by the time, a piece rate, or by the job;
7. Whether or not the work is part of the regular business of the principal, or whether the work is not within the regular business of the principal;
8. Whether or not the parties believe they are creating the relationship of employer and employee;
9. The extent of actual control exercised by the principal over the manner and means of performing the services; and
10. Whether the principal is or is not engaged in a business enterprise or whether the services being performed are for the benefit or convenience of the principal as an individual.

The factors weigh differently depending on the facts and circumstances of the case at hand.

The difference between *Borello* and the ABC test is that in *Borello*, the factors are weighted, and not all factors must be met in order for a worker to be an independent contractor, while under the ABC test, unless a worker meets one of the exceptions, all three factors must be met or the worker is an independent contractor.