



# BBSI™

## Navigating California AB5: Your Definitive Resource

When California Governor Gavin Newsom signed Assembly Bill 5 (A.B. 5 or AB5) into law on September 18, 2019, it changed the way businesses classify contractors and employees. This legislation has reshaped the workforce in California, as many people who were previously classified as “independent contractors” now fall under the “employee” classification. It is a turning point that reclassifies millions of workers and radically changes 30 years of employment classifications.

Are you classifying employees and contractors correctly? As a business owner or manager, you are responsible for ensuring that your organization stays compliant with AB5. It’s critical to ensure accuracy in your workforce classifications to avoid harsh penalties and fines.

# History of AB5: Why It Was Necessary

As companies statewide are experiencing these changes in worker classifications, it begs the question: Why was it necessary to introduce this legislation?

It all started with the **Dynamex case**. Dynamex was an office supply company using a team of employees to deliver everything from printer paper to staples for local businesses.

Strategically, Dynamex decided to switch its workforce from payroll employees to independent contractors. This change sparked unrest among a group of workers who would no longer receive insurance or other employee benefits. The group filed a class action lawsuit asking for continued benefits through employee classification. (Dynamex Operations West, Inc. v. Superior Court of Los Angeles (2018) 4 Cal.5th 903).

The employees won the case in April 2018, and the court's decision set a precedent. Not only did the workers get what they were asking for, but the case changed the legal grounds for other similar situations moving forward.

The California Supreme Court created the **ABC Test** to determine which workers should be classified as independent contractors. Not only does AB5 use the three-pronged ABC Test, but it also protects workers by expanding the classification to update the entire Labor Code and Unemployment Insurance Code.

## What is AB5?

California Assembly Bill 5 (AB5) is nicknamed the "gig worker bill." When this legislation went into effect on January 1, 2020, it reclassified many independent contractors as employees. Now because of AB5, businesses must put each worker through the ABC Test to determine whether they are contractors or employees.

A worker is always considered an employee rather than an independent contractor unless the hiring entity meets all three conditions of the ABC test, described in more detail below.

## Who is Exempt from AB5?

While AB5 has specific requirements for worker classifications, there are **exemptions** for certain types of work.

Exemptions include:

- Physicians with licenses
- Dentists
- Architects
- Engineers
- Accountants
- Securities broker-dealers
- Psychologists
- Veterinarians
- Lawyers
- Investment advisers
- Real estate licensees
- Particular marketing and human resources professionals
- Licensed manicurists and barbers meeting certain conditions (including setting their rates)
- Private investigators

AB5 also offers exemptions for business-to-business contractors and referral agencies. However, these exemptions require a carefully planned strategy to comply with various industry-specific requirements.

When a worker is AB5 exempt, it's necessary to evaluate the worker under the flexible multi-factor test outlined by the California

Supreme Court in the 1989 case of *S. G. Borello & Sons, Inc. v. Department of Industrial Relations*.

The process is known as the “**Borello Test**.” It uses multiple factors, such as whether the employer has the necessary control over the manner and means the worker accomplishes desired results. This control doesn't need to be direct, detailed, or exercised. For example, suppose an employer chooses to classify a worker as an independent contractor. In that case, it's necessary to have an arrangement with deliberate structuring and complete documentation that complies with the Borello Test.

## Two Employer Tips for Navigating AB5

Independent contractor misclassifications have been an issue for many years, and AB5 tightens these requirements for employers.

Historically, many businesses looked at 1099s from the previous year to see if payments were going to a person with a Social Security number or to a company with a Corporate Tax ID number. Now, it is necessary to look at the person's work and how central that work is to the value provided by your business.

How should you evaluate your current workforce to decide if your workers are being classified appropriately? Here are two tips to help:

### Tip #1: Use the ABC Test

The first step is to complete a full analysis of the contractors working for your company. Then, use the ABC test to determine if it's necessary to reclassify any of these workers.

The “ABC Test” starts with the presumption that each worker falls under an employee classification. The following criteria should be used to evaluate if the presumed employees should instead be classified as independent contractors:

1. The worker is free from control and direction in the performance of services; and
2. The worker is performing work outside the usual course of the business of the hiring company; and
3. The worker is customarily engaged in an independently established trade, occupation, or business.



The 2nd clause of the test is often the most challenging. To meet the criteria for an independent contractor as outlined in the 2nd clause, the worker can't provide services that are the same or similar to what the business is already providing.

For example, suppose you have a plumbing company with independent contractors performing plumbing services. Because the workers are completing tasks that fall within the usual course of business, these workers should be classified as employees - not independent contractors - unless they meet a specific exemption. When employers use independent contractor classifications for workers, it's the business's burden to maintain thorough documentation showing that they meet the three requirements listed above.

## Tip #2: Understanding Classification Exemptions

Ideally, you should have a lawyer and/or experienced business consultant review your workers' responsibilities to see which classification is appropriate. Some of these exemptions are broad (such as dentists, doctors, insurance agents, real estate agents, lawyers, and hairstylists), which is why many employers benefit from professional advice on the topic.

The nuances of how workers are engaging with the company and the types of services they offer vary from one company to the next. One example is a referral agency. Because they refer people without managing employee responsibilities and tasks, their workers may be exempt from employee classifications.

The best approach is to utilize the ABC Test. Then, consult with an experienced provider who understands AB5 to ensure these classifications are correct.

If you want to utilize exemptions, it's easiest to adjust your business model around these exemptions. That means if you are a restoration company, for example, consider removing ancillary services from your packages that require you to outsource labor. That way, occasional projects that utilize services like landscaping to complement core restoration services should be able to maintain exempt status. And as always, make sure each independent contractor has a signed contract that clearly states their exempt or non-exempt status to eliminate any questions about classifications.



## Actual Costs: Converting Independent Contractors to Employee Status

As you learn more about AB5, you face the potential reclassification of your workers. How much will it cost to convert these workers from independent contractors to employees?

### Direct Reclassification Costs

Direct costs are the most apparent expenses you will pay, such as payroll, benefits, and taxes. You can quantify direct costs by comparing them to the cost of current employees. Alternatively, many small and medium-sized businesses have opted to enlist the services of a Professional Employer Organization (PEO), such as BBSI, to make reclassification less burdensome. Your PEO should be able to provide close estimates regarding the direct costs associated with classifying each person as an employee, including taxes, impact on workers' compensation insurance, health insurance, unemployment insurance, and more factors.

### Indirect Reclassification Costs

Indirect reclassification costs are harder to identify and quantify, but a PEO can help.

Examples of indirect reclassification costs include the money you will be paying for increased HR support to oversee and manage recruitment, hiring, retention, and training. In addition, as your employee base grows, your need for HR services increases as well.

## Bolstering Contractor Status for “Gray Area” Workers

Many of your workers may reside in the “gray area” – people who could fall under either classification. You might choose to keep them classified as employees or decide that it's better to manage contractor classifications. Once you establish employees vs. contractors, you need to be ready to build your case.

If you leave these workers as independent contractors, you need to be proactive about establishing the evidence to prove their contractor status based on the requirements outlined in AB5. The written contract is an essential detail. Even if you are only hiring one independent contractor, this document needs to look like a business employing another business.

Depending on your business model, the cost-benefit analysis might not justify the reclassification of independent contractors. It can be helpful to work with a PEO or legal counsel to consider other options based on the viability and nature of your business.

When independent contractors fall in the “gray area,” you may consider whether contractors can be based outside California. This option is particularly valid for administrative support services such as payroll specialists and consultants.

Finally, as you evaluate risk, you may choose to continue operations as usual regardless of potential legal

challenges down the road. In some situations, business owners make the decision to continue operating without re-classifying contractors as employees. The decision is usually based on the premise that it is not feasible for the business to remain profitable should it have to incur the costs associated with re-classification. If this decision is reached, businesses should:

- Retain legal counsel to develop a defense strategy should they face litigation
- Begin planning for business model adjustments to rely less on independent contractors in California

## Logistical Considerations for Reclassification

A wide range of logistical adjustments are necessary to reclassify workers. Again, you must comply with AB5 requirements when using independent contractors.

For example, if you run a delivery business and use independent contractors on an as-needed basis during your busy season, you'll likely have to re-classify the workforce to part-time employees. In this instance, will the employees have set schedules or fixed routes? Will they be able to set their own hours? These job-specific responsibilities will have to be thoroughly considered, as the wrong decision could result in morale or productivity decreases.

The overall costs and logistical details vary from industry to industry and business to business. However, logistical considerations boil down to adjusting workflows to maintain profitability and productivity. For example, some companies realize cost savings by not paying for higher-rate workers. Others set off in search of technological efficiencies that can offset a leaner workforce.

As you evaluate your options, ask yourself: Can part or all of the cost savings be passed along to the customers? Will a portion of increased costs cut into your bottom line?

## Reclassification is Viable - How Do You Implement?

Once worker classification analysis is complete and you see that reclassification is viable, it's time to design an implementation plan. Follow these four steps for a smooth transition:

### 1. Strong Internal Communications Strategy

Shape your messaging to send the proper communication to contractors. Help workers see the benefits they will receive by becoming an employee. Independent contractors often resist reclassification as an employee, so you need to show them the available benefits. These benefits include eliminating self-employment tax issues, workers' compensation insurance access, and the camaraderie of working with others as a team. Talk to your legal counsel and be ready to answer complex questions, such as employees asking why they weren't an employee all along.

### 2. Consider Optimal Timing

Next, you need to determine the right timing for reclassification. You can make the switch any time, but it might reduce paperwork and other issues by reclassifying at specific points during the business year. For example, making the change at the end of the year means you can start fresh in the new year – eliminating the hassle of co-mingled tax years for contractors and employees.



### 3. Add Extra Perks to Incentivize New Employees

Independent contractors often enjoy the flexibility that comes with being “their own boss,” which is why many workers don’t want to become employees. But extra perks can soften the blow of these changes. Consider offering a flexible schedule or part-time options. Consider what the workers will miss most about being an independent contractor and look for ways to integrate these details into the employee structure. What is their pain point, and how can you solve these problems? For example, maybe payroll taxes hinder cash flow, and you can overcome these issues with pay increases or bonuses.

### 4. Enlist Committed HR Support

It takes more work to manage a team of employees than independent contractors. Hiring a PEO is a great way to access HR consulting services. In addition, a professional team makes the transition smoother by giving you access to ongoing Human Resources support and employee management solutions.

## Addressing Potential AB5 Retroactivity Issues

AB5 went into effect on January 1, 2020, which has some employers wondering if retroactivity is a concern. Reclassified “employees” might start asking whether the business will provide benefits for previous months or years when they were classified as a contractor. Retroactivity is still being litigated, but its potential effects on business finances could be extreme.

What do you do about these retroactivity issues? Most employers don’t choose to offer back pay or compensation. There’s no sure answer that works for every business, which is why you need to be ready to talk to your lawyer about the situation if someone makes these claims.

If a significant number of workers are concerned about retroactivity, then businesses could be facing a risk when one or more workers engage legal services, resulting in a class-action suit. You can reduce this risk with legal preparation before reclassification. However, the best thing you can do to protect against legal action is to ensure all re-classified employees are taken care of. Keeping your workforce satisfied will be your best defense against this type of action.

## Using a PEO to Ensure AB5 Compliance

Running a business takes a lot of time and energy, and it's no surprise that many business owners are overwhelmed by AB5 compliance requirements. As you are considering worker reclassification, it's critical to ensure that you are carefully navigating labor laws while still maintaining profitability.

A PEO, like BBSI, can help companies navigate AB5 to minimize the potential effects of these labor laws. Employers must carefully navigate the transition of moving independent contractors to employee status. At the same time, a strong case and solid documentation are essential for employers choosing to maintain independent contractor status for certain workers.

The truth is that most businesses aren't equipped to handle this process in-house. It involves a change in payroll, shifts in worker management, and a new set of challenges due to taxes, compliance, and more. In addition to the immediate costs of reclassification, you also need systems to review contractors to avoid mistakes in the future.

A Professional Employer Organization (PEO) provides a proven structure for handling the transition and supporting employee needs. Working with a PEO means that you have instant access to a payroll system and workers' compensation insurance.

Hiring a PEO simplifies the reclassification process because you can plug new employees into the system without redesigning the system from scratch.

Even though it can be expensive to transition your business model from independent contractors to employee status, this process could potentially force you to close your doors.

Don't get caught off-guard with compliance issues. Instead, invest in the future of your business with **professional services** to consult on classifications, minimize employment risk, develop efficiencies, and create a happier, more productive workforce overall.

**BBSI is here to help** – contact our  
team for a consultation to learn more  
about our available services.

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