



THE AB5 TEST

The distinction between who qualifies as an independent contractor over an employee is extremely significant. The reason is contractors are not entitled to the many protections that a lot of these laws provide to employees.

These protections include:

- Coverage by workplace discrimination laws
- Eligibility for overtime pay
- Coverage by workers compensation statutes
- Collection of post-termination unemployment
- Eligibility for health insurance and other employee benefits

When AB5 went into effect on January 1, 2020, many contractors who didn't receive the protection and benefits above are now entitled to them.

There are also several key differences between how a company interacts with an employee compared to how it interacts with an independent contractor.

| | Employee | Independent Contractor |
|-------------------|---|---|
| Hiring | Typically fills out an employment application, meets with HR, and must complete additional requirements before hiring, such as a background check and drug test | Typically interacts with the person or department needing services, and may submit a proposal; signs a contract or statement of work before starting work |
| Taxes | Customary withholdings are taken from wages (payroll taxes, Social Security, etc.); all money paid during the tax year is reported on a W-2 | No withholdings are taken from wages; all money paid during the tax year is reported on a 1099 |
| How they're paid | Earns either an hourly wage or a salary | Paid by the job, either in total when it is completed, or incrementally per a fixed schedule |
| When they're paid | Paid from payroll per a fixed period that cannot be changed (weekly, every other week, twice per month, monthly) | Paid by accounts payable whenever an invoice is submitted |

California Supreme Court set forth a three-part test (commonly known as the “ABC Test”) to determine whether a worker is truly an independent contractor or an employee.

California’s Assembly Bill 5 codified the ABC Test, which says that a worker is “properly considered” an independent contractor only if they meet each of the following three criteria.

| Criteria | What it means |
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| (A) “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 such work and in fact.” | The “control and direction” test is what the IRS usually uses to define an independent contractor. It looks at three key points of control: behavioral (who controls the how, what, and when of the work), financial (does the workers have the opportunity not only to make a profit through the work, but also take a loss), and relationship (is the worker limited only to working for the one business, or are they free to work for others). |
| (B) “The worker performs work that is outside the usual course of the hiring entity’s business.” | This factor looks at whether the work performed is outside the core function of the business. Think functions such as IT maintenance, which a business can easily outsource. |
| (C) “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.” | This factor examines whether the worker is traditionally engaged in their own business. For example, degreed professionals, such as lawyers and accountants, licensed service trades, such as barbers or massage therapists, and traditional freelancers, such as landscapers and artists, could all qualify as contractors under this factor. |

If you need to reclassify an independent contractor to an employee, you will need to make sure all employment requirements are taken care of properly with a payroll service provider.