



California Assembly Bill 5 and
Worker Misclassification:
Their Effects on Nonprofit Arts and Culture Organizations

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SUMMARY

On September 18, 2019, Governor Gavin Newsom signed Assembly Bill 5 (AB5)ⁱ into law, making it more difficult for employers to classify workers as independent contractors, instead of employees. Though much of the press about this new law has focused on restructuring the employment relationship related to the “gig economy” and the tech sector, ultimately its passage will affect businesses of all types throughout California, including the nonprofit arts and culture sector.

AB5 is part of a trend by state and federal governments to increase the focus on misclassification of workers, not only to increase revenues from state and federal income taxes, and bolster unemployment insurance and workers compensation coffers, but to protect workers who are often in low paying, service-oriented jobs, from undue financial hardship. Jobs that are often misclassified as contractors include those in landscaping, home health care, house cleaning, janitorial, maintenance, and, security watchmen industries.

Arts and cultural organizations should be proactive in considering whether their employees are properly classified, not only as a risk management issue, but also to help to ensure that an organization’s employees – key stakeholders in any organization – receive employment protections to which they are entitled.

This paper discusses the serious consequences that organizations face when workers are misclassified as independent contractors, as well as AB5 and its application to arts and cultural organizations, and what organizations should consider when planning for compliance with the law.

WHY SHOULD I CARE IF A WORKER IS MISCLASSIFIED?

Often an organization and a worker both prefer an independent contractor arrangement. The worker gets more “take home” pay as an independent contractor, since payroll taxes are not withheld. The organization has reduced personnel expenses and may also feel it has more flexibility to expand or contract its workforce when finances permit.

However, misclassification may lead to serious financial consequences, including possibly years of exposure for:

- Unpaid federal payroll taxes, including federal, state, and local income taxes, Social Security, and Medicare payments, along with possible interest and penalties;
- Unpaid overtime and minimum wage;
- Meal periods and rest break premiums (one hour of pay per day);
- Unpaid business expenses;
- Penalties for improper wage statements;
- Waiting time penalties for failure to pay all wages at the time the employment ended (up to 30 days of pay);



- Unpaid workers' compensation premiums; and
- State and federal penalties for misclassifying employees.

These issues may come up in unexpected ways and from many different sources. For example, if a misclassified worker is injured on the job and files a workers' compensation claim, an employer could be held responsible for paying the medical bills and receive fines for not having workers' compensation insurance. Similarly, a former worker who was paid as an independent contractor might file an unemployment claim or a claim for unpaid overtime with the state Labor Commissioner, actions that may lead to audits by state agencies.

Workers could also sue in state court to enforce their rights. California is an extremely "employee friendly" state, and state agencies generally favor the claims of employees over employers.

AB5 PASSED, SO WHERE ARE WE NOW?

The full financial and administrative impact of AB5 on arts and culture organizations is unclear at this time, as is whether or not there will be any amendments to AB5 in the future that will redefine its requirements. What we do know is that starting at 12:01AM on January 1, 2020, the law went into effect as did the need to comply.

WHAT IS THE ABC TEST?

The ABC test, a three-factor assessment to determine whether or not a worker is considered an "employee" is not exclusive to California. Most states use some form of the ABC test to categorize workers. With AB5, California legislators codified the ABC test making it the law.

Background

In 2018, the California State Supreme Court's *Dynamex* decisionⁱⁱ adopted the ABC test to determine whether a worker was an employee for purposes of California Department of Industrial Relations' wage orders, which regulate wages, hours, and working conditions.ⁱⁱⁱ

However, with AB5, California legislators expanded the ABC test to also apply to state unemployment and disability insurance and the California Labor Code, which includes workers compensation insurance contributions, with some exceptions.^{iv} AB5 does not impact the more flexible tests that federal agencies, such as IRS or Department of Labor, use to determine whether a worker is an employee.

While there were efforts by arts advocates to add exemptions to AB5 for nonprofit arts and culture organizations, they were only able to include "fine artists". California Arts Advocates, California's statewide advocacy organization, continues to work directly with the legislature and expects technical corrections to be made in 2020. However, until those are defined or made into law, affected arts and culture organizations must comply.



HOW DOES THE ABC TEST WORK?

As a result of AB5, California Labor Code Section 2750.3 now reads as follows^v:

- (A) (1) for purposes of the provisions of this code and the unemployment insurance code, and for the wage orders of the industrial welfare commission, a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that all of the following conditions are satisfied:*
- (a) the person 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.*
 - (b) the person performs work that is outside the usual course of the hiring entity's business.*
 - (c) the person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.*
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Note the word “all” in the last line of paragraph (A)(1). If any one of these factors does not apply, the worker must be classified as an employee. This is different from other worker classification tests used by the IRS or the Department of Labor which use multi-factor balancing tests.

Factor B is the real key to worker status determination as it requires that the independent contractor provide services to the organization that are outside of the usual course of the hiring entity's business. This is the most consequential for arts and culture organizations as it goes to the heart of most nonprofit business models that use independent contractors to deliver core programs and services.

If an organization's mission includes performances, exhibitions, and/or education, for example, anyone who is hired to perform those services is likely to be considered an employee. Let's say an organization's core service (i.e. its usual course of business) is to provide afterschool arts programs. The people who are hired to create, coordinate and teach the programs it offers would be classified as employees. If a social media consultant is hired to get the word out, they could be classified as an independent contractor because social media services are (presumably) outside the organization's usual course of business.

WHAT EXEMPTIONS IN AB5 CURRENTLY APPLY TO NONPROFIT ARTS AND CULTURE ORGANIZATIONS?

There are two forms of exemption under AB5: 1) Professional Services; and 2) Business to Business.

Professional Services Exemption

AB5 exempts a number of “professional services” from the requirement to satisfy the ABC test, including:



- Freelance writers
- Graphic designers
- Photographers
- Human resources administrators
- Grant writers
- Marketing professionals
- Fine artists

You can see that there are several professional areas that do engage with nonprofit arts and culture organizations such as grant writers, graphic designers, and photographers that are fairly easily defined. However, the term “fine artist” has raised questions with regards to the breadth of its interpretation. What artistic and creative professions the legislature intended to include in this exemption were not identified in the statute. Without additional information, the definition remains open to interpretation. It may however, be clarified through future legislation or litigation.

Keep in mind however, that even if the worker provides services defined as Professional Services, they are still subject to the following:

- the hiring entity must satisfy the six-part test, and
- the worker must be determined to be an independent contractor under the Borello or “economic realities test” as defined in the California Supreme Court case of *S. G. Borello & Sons, Inc. v Department of Industrial Relations*, 48 Cal.3d 341 (1989).

AB5’s Six-Part Test

The six-part test requires that workers meet all of the following criteria in order to be eligible for the Professional Services exemption:

- (1) have a separate business location, although the worker may perform services at the hiring entity’s location;
- (2) have a business license and any required professional licenses or permits
- (3) have the ability to set or negotiate their rates;
- (4) have the ability to set their own hours, outside of project completion dates and reasonable business hours;
- (5) be customarily engaged in the same type of work with another hiring entity or hold themselves out to potential customers who perform the same type of work; and
- (6) be able to customarily and regularly exercise discretion and independent judgement.

The Borello Test

Under the *Borello* test, the most significant factor to be considered is whether the company or organization has control or the right to control the worker both as to



the work performed and the manner and means in which it is performed.

Additional factors that may be considered include:

- whether there is the right to discharge at will, without cause;
- whether the one who is performing services is engaged in a distinct occupation or business;
- the kind of occupation, with reference to whether, in the same vicinity and professional community, the work is usually done under the organization's direction or by a specialist without supervision;
- the skill required in the particular occupation;
- whether the organization or the worker supplies the instruments, tools, and the place of work for the person doing the work;
- whether the worker invested in the equipment or materials required by their task or by their employment assistants;
- the length of time for which the services are to be performed;
- the method of payment, whether by the time or by the job;
- the alleged employee's opportunity for profit or loss depending on their managerial skill;
- whether or not the work is a part of the organization's regular business; and
- whether or not the parties believe they are creating the relationship of employer-employee.

Business to Business Exemption

Similar to the professional services exemption, under the "Business to Business Exemption" a Business Services Provider who provides services to a nonprofit arts and culture organization may be classified as an independent contractor. The following describes the definitions and tests that must be met to use this exemption option. Business Services Providers are defined to include:

- Sole proprietorships
- Partnerships
- Limited Liability Companies
- Limited Liability Partnerships, and
- Corporations

The relationship of the Business Services Provider to the organization must also satisfy all of the following 12 requirements:

- (1) be free from control and direction for performance of the work- both under the contract and in fact;
- (2) provide services directly to the contracting entity – not customers of the contracting business;
- (3) the contract must be in writing;



- (4) hold the required business licenses, certifications or tax registrations;
- (5) maintain a business location that is separate from the business or work location of the contracting business;
- (6) be customarily engaged in an independently established business of the same nature as the work performed;
- (7) contract with other businesses to provide the same or similar services to the same or similar clientele without restrictions from the hiring entity;
- (8) advertise and hold itself out to provide the same or similar services;
- (9) provide its own tools, vehicles, and equipment;
- (10) negotiate and set its own rates;
- (11) consistent with the nature of the work, can set their own hours and location of work; and
- (12) not a contractor regulated under the Business and Professions Code.

This test is quite arduous for workers in the nonprofit arts and culture sector to meet for classification as independent contractors. Two items in particular that can be difficult for many to prove are numbers 2 and 10 - providing services to the hiring entity and not its clientele directly, and setting and negotiating one's own rates, respectively.

In order for a organization to use the Business to Business exemption, an it must prove all of the following:

- that the entity is a “Business Service Provider” as defined above; and
- that the Business Services Provider satisfies the 12-part test; and
- that the Business Services Provider is an independent contractor under the *Borello* test.

Examples of the appropriate application of the Business to Business Exemption would be:

- a lighting designer hired by a dance company to light a production – the dance company is not in the lighting design business, or
- a videographer hired to document the dance performance – the dance company is not in the video production business.

Both of these examples assume that the 12-part test and the *Borello* test are satisfied and that the service provider meets the definition of Business Services Provider.

HOW CAN ORGANIZATIONS COMPLY WITH AB5?

There are a variety of options including, but not limited to, doing nothing, fighting it in court, or reclassifying all or some independent contractors as employees. Since the cost of a court battle would be prohibitive for most, if not all, organizations, the following information provides some productive actions an organization can take.



Convert All Independent Contractors to Employees

The safest option is to convert all independent contractors to employees, period. This protects the organization against risks from misclassification, and protects arts workers by giving them access to workers compensation insurance, disability insurance, unemployment insurance, sick leave, and reimbursements for expenses. It is also the most expensive option.

Convert Some Independent Contractors to Employees

Alternatively, an organization may convert some of the independent contractors to employees. For example, while it may be clear that teaching artists for an arts-in-education program are employees, the organization may have a legitimate claim that the PR consultant is an independent contractor.

Hire Contractors Through a Staffing Agency

An organization can hire contractors through a staffing agency. This places the responsibility to handle employment requirements to a third-party, as the contracted worker will be an employee of the staffing agency. Of course, positions that fall into this category for an arts and culture organization are generally administrative (bookkeeping or database entry) rather than artistic. This option is more expensive and less common in the nonprofit arts and culture sector but has rapidly expanded in the private sector and may be a viable alternative for some organizations.

No Reclassification

Organizations can choose not to reclassify workers and to continue to treat them as independent contractors. If an organization chooses not to reclassify its workers, staff should consider reviewing independent contractor agreements as described above. This option is the riskiest and may be more expensive if the organization is subjected to an audit or claim.

Reducing the Risks of Misclassification

Organizations should work with an experienced HR professional or employment attorney to review all existing independent contractor agreements and policies and revise agreements as needed. While there is still risk from potential audits or employee claims, organizations can further reduce the risks from misclassification of independent contractors if they:

- Have a written agreement with an assigned specific scope of work for a specific, limited, duration;
- Require the worker to use the worker's own tools and/or work off the



organization's premises;

- Pay the worker by a flat fee, rather than by the hour;
- Ensure minimal supervision and control over the worker;
- Do not reimburse expenses;
- Do not have employees and contractors performing the same work;
- Do not require set hours; and
- Require the independent contractor to have a business license and general liability insurance in addition to any required professional licenses, certifications or required permits.

WHAT ARE POTENTIAL IMPACTS OF RECLASSIFICATION ON THE BOTTOM LINE?

Every organization is different, so it is difficult make blanket assumptions, however there are a few things to consider:

- The hours of staff time it will take to make the conversion. Reclassification of employees will take time and attention away from other organizational business for at least one employee in each organization while the conversion is in process.
- How much additional money should be budgeted for payroll taxes? Some estimate that these changes to payroll could cost a business around 30% more assuming that health and life insurance and retirement benefits are included. However, the additional cost of the “basics” such as workers compensation, Social Security, and state disability and unemployment insurance is approximately 15% more per worker.
- Changes to the number of employees in an organization can trigger thresholds for certain employment laws and regulations.
- The need for more organizational knowledge about how to comply with labor rules and regulations and worker benefits provisions could require hiring outside assistance or professional development training for an existing staff person.
- Organizations that have not already done so may choose to outsource payroll activities or purchase new software to support in-house HR and payroll administration.
- There may be increased costs related to seeking legal counsel for expert advice on reclassification procedures and requirements, the options available to your organization, the creation of new independent contractor agreements etc.

These additional costs will have to be weighed against the potential risks from misclassifying employees.



FINAL THOUGHTS

We haven't heard the last word on AB5. There could well be "clean up" language and new exemptions in the future that may or may not benefit arts and culture employers and workers. However, there are a lot of reasons to make the changes in your organization to reclassify workers regardless.

Because our sector provides relatively low wages compared to the private sector and many organizations have few perks or benefits beyond those that are required by law, ensuring that arts workers have access to unemployment, disability and workers compensation insurance, as well as assistance with Social Security contributions is a positive and meaningful step towards supporting our most valuable organizational assets.

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DISCLAIMER

Nothing in this document should be construed or understood as legal advice or a replacement for legal counsel. It is provided for informational purposes only. If you have questions or need legal advice, please contact an experienced employment attorney.



- ⁱ leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB5
- ⁱⁱ *Dynamex Operations West, Inc. v. Superior Court*, 4 Cal.5th 903 (2018).
- ⁱⁱⁱ Orders of the Industrial Welfare Commission regulating the wages, hours, and working conditions in certain industries or occupations. There are 17 such orders that are also known as "IWC Orders," or "Wage Orders." <https://www.dir.ca.gov/IWC/WageOrderIndustries.htm>
- ^{iv} <https://ogletree.com/insights/2019-09-12/the-abc-test-may-soon-be-law-in-california-what-employers-need-to-know/>
- ^v http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB5
- ^{vi} <https://www.bls.gov/ooh/arts-and-design/craft-and-fine-artists.htm#tab-1>

