

YOUR DEFINITIVE GUIDE TO

California EDD Audits, The Dynamex Case and Independent Contractor Classification

*What Business Owners Need To Know About
AB-5 and the New Law.*

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CHAPTER ONE

Introduction & Overview of AB-5



CA EDD

Unbridled Power after the Dynamex Decision

CA Assembly bill AB5, inspired by the Dynamex Case April 2018, was signed into Law by Gov. Newsom on September of 2019 and goes into effect January 1, 2020. This is not just another bill. The new AB-5 law directly affects the way Small Business Owners (SBOs) who hire Independent Contractors (ICs) will operate in California. The law impacts ALL SBOs. In a nutshell this new law redefines the way you as a business owner must classify your workers. Starting in January 2020, the California Employment Development Department (EDD) places the burden of proof on business to show that workers are correctly classified as 1099 contractors and that they should not be reclassified as employees under the stricter criteria set out in the new law.

Before AB-5 was signed into law, there were 13 criteria (the Borello Test) used to determine if a worker should be classified as a contractor or as an employee.

Beginning January 1, 2020 the new, stricter legal rules go into effect pushing CA business owners to employ workers as W-2 employees and pay for benefits and protections (unemployment, overtime, sick-leave and worker's comp) that employees get under California Law. However there are several exceptions for specific industries and job categories. For those industries, the worker classification guidelines under Borello remain the standard by which CA EDD will determine worker classification.

CA EDD

Unbridled Power after the Dynamex Decision

Honest businesses who follow the rules are at a disadvantage as they are competing with businesses who hire 1099 contractors (without benefits and are not paying the employer portion of payroll taxes) who should be W-2 wage earners. With the Dynamex decision and the three point test of AB 5, companies that do not follow the law will have dramatically lower overhead but a high risk of an EDD Audit. Companies who are audited and whose 1099 contractors are reclassified as employees will be assessed payroll taxes on the total payments to these misclassified workers, which includes taxes, penalties and interest. The new AB-5 law Certainly raises standards for many California workers.

Who benefits and who is at a disadvantage?

In short, this law is targeting the gig economy of Uber, Lyft, DoorDash and PostMates. The aforementioned companies have pledged \$30 million each to fund a ballot initiative to reverse AB5 in 2020. The worker's comp, unemployment insurance, payroll taxes and benefits (overtime pay, paid time off, health insurance, etc...) would be required to be offered all to all of the newly classified W-2 wage earners. This change can be financially devastating to many California companies. The National Employment Law Project estimates businesses save roughly 30% in costs when they work with independent contractors instead of hiring W-2 employees.

CA EDD

Unbridled Power after the Dynamex Decision

Beneficiaries of the stricter classifications are those workers in the gig economy who want to be able to unionize, who are working full time without benefits and who will, under AB-5 have to be offered benefits, protections and earnings guarantees. An example of a beneficiary of the new law might be 1099 workers for a large cleaning company, for example, who work fewer than 40 hours but only work for one company and do not have the benefits or protections of being an employee. These workers would, under the new law, be classified as employees and would be offered benefits, unemployment insurance and protection under the labor laws from being fired without just cause among many other W-2 wage earning employee benefits.

Those companies who will find AB-5 puts them at the biggest disadvantage in this new classification system are small to mid-sized business owners who want a flexible work force by employing workers to help when times are good and then scale back either seasonally or due to market conditions. These small business owners will have to pass a much stricter analysis in order to be able to hire 1099 workers as opposed to W-2 employees. The burden of proof lies with the employer to prove that a worker is correctly classified as a 1099 contractor. and EDD will request proof that 1099 contractors have a legitimate business starting in January 2020.

CA EDD

Unbridled Power after the Dynamex Decision

Another group who may find the new law puts them at a disadvantage is the gig worker who prefers to remain a 1099 contractor. According to Forbes and Gallup, 36% of US workers are in the Gig Economy. Retired people choose to pick up work as do recent grads and stay at home mothers. For many of these workers a 1099 contractor status is just fine and they do not want to be managed as a W-2 wage earner. For those workers, these new AB-5 classification rules are not offering any tangible benefits, they are creating impediments. Surveys done by Intuit in 2016, found more than 90% of contract workers prefer the flexibility and personal control they have as independent contractors. They can accept or reject a job based on the amount offered, timing, or indeed any reason – these workers work only when they want. For those drivers in the gig economy who drive for Uber, Lyft and HopSkipDrive, they may have to choose one “employer” and thereby not be able to pick up as much work in a given period of time. The ramifications of this shift will certainly affect both companies and workers.

“ According to Forbes and Gallup, 36% of US workers are in the Gig Economy. ”

Forbes & Gallup

CA EDD

Unbridled Power after the Dynamex Decision

What are the classifications and how strict will EDD be?
These are new ABC's of worker classification:

AB-5 & the NEW 1099 Contractor Classification Guidelines *Your Definitive Guide*

13 Point Borello Test

13 pts of varying weights

NEW 3 criteria "ABCs"

3 pts. Workers must meet all criteria to be considered contractors

Control

- Do you instruct or supervise the person while he or she is working?
- Can the worker quit or be discharged (fired) at any time?
- Is the worker free to make business decisions which affect his or her ability to profit from the work?
- Is the worker paid a fixed salary, an hourly wage, or based on a piece rate basis?



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.



Scope of Work

- Is the work being performed part of your regular business?
- Do you have employees who do the same type of work?
- Did the worker previously perform the same or similar services for you as an employee?



The worker performs tasks that are outside of the usual course of the hiring entity's business.



Independent Entity

- Does the worker have a separately established business?
- Does the individual have a substantial investment in their job which would subject him or her to a financial risk of loss?
- Do you furnish the tools, equipment, or supplies used to perform the work?
- Is the work considered unskilled or semi-skilled labor?
- Do you provide training for the worker?
- Does the worker believe that he or she is an employee?



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 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 worker performs work that is outside the usual course of the hiring entity's business.

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.

Some Businesses are exempt from the new classification rules and fall back to the original 13 point Borello test: Real Estate Agents, Lawyers and Stockbrokers, Insurance Companies, Doctors, Dentists, Accountants and Engineers. Forestry workers and truck drivers have been vocal opponents of the reclassifications that AB-5 requires while many ride share drivers have banded together to support the new legislation.

What Do Business Owners
Need To Do NOW

If you are going to keep your 1099 workers as contractors; Fill-in this worksheet and keep this in the event of an EDD audit

Be Prepared

Your Contractor

Worksheet

Criteria per the NEW ABCs		Information to gather
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	What are project deliverables and how are they delivered?
		Have your contractor submit an invoice
		Keep correspondence about project timelines clearly recorded. Ensure you are not placing requirements on your 1099 contractors regarding how they perform their work. ie: Do not tell them what to do and do not specify reporting requirements.
		Document and file S.O.Ws from your contractor
B	The worker performs work that is outside the usual course of the hiring entity's business	What is the definition of your contractors line of work?
		What is your definition of your line of work ? What products or services does your company provide?
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[16]	Does your 1099 have insurance?
		Do they have a legal entity?
		Do they have associations, unions or other affiliations?
		What professional certifications do they hold?
		Gather their business card, website and a short list of other clients your contractor works for.



CHAPTER TWO

Case Study: Plumbing Company

The Black and White



Case Study

Plumbing Company

As the new AB-5 law becomes law at beginning of 2020 there will be cases where EDD views many companies and potentially reclassifies 1099 contractors to employees. While some business owners will be prudent and research their workers and review the information with a professional to minimize the risk that EDD will reclassify their workers, others will simply convert all their 1099 contractors to employees. For some companies, converting workers to employees is not an option due to their business profit model (low margin businesses) or other reasons. One thing is certain, those business owners who investigate and research the facts about their own contractors will be in a better position to make informed decisions based on facts. At the same time, as with any new regulation there will be many cases and industries that are in the gray, not only for business owners but also EDD.

Let's look at case studies both for a black and white worker reclassification and a gray area where both business owner and EDD will find it difficult to decide whether workers really should be reclassified as employees.

Case study: Plumber Black and White

Bob owns a plumbing company. He employs 20 plumbers who work from the Inland Empire down to Imperial Beach. His plumbers come into the office to submit time sheets, pick up specialized equipment or check in on challenging jobs but many of them don't come into the office for weeks at a time.

Case Study

Plumbing Company

If the jobs are getting done, Bob is fine with his employees working the hours that work for them (so long as they get in their 40/week). It's better with this flexibility because pipes don't break between 9 - 5 Monday - Friday so there's always work, overtime and odd hours to be covered.

With all the rain in the winter of 2018, Bob needed more help so he hired 4 new contractor plumbers. Two of the guys were plumbers in North County who were able to cover the Rancho Santa Fe and Encinitas calls in a really timely way. They were brothers and Bob knew them from years ago when his son went to soccer camp with their little brother. The other 2 hires were a husband and wife team with a pressure hose for high pressure sewer clog removal. Jane and Michael own their own service but haven't really invested in marketing and they were happy to have jobs provided to them by Bob.

With the passing of AB-5, the new ABCs and the Dynamex case, Bob was really worried that he would have to take on 4 more employees. The payroll taxes, worker's comp and benefits would make it impossible (or at least not profitable) to keep all 4 of them but he couldn't figure how to cover the work that he knew was on the way with the 2019 El Niño.

Case Study

Plumbing Company

Bob came to Milikowsky Tax Law for a consultation. John did a complete analysis and determined that the plumbers in N. County would, in fact have to be brought on as W-2 employees. They perform the same services as Bob's other W-2 employees and they don't work for anyone else, they don't have their own business entity, though they are licensed plumbers in their own right.

The husband wife team, however, John determined can remain as contractors. While they don't invest as they might in marketing and their website hasn't been updated since they were first married in 2008, they do have insurance, a DBA filed in San Diego county and a business checking account with their company name on it. They pick up occasional work from Yelp searches and they qualify as specialists of sorts as they own plumbing equipment that is specialized. Most importantly, the husband and wife team specialize in commercial plumbing, Bob's company, however, only work on residential jobs.

Bob was able to keep all four workers after his consultation and he felt secure in the decision he made knowing that his tax lawyer had carefully reviewed the facts and made an educated recommendation.



CHAPTER THREE

*Case Study:
Entertainment
Industry*

The Grey Area



Case Study

Entertainment Industry

Case study: The Gray Areas

Brad owns an entertainment company. He brings world class caliber shows to conferences and hotels all over the US. Brad's Entertainment company hires performers based on the show that they are putting on and each show is unique. Shows are tailored specifically for the guests and presenters at the conference. Think Cirque De Soleil but for different groups at different venues and never the same setup!

Bob hires dancers, singers, musicians, as well as models. He has a group of people he regularly hires but hires many new performers each year. And there's no guarantee that he will get his next gig, much less a guarantee that they will be a part of it. And that's showbiz.

Or is it?

Given the criteria of AB-5, Brad is worried that he may be forced to make all of his performers W-2 wage earners. After all, when they get hired, they have to be at rehearsal on time, they cannot come and go as they choose. Very few of them have an LLC, Sole proprietorship or any other business entity. Most have websites to showcase their unique skills, but not all.

Case Study

Entertainment Industry

If Brad is not the employer, and the workers are all contractor, then nothing changes. But what if the workers lack of an independent business entity and insurance, projected Scopes of Work and invoices which causes EDD to classify all of his workers as W-2s. Then Brad is finished. The profit margins are not wide enough to afford to employ all the stagehands, choreographers, dancers, actors, servers, musicians and so on on a W-2 payroll and pay patrol tax, workers compensation, paid time off, health insurance (now required in California)

Brad's case, while hypothetical here is a good example of the grey areas that will arise with the advent of these new legal criteria in AB-5 for classifying workers.

Remember, workers are either employees or independent contractors.

Some of the questions that will arise and need to be addressed on a case- by – case basis are:

- Many 1099s are out of state, NYC actors etc... If they perform in CA, it counts. What if the company is in CA and hires performers in Las Vegas and the worker lives in NY or in CA. How do you minimize the risk of 1099 misclassifications in CA?
- Do all performers qualify for a Fine Arts Exception under AB-5?
- Does it matter if the total payment amount to a 1099 contractor is below \$600?

Case Study

Entertainment Industry

If one worker is 1099 does that mean all in that category are contractors?

For stage managers - not performers and may indicate you have control based on the worker's role.

For costume Designers - not performers, they have their own shops and do not consider themselves employees. They could be stronger candidates to be considered 1099 contractors.

Do your accounting records accurately reflect all of your payments. To all workers (i.e.: do you pay any workers in cash?)

So what should the business owner whose industry falls in the grey area do?

First and foremost. Be knowledgeable about the audit process.

An Audit Generally has the following phases:

1. EDD requests a business to submit a preaudit questionnaire .
2. EDD schedules and initial audit meeting with the EDD auditor who will ask many questions about your business, workers and request detailed accounting reports as well as a list of all payments to contractors and a copy of your independent contractor agreements. EDD will also request details of the scope of work performed by cash contractors, including evidence that cash 1099 contractor has a legitimate trade or business (i.e.: business license, valid EIN, etc...)
3. EDD reviews your records and usually submits multiple requests for additional documents and information if and when an issue is uncovered.
4. EDD will make a formal determination and mail a notice of assessment in which a dollar amount is specified.

Case Study

Entertainment Industry

You may feel that it's not going to be that bad, I can handle it and the EDD auditor seems really nice.

The EDD Auditor does seem nice and they are hoping you will give them all the information and allow the auditor to confirm their own assumptions that your 1099 workers should be converted to W-2 employees. An aggressive EDD auditor would get your guard up and defeat their purpose of you providing more information than is necessary.

Important questions to consider:

- Do you have any disgruntled past or present workers? Those who no longer work with your company, and perhaps have since become competitors, may represent information about your business to EDD in an unflattering and inaccurate light.
- How much time can you afford to spend digging into the audit details, searching through records and researching your 1099 workers while you run your business?

The Audit process is complex. What can you expect? Read on for a step-By-Step Walkthrough of the CA EDD Audit process. What you can expect, what to look out for and where you may find pitfalls.



CHAPTER FOUR

*CA EDD
Audits: What to
Expect*

Your Step – By – Step Guide



CA EDD

Audit Guide

The outcome of an EDD Audit of your 1099 workers can have one of three outcomes:

1: No Change: You've done it all correctly! Your 1099 workers are really all bona fide 1099 contractors. You continue to do what you have been doing (after of course you catch up on all the work you fell behind on during the audit process)

2: Refund: You have actually been classifying a few of your 1099 contractors as W-2's. In your zeal for compliance, you have overpaid and CA EDD would like to give you a refund as well as the go ahead to continue to classify those workers as 1099s.

3: Balance Due: As they suspected, EDD finds that your 1099 workers were W-2s all along. EDD will now convert your 1099 contractors into w-2 employees and assess payroll taxes, penalties and interest on all payments to each worker. For payments to workers who were required to receive a 1099 but didn't, the business will be assessed an "additional worker information penalty". You will then pay this balance, convert all current workers and future workers to W-2 employees and pay benefits. Additionally, you will have to start reporting all current and future workers as well as W-2 employees to IRS as well.

The key to your audit: Will you or will EDD control the narrative in the discussion and discovery process with EDD? It all comes down to key facts in each audit.

EDD AUDIT PROCESS

What You Can Expect & How to Handle It

RECEIVE A PAQE

The Pre-Audit Questionnaire Will Arrive in the US Mail letting you know that CA EDD is starting their Audit process and would like more information their lead.



YOU SUBMIT YOUR RESPONSES TO CA EDD

Once you submit your responses an Audit meeting Is scheduled. The responses you give are crucial to the tone that Is set for the meetings.



YOUR AUDITOR REQUESTS DOCUMENTS

At this point It Is crucial that you drive the narrative. Every document you provide, If not carefully curated, gives your auditor fuel to support his or her assumptions and to create their own narrative.



YOUR 1099 WORKERS PAST AND PRESENT ARE INTERVIEWED

Think about workers who left with less than a great feeling. Perhaps those who went Into business as competitors. These are the people who can make your life difficult.



CA EDD MAKES THEIR DETERMINATION

At this point the train has left the station. If you have pieced together your narrative poorly you could be on the hook for a lot of money. So take care at the outset to drive the narrative yourself.



CA EDD

Audit Guide

EDD Audits frequently start when a 1099 contractor attempts to file for unemployment (although they did not receive a W-2). Often an audit of one or two workers opens inquiries into other elements about the way you run your business. When your very kind EDD auditor requests documents and you provide loads of documents that you believe verify your case, an EDD auditor can come back and say: while we agree that person A is a 1099 contractor, we believe you have another issue, for example, the amount you have paid yourself.

By losing control of the narrative you may now find yourself defending how much you have been paying yourself as the company's CEO.

As an owner you must prove you are paid a reasonable salary. This is true only for C and S Corporations.

Your Auditor may look at the documentation you provide and think, you underreported your wages! You reported paying yourself \$5,000 while you took disbursements of \$80K.

This may seem cut and dried. But no: it is perfectly legitimate for a semi-retired owner of a company to take a smaller salary for what is, quite truly, a small amount of work. Reasonable compensation can be a measure of how many hours you work and the role you fulfill at the company. EDD will look for proof of payments to yourself, payments for services, documentation of interviews with your company managers who can prove your role is limited to building team morale.

CA EDD

Audit Guide

Those managers will need to confirm that they are running the company. As for the disbursements. Assuming you are majority owner, you may also be entitled to those payments. However, EDD may want to convert those payments into taxable wages.

One perspective may look like a blatant misrepresentation. However, from another point of view (from the business owner's perspective) it can seem like a perfectly legitimate fee structure. The most important 3 factors in the face of an EDD audit is to be organized, prepared with the correct facts to prevent your audit from becoming *a runaway train*. You must take control of your factual narrative.

In your audit, the “magic”, the real ability to change your fate, happens in how you convey specific facts in the negotiation.

These 3 points must be addressed:

1. **Control** (addressed through your clear narrative)
2. **Does the Company and the 1099 perform the same service?** Your narrative should focus on the contractor's business.
3. **Do your 1099s have their own legitimate trade or business regarding the work they do for you?** This can be verified using a tool like Clear1099 [LINK] which verifies each contractors' business using a proprietary and secure database. Clear1099.com provides a report summarizing the details for each 1099 contractor to substantiate a legitimate trade or business (i.e.: EIN verification, Website, Business License and other information.)



The State Has
All The Power

If you come back with statistics, charts and verification, you will have a HUGE advantage.

Get the Data

Control The Narrative



CHAPTER FIVE

Conclusion & Action Items

What to Do Next



Conclusion

& Action Items

In the face of a department so dramatically emboldened by the recent CA Supreme Court *Dynamex* Decision, how can a Small Business Owner hope to win? Why would anyone try?

The truth is that without help in preparing the correct and relevant facts, documents data and analysis along with professional experienced representation, the process can be daunting. It is always time consuming, and often, EDD has already determined their desired outcome. One wrong move along the way and they have all they need to proceed with converting your contractors and then assessing and collecting of the balance due.

However, by controlling the narrative, you can make your case to CA EDD and show them that your 1099 classifications are correct with data, with statistics, and with the ultimate authority.

The team at Milikowsky Tax Law is here to help. Either as counsel for your entire EDD Audit process, advocating on your behalf with years of experience and expertise or, by providing referrals to DIY tools such as the Clear1099.com online tool which allows business owners to upload their documents to a secure portal and have their 1099 contractors' legitimate businesses verified with a concise report to guide a business owner.

If you are facing an EDD Audit, reach out to the team at Milikowsky Tax Law today. We can help build a strong defense based on facts, data, and legal authority.



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