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IN THIS ISSUE

NEW DEFINITION OF "EMPLOYEE" MAY INCREASE YOUR TAXES

By DeEtte L. Loeffler, J.D., LL.M., Taxation

If you own a small business and hire independent contractors, you may need to reclassify and pay them as employees beginning January 1, 2020. Likewise, if you market your services as an independent contractor, you may no longer be free to do so. Under a new bill, AB 5, signed into law by Governor Newsom in September, most California workers must now be classified, and paid, as employees. In addition, the bill says it declares existing law, rather than changing existing law, so it applies retroactively.

Why the Change? The gig economy, with companies like Uber, Lyft, and DoorDash, has impacted the way the economy works and potentially denied the state and federal government billions in tax revenue while shifting the risk of loss from companies to workers (or the public who must provide benefits that employers used to provide). Lost tax revenue and increased use of public benefits catches the government's attention.

What Was the Law Before? California workers have been classified as either employees or independent contractors using tests from two state Supreme Court cases: the 1989 case of *S.G. Borello & Sons, Inc. v. Dep't of Indus. Relations*, 48 Cal.3d 341, and the 2018 case of *Dynamex Operations West, Inc. v. Superior Court*, 4 Cal.5th 903. *Dynamex* applies only to wage order claims (i.e., minimum wage, overtime, meal and rest breaks), while *Borello* applies to all other claims. The new law codifies the rules from these cases, but makes exceptions for some industries and occupations.

New Definition of "Employee". Under new Labor Code section 2750.3 and amended section 3351, and Unemployment Insurance Code section 621, workers are presumed to be employees unless the hiring entity can demonstrate they either meet a three-part test taken from the *Dynamex* case or are otherwise exempted. The hiring entity must demonstrate:

(1) 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 to perform the work and in fact;

(2) The worker performs work that is outside the usual course of the hiring entity's business; and

(3) The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

Given the scope of the new law, it appears likely that most workers will now be employees whether or not they want to be. However, in the event a court determines the *Dynamex* test cannot be applied to a claim, and the worker is not excluded by another exception discussed below, the multipart test from *Borello* will apply.[1]

How Will This Affect Your Business? Employees are generally more expensive than contractors, and they have more protections under the Labor Code. They are covered by wage and hour laws including minimum wage, sick pay, paid family leave, workers' compensation, rest periods, hour limitations and overtime pay, and must receive benefits, such as medical and pension, if offered to your other employees. Additional taxes apply, including Social Security tax, payroll tax, California employment tax, and unemployment insurance tax. Employers must also remit state and federal income tax withholding from payroll. As a rule of thumb, benefits add about 30% to the cost of each employee over an independent contractor, which could have a significant impact on a company's ability to hire (or retain) workers.[2]

Those who have been acting as independent contractors may find themselves taking home less money as they must pay more for benefits like medical insurance, and cannot put as much into their pension plans. Others may find themselves no longer employed as companies cut back to cover the increased cost of benefits.

Who is Exempt Under the New Law? Certain occupations have been excluded, including:

- insurance agents, doctors, dentists, podiatrists, psychologists, and veterinarians;
- lawyers, architects, engineers, private investigators, accountants, and enrolled agents;
- stock brokers and investment advisors;
- direct sellers and commercial fishermen;
- marketing professionals, human resource professionals, travel agents;
- graphic designers, grant writers, fine artists;
- photographers, photojournalists, freelance writers, editors or newspaper cartoonists who make 35 or fewer submissions per year;
- licensed: estheticians, electrologists, barbers, cosmetologists, and until 2022, also manicurists, if they set their own rates, hours, appointments and client list, process their own payments, and have a book of business; and
- real estate agents and repossession agents.

Subject to additional tests, business-to-business contractors, construction industry contractors, referral agencies, and motor clubs may be exempt.

If you, or your business, have been providing services as an independent contractor and you want to retain your independence, you should review your written agreement to ensure you can fit within one of the exceptions. The business-to-business exception may be the broadest as it allows you to perform services as a sole proprietor as well as in other entity

[1] *Borello* factors include, in part, (i) how much control the employer can exercise, (ii) whether the worker is engaged in a distinct occupation/business; (iii) whether the type of work is usually supervised; (iv) who provides the tools and place of work; (v) the length of the contract; (vi) if payment is by the time or the job; (vii) whether the work is a part of the hirer's regular business; (viii) what relationship the parties believed was formed; (ix) the worker's opportunity for profit or loss; (x) the worker's financial investment in equipment, materials or helpers; and (xi) the skill required.

[2] *Los Angeles Times*, September 11, 2019, https://www.latimes.com/business/story/2019-09-11/sweeping-bill-rewriting-california-employment-law-moves-to-gov-newsom; https://smallbusiness.chron.com/costs-employee-vs-independent-contractor-1077.html

forms. In addition to a written agreement, you may need to obtain a business license or tax registration, maintain an office separate from the work site, and have more than one customer.

What's Next? We recommend you speak with your CPA and benefit providers soon to determine how paying all workers as employees (or being paid as an employee) will impact your taxes and bottom line in 2020. If you have concerns about your ability to continue certain independent relationships, you should consult an experienced employment attorney to review your agreements and options.

RENT CONTROL IN CALIFORNIA: HOW WILL IT AFFECT LANDLORDS?

By Katie Lepore, CPA, J.D., LL.M., Taxation

Most California landlords and tenants alike have heard "buzz" about the recent California rent control bill, AB 1482, *the Tenant Protection Act of 2019*, which was passed by the California legislature on September 11, 2019 and is expected to be signed into law soon by Governor Gavin Newsom. The bill represents significant legislation related to housing laws and imposes more severe restrictions on landlords than before, though there are several caveats and exceptions provided for in the new law. The bill is unlikely to have a significant impact on investors owning single-family residential units, but those with multi-family properties may feel a greater impact.

While several versions of the bill were considered, this article will focus only on the final provisions that would be enacted upon signature by the Governor. This article also does not address the rent control proposition that was overwhelmingly voted down by California voters on the November 2018 ballot.

There are two main goals of the bill, the first of which deals with protecting tenants from unjust evictions and the second aims to protect tenants from unjust rents. This article will review each of these in turn. The bill would be effective from January 1, 2020 until January 1, 2030, though there are some retroactive provisions as mentioned below.

Furthermore, it is important to note that as with all new laws, there is no case history or other authority than the bill itself to govern its implementation. As time goes on, courts and other governmental agencies may shape the interpretation and meaning of the bill through rulings and regulations.

Exemptions

The law does not apply to all rental properties. It does not apply to properties built within the last 15 years. It also does not apply to properties where the landlord lives on site as a primary residence and shares a bathroom or kitchen facility with the tenant. Further, it does not apply to a single-family residence that is owner-occupied so long as the owner does not rent more than 2 units or bedrooms, including an accessory dwelling unit. Additionally, duplexes are exempt so long as the landlord lives in one of the units.

Most single-family residences and condos will also be exempt. For residential property that is not owner-occupied, and "that is alienable separate from the title to any other dwelling unit," the law will *not* apply so long it is *not* owned by a real estate investment trust (REIT), a corporation, or a Limited Liability Company (LLC) that has a corporation as a member. Therefore, it appears that a single-family residence (or condo) that is owned by an individual, trust, or LLC with only individuals or trusts as members, would not be subject to the new laws. However, it appears that multi-family complexes would likely be subject to the new rules regardless of ownership because the title is not separate from the title to other dwelling units.

Landlords who have a single family residence that is not owner-occupied and are not any of the previous types of owners (REITs, corporations, etc.) must provide written notice that the property is exempt from the rent control laws in any leases that begin or renew after July 1, 2020 (leases that begin before that date may include this language but are not required to do so). The specific language that must be included is as follows:

> "This property is not subject to the rent limits imposed by Section 1947.12 of the Civil Code and is not subject to the just cause requirements of Section 1946.2 of the Civil Code. This property meets the requirements of Sections 1947.12(d)(5) and 1946.2(e)(8) of the Civil Code and the owner is not any of the following: (1) a real estate investment trust, as defined by Section 856 of the Internal Revenue Code; (2) a corporation; or (3) a limited liability company in which at least one member is a corporation."

Therefore, the bill is aimed at institutional investors and those with larger complexes. It still may affect some "mom and pop" individual investors who own smaller multi-family complexes, and certainly would hurt those who have not kept rents in line with the fair market value.

New Limits on Evictions

Landlords of residential real property may not terminate a tenancy without "just cause" after the tenant has lived there for at least 12 months (prior law required a mere 60 days' notice for such tenants). Further, owners must now give the tenant a chance to "cure" most problems before the lease can be terminated.

Additionally, for terminations where the landlord has just cause and the cause cannot be cured, if the tenant is not at fault, the landlord must either: a) assist the tenant with relocation efforts by paying to the tenant the equivalent of one month's rent (without regard to whether the tenant is a low-income or high-income earner), or b) waive collection of the final month's rent from the tenant. If the landlord fails to provide such "relocation assistance," the eviction notice is void. Furthermore, tenants *cannot* waive these rights under any contract or lease agreement.

If a local ordinance or rule, such as a city or county imposing their own rent control, is more restrictive than the provisions of this new law, the local rules will govern.

Just Cause

Just cause is defined in the bill. There are several instances of "at-fault" just cause in which the tenant is directly at fault, and several other instances of "no-fault" just cause for which the tenant is not at fault. Examples of at-fault just cause include: failure to pay rent; a material breach of the lease; committing a nuisance; criminal activity; assigning or subletting in violation of the lease; refusal to allow the owner access to the property within certain parameters; failure to deliver possession of the property after termination; or failure to sign a lease extension with similar terms and similar duration after written request from the landlord.

Examples of no-fault just cause (triggering the relocation assistance provisions for those who rented for 12 months or more) include: the owner or a family member wants to reside on the property; withdrawal of the property from the rental market; compliance with a government order; and intent to demolish or substantially remodel the property (for which "substantial" means requiring a permit from a governmental agency, not mere re-painting).

The bill does not state how long the owner or family member must live in the property or what factors would be analyzed to determine if just cause is present in any given case. It is worth noting as well that the provision regarding an owner or owner's family member living on the property only applies if the tenant agrees, in writing, to the termination, or if the lease allows the owner to terminate under these circumstances, for all leases beginning

after July 1, 2020. However, the new law explicitly states that if the owner added a provision to the lease agreement to comply with this rule, it is a "similar" term such that if the tenant fails to sign a renewal or lease extension with reference to this provision, it could still be at-fault just cause. *It appears that landlords may wish to amend their lease agreements now if they anticipate that they might want the option to live in the property later.*

Application of Evictions

It is imperative to understand that the provisions regarding evictions, at least for at-fault just cause such as failure to pay rent or material breach, will likely apply during the lease term rather than at the termination of a lease for a term of years (assuming rules are followed to properly terminate the lease). Therefore, most at-fault and curing restrictions outlined above will likely apply in practice to landlords who unfortunately determine they have a "bad" tenant during the lease term, or those who are renting on a month-to-month basis. It may also affect those investors who purchase a property that already has existing tenants on the premises, making due diligence all the more important during the purchase process. The provisions regarding no-fault just cause appear to trigger the relocation assistance provisions even at the end of a contractual lease unless it is the tenant who does not want to renew a similar lease, which provides at-fault just cause.

This would appear to override contract law to a degree, such that even at the conclusion of a 12-month lease, if the landlord is the person who does not want to renew the lease, relocation assistance must be provided. Landlords may therefore wish to rent based on an 11-month lease, or if landlords anticipate not wanting to renew at the conclusion of the 12-month contractual period, notice of termination should be given in month 9 or so to ensure the lease does not extend past the 12-month period. For all tenants who have lived on the property for 12 months or more, a no-fault termination appears to trigger the one-month rent relocation assistance provisions without exception. This was confirmed by the office of the bill's main drafter.

Limits on Rent Increases

Over the course of a 12-month period, a landlord may not increase the "gross" rent more than 5% plus the cost of living (which is typically about 2-3%)[1], or 10%, whichever is lower (gross rent is the amount of rent prior to any discounts, credits, or discounts offered by the landlord).

This rule is *retroactive* and applies to all rents that were increased on or after March 15, 2019. In the event a landlord increased rents by more than the proscribed amount between March 15, 2019 and January 1, 2020, the rent for January 2020 going forward will be the maximum increase allowed under the new rent control laws. However, the bill explicitly states that the owner will *not* need to reimburse the tenant for the "overpayment" paid from March until January; he or she simply cannot continue collecting rents at that rate beginning in January. This provision appears to affect landlords even if not the owner on March 15, 2019, meaning a small number of owners who purchased a property after March 15 with existing tenants and possibly signed new leases with those existing tenants may be restricted by the low rents imposed by the seller, even if the buyer renovated after closing.

[1] The percentage change in cost of living is defined in the bill as, "the percentage change from April 1 of the prior year to April 1 of the current year in the regional Consumer Price Index for the region where the residential real property is located, as published by the United States Bureau of Labor Statistics. If a regional index is not available, the California Consumer Price Index for All Urban Consumers for all items, as determined by the Department of Industrial Relations, shall apply." *See:* https://timesofsandiego.com/business/2019/09/14/landlords-developers-ok-with-californias-landmark-rent-gouging-law/

Some Takeaways

The evictions rule does not appear to be retroactive, meaning, a 60-day notice for tenants who lived on the property for 12 months should be sufficient until the bill takes effect January 1, 2020.

It is important to note that the new rules do not apply at vacancy. When a tenant vacates a unit, the landlord may reset rents to fair market value. To that end, landlords concerned about the bill's provisions may wish to rent for a period of time rather than month-to-month and be careful at the termination of a lease to not let it automatically roll to a month-to-month period. Lease forms may need to be reviewed to remove such automatic provisions. As stated earlier, if the landlord anticipates not wanting to renew a 12-month lease, notice likely should be given before the 12-month mark arrives.

While the bill is aimed at protecting tenants, it may actually provide protections to landlords in new ways. Some experts think this will make landlords feel obligated to raise rents every year, whereas previously some years landlords may have foregone a rent increase for "good" tenants. Now, if a landlord falls behind in raising rents in any one year, he or she may be jeopardizing the right to raise rents to fair market value in the future because the rent increase allowed is annual. Foregoing a 5% increase in one year does not mean the owner may raise rents by 10% the next year; the 5% increase plus the cost of inflation is a "use-or-lose" opportunity each year. It also provides a sort of cover for landlords to raise rents and justify the increase to tenants without appearing to be intentionally raising the rent on that tenant, such that the 5% plus cost of inflation has been approved by legislators as a fair benchmark of what *should* be charged rather than a limit on what *can* be charged. Landlords can now raise the rent with simple justification that "the law" provides the rental increase guideline rather than an increase being an arbitrary number chosen by landlords (if the landlord chooses to increase by the full 5% plus cost of inflation).

Others think landlords may draft more stringent rental contracts making it more difficult for tenants to follow all the provisions of the contract, to create an "at fault" just cause in the event the landlord desires to evict the tenant. For example, this could include changing the lease agreement to require the tenant to upkeep the grounds of the property or cover pest control, which typically are responsibilities of the landlord. If a tenant fails to maintain the lawn, it may provide an opportunity for a landlord to evict the tenant with cause, assuming the provision constitutes a material breach.

Some investors seem to be alarmed that their real estate can no longer be owned in an LLC or else they would be subjecting themselves to rent control. On the contrary, unless one of the members of the LLC is a corporation, an LLC has no bearing on the analysis of whether a property is subject to the new laws or not.

Conclusion

The laws are brand new and there will undoubtedly be several future cases and regulations that shape their application and provide clearer guidance. For now, the only legal source is the text of the bill itself. If you should have any questions about your rental real estate, please contact our office.

FEDERAL TAX UPDATE

By Katie Lepore, CPA, J.D., LL.M., Taxation

Estimated 2020 Estate and Gift Exemptions. Thomson Reuters Checkpoint has calculated the estimated 2020 estate and gift tax exemptions for those values that are slated to

be indexed with inflation after the U.S. Bureau of Labor Statistics released the August 2019 CPI summary. The unified estate and gift tax exclusion amount and Generation Skipping Transfer Tax Exemption are estimated to be $11,580,000, increased from $11,400,000 in 2019. The annual gift tax exclusion is expected to remain at $15,000, and gifts to foreign spouses increased to $157,000 from $155,000. The top trust income tax bracket incurring a 37% marginal income tax rate is expected to begin at income levels over $12,950.

Federal Government Aims for Housing Reform. On September 5, 2019, the Treasury Department and the Department of Housing and Urban Development both released plans to reform the government's control over Fannie Mae and Freddie Mac, along with the broader housing finance system. The plans call for privatizing these entities to end the government conservatorships that began in 2008 and to ensure that they are properly capitalized to continue as viable companies in the future. The Treasury emphasized that shareholders and unsecured creditors, rather than taxpayers, should shoulder the burden of any losses in the future. The Senate Committee on Banking, Housing, and Urban Affairs held a hearing on September 10 about the plans.

Qualified Business Income Deduction Draft Released. The IRS released draft instructions to the draft Form 8995, Qualified Business Income Deduction Simplified Computation, computed under Section 199A. The draft form was initially released in April 2019 along with Form 8995-A, Qualified Business Income Deduction. A later draft Form 8995 was released in July 2019. The Form states that a business's Qualified Business Income is reduced by charitable contributions, which was not previously well-known.

IRS Releases Regulations on 100% Depreciation. On September 13, 2019, the IRS released final regulations (T.D. 9874) and additional proposed regulations (REG-106808-19) regarding 100% bonus depreciation under Section 168(k) of the Internal Revenue Code. The Regulations were originally issued in August 2018, but the final version contains new provisions that were not previously addressed, according to the IRS.

Senator Wyden Proposes Mark-to-Market System. Senator Ron Wyden (D-OR), the ranking Democrat on the Senate Finance Committee, released a detailed proposal on September 12 wherein high-income earners would mark-to-market their investments, meaning they would pay tax annually on any gains earned over that year (or take losses) rather than only in the year of sale. Furthermore, these households would have capital gains taxed at ordinary rates, instead of more preferential lower rates. Certain "nontradable assets" such as real estate or business ownership interests would be governed differently and not be required to be appraised annually. The proposal would affect taxpayers with more than $1 million in annual income or more than $10 million in assets for 3 consecutive years. Certain values of the taxpayer's personal residences, retirement accounts, and family farms would be exempt from the asset value calculation. The proposal would dedicate the revenues from the tax to the Social Security fund, but it is unlikely to see any action while the Senate is controlled by Republicans.

STATE TAX NEWS

By Katie Lepore, CPA, J.D., LL.M., Taxation

Reminder to Have Health Insurance. As a reminder, SB 78 takes effect on January 1, 2020, requiring all Californians to maintain health insurance for themselves and their dependents. Those who do not meet this requirement may owe a penalty on their 2020

state tax return. Please see our August 2019 newsletter for more information.

Housing Bill Passes. SB 330, *the Housing Crisis Act of 2019*, passed September 6, 2019 and awaiting the Governor's signature declares a housing crisis in California, stating that California ranks 49th out of the 50 states in housing units per capita, and that 7 of the 10 most expensive real estate markets in the country are in California. The bill states, "California needs an estimated 180,000 additional homes annually to keep up with population growth, and the Governor has called for 3.5 million new homes to be built over the next 7 years." The bill therefore requires local governments to process housing permits more quickly and may remove certain limits on housing production. A standardized process as developed by the California Department of Housing and Community Development should be used to evaluate applications. The bill would take effect January 1, 2020.

Special Taxes Require Supermajority Vote. As reported in our September newsletter, a San Francisco trial court recently held that local taxes created by voter initiative are not "special taxes" requiring a two-thirds legislative vote for validity. However, on September 5, a Fresno trial court found the opposite, that local taxes created by voter initiative are indeed "special taxes" which would require approval from Sacramento before being enacted. The decisions are both likely to be appealed and may eventually need to be reviewed by the California Supreme Court. The decision is important as it affects a locality's ability to enact taxes without going through a more formal legislative process.

Mission Valley Housing Plan Approved. On September 10, 2019, the San Diego City Council approved a 30-year plan for Mission Valley focusing on allowing for "50,000 additional residents and 7 million more square feet of commercial development" according to *The San Diego Union Tribune*.[1] The Mission Valley Community Plan focuses change into sectors based in reference to the San Diego River, with an approximately 28,000 additional housing units to be created by 2050 and re-zones many areas as mixed use between commercial and residential.[2] According to the *Tribune*, "[t]he community's residential population is anticipated to balloon by 248 percent from 20,800 people in 2012 to 72,400 people in 2050."[3]

Los Angeles Approves Rent Control Measure. On September 10, 2019, the Los Angeles County Board of Supervisors approved a rent control measure that would also prohibit evictions without cause in unincorporated parts of the County. Unlike the new state-imposed rent control measures which expire after 10 years, the Los Angeles proposal is permanent for these areas, including parts of East LA, Altadena, West Hills, and Universal City. Rents may increase only with the rate of inflation, up to a maximum of 8% per year. Additionally, the Board approved a measure that would allow low-income tenants facing eviction to receive publicly funded legal assistance at any of five pilot sites around the County. To view a list of unincorporated areas, go to the following link: https://lavote.net/apps/precinctsmaps?utm_content=&utm_medium=email&utm_name=&utm_source=govdelivery&utm_term=#

[1] https://www.sandiegouniontribune.com/business/growth-development/story/2019-09-10/mission-valley-cleared-for-massive-overhaul?_amp=true

[2] *See* id.

[3] *See* id.

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