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In the classic story of "Romeo and Juliet" there is a well-known and often repeated line, "What's in a name?" In the tax world, a name can mean the difference of thousands of dollars. It is important for business owners, employers, employees and independent contractors to understand the distinction between titles and to plan for the associated tax implications accordingly.

The Internal Revenue Service's Approach to Defining Employees and Independent Contractors

The Internal Revenue Service (IRS) defines an employee as someone who performs a service under the control of the employer. If the employer has the ability to control the details of

how a service is performed--specifically *what* actions will be performed and *how* they will be performed--then the individual providing the service is considered an employee. In some instances, an individual may have the ability to make some limited choices as to how a job may be performed on a daily basis. Regardless, the individual is still considered an employee if the details of how a service will performed are left to the employer's discretion.

In contrast, an independent contractor is someone who is hired to perform a service with a direct result. How that result will be reached, what services will be performed, and how they will be done, are left to the independent contractor. The hiring agent has the right to control what result is sought. The details as to how the services will be performed, so as to achieve that result is left to the independent contractor.

There are several statutory exceptions to an independent contractor determination. These include drivers who pick up or deliver certain types of goods; full-time insurance agents who sell specific types of products; individuals who produce certain goods or materials in their homes and under specific work agreements; and, in certain situations, full-time traveling salespeople. Although these individuals may be considered independent contractors under common law, they are actually categorized as employees by statute.

In order to analyze the level of "control" that will determine whether a worker is an employee versus an independent contractor, the IRS has provided three categories of questions that assist hiring agents in determining how an individual should be characterized for tax purposes:

First, look to the *behavioral* factors involved in the work relationship at issue. According to the IRS website, the question one must ask in regards to this specific category is: "Does the company control or have the right to control what the worker does and how the worker does his or her job?"

Second, determine the *financial* implications of the work relationship. Does the hiring agent control the business aspects of the individual's job, such as how and when an individual is paid and what tools are provided to accomplish the job?

Third, has the *type of relationship* been discussed or outlined in contracts entered into between the hiring agent and worker? Is the hiring agent providing the worker with benefits such as pension plans or insurance? How long is the relationship intended to last and how integral to the business is the type of service that the worker is being asked to perform?

Maryland's Approach to Defining Employees and Independent Contractors

Maryland's Department of Labor, Licensing and Regulation (DLLR) takes the firm stance that a signed agreement stating that an individual is to be classified as an independent contractor is *not* sufficient on its own to firmly establish the worker's status. Instead, DLLR instructs employers and workers to analyze the *economic reality* of a work relationship for worker classification purposes.

The economic reality of a work relationship seeks to determine the worker's dependency on the employer. Does the employer dictate whether the worker is permitted or prevented from working? Is the worker economically dependent on the employer? Factors such as how compensation is measured, paid, or designated is not key to the economic reality analysis. The main thrust of the analysis is to determine how reliant a worker is on an employer to have the opportunity to work and thus receive compensation. If a work relationship exists that *does* involve some degree of dependence, an employer-employee relationship has been created.

In certain instances, DLLR analyzes worker classification based on the "ABC Test." The ABC Test is predominantly used for determining worker classification for purposes of administering the Workplace Fraud Act, as well as the Unemployment Insurance law. The test presumes that an individual is an employee *unless*:

- A. The worker is free from direction and control;
- B. The worker is customarily engaged in an independent business of the same nature as that involved in the work; and
- C. The work is outside the usual course of business of the person for whom it is performed or the work is performed outside any place of business of the person for whom it is performed. (www.dllr.state.md.us/workplace/wfempfaqs.shtml)

Just as different states implement different employment classification tests, different agencies (sometimes within the same state) will focus on varying factors for analyzing and identifying worker status for a specific purpose. For example, some agencies will use the ABC Test, while others may adhere to the common law test that focuses on degrees of direction and control exercised over a worker. Other tests will look to the economic realities of the work relationship.

In contrast, the Comptroller of Maryland predominantly adheres to the federal test used by the IRS that focuses on the degree of control exercised over the worker. Although the factors of the test may shift in relation to the agency reviewing the situation, or the purpose necessitating the analysis, the concept of direction, control, and financial considerations typically play an important role in whatever test is applied.

Why Define?

When an employer hires an individual to perform a service, it is critical that the individual is properly identified as an employee or independent contractor. The "name" is what informs what taxes become the responsibility of the employer versus the worker. Furthermore, workers must consider that a difference in classification can impact the individual's claims for minimum wage and overtime pay, unemployment and workers' compensation benefits, and employment discrimination protections, among other important factors.

For example, an employer is responsible for withholding and paying several taxes from employee wages. Income taxes must be withheld and Social Security and Medicare taxes must be both withheld and paid. An employer must also consider payment of unemployment taxes.

When making payment to an independent contractor, however, these taxes are not required to be withheld and remitted by the hiring agent. Instead, an independent contractor is responsible for paying Self-Employment Tax. This tax refers to Social Security and Medicare taxes, similar to those taxes that are withheld and paid by employers in employer-employee relationships. An independent contractor may be required to pay additional taxes, however that is determined on a case-specific basis.

Do Your Research Ahead of Time

When entering into a new work relationship, hiring agents and workers may believe that they have clearly identified the worker as an employee or independent contractor through a mutually-agreed upon contract. Unfortunately, if a state or agency analysis would conclude that a worker should fall under a different classification, written agreements stating otherwise are not enough to overcome such formal findings. As an employer, therefore, it is important to spend the time to analyze work relationships. Applying questions such as those outlined above can assist a hiring agent in determining the appropriate manner to classify a worker. In some cases, answers to these questions may point clearly in one direction or another. However, in many situations the answers may split between pointing towards an employee or independent contractor classification.

It is important that the right determination is made at the beginning of a work relationship to ensure that the hiring agent and worker are not making improper decisions concerning their tax obligations. If you have any questions about how to classify a new hire, or how you should be classified as a worker, contact Frost & Associates today.