Worker Classification Issues: Generally and in Professional Practices

William P. Prescott, Esq., M.B.A. – Executive Program, is a shareholder of the law firm of Wickens, Herzer, Panza, Cook & Batista Co. in Avon, Ohio. Mr. Prescott represents dentists and dental specialists in practice succession and entry planning and has written several books and numerous articles on the topic. Mr. Prescott can be contacted at (440) 695-8067 or WPrescott@WickensLaw.com.

Mark P. Altieri, J.D., L.L.M., CPA, PFS, is special tax counsel with Wickens, and an Associate Professor of Accounting at Kent State University. Mr. Altieri can be contacted at (440) 695-8072 or MAltieri@WickensLaw.com.

Kelly A. VanDenHaute, J.D., is a member of Wickens' Business Organizations & Tax Department whose practice is focused on employee benefits, non-profit, tax-exempt entities, charitable organizations, and general corporate law. Ms. VanDenHaute can be contacted at (440) 695-8075 or KellyV@WickensLaw.com.

Russell I. Tietz, CPA, is an Assistant Professor of Accounting at the University of Mount Union. Mr. Tietz can be contacted at (330) 829-8975 or tietzri@mountunion.edu

William P. Prescott, Mark P. Altieri, Kelly A. VanDenHaute, and Russell I. Tietz

IN THE SUMMER 2010 edition of The Practical Tax Lawyer[1], we reviewed worker classification issues in professional practices. The law, both tax and non-tax law, has continued to evolve since that time with the result that we have been asked to update our research both as to general worker classification issues and to, again, reiterate the law as particularly of interest to professional practices.

Imagine that you are a business owner and you hire someone to perform services for you. Is this person an employee or are they an independent contractor? On the other side of the issue, the person providing the services is going to have the same question. Am I an employee or am I an independent contractor? The IRS is also very interested in this issue. Their focus on this issue has increased in the past 8-10 years.

Individuals provide services to others (e.g. businesses, individuals, etc.) in exchange for compensation. This relationship between service provider and recipient of those services can present challenges regarding the classification of the service provider as an employee or as an independent contractor. Proper classification of individuals providing services to others is important from a tax perspective to both the service provider and the recipient of those services.

We have more than payroll tax concerns with regard to worker classification (although our prior publication on the issue did not extend to non-tax issues). We will

1 William P. Prescott, Mark P. Altieri, and Kelly A. Means, *Worker Classification Issues in Professional Practices.* 24 Prac. Tax Law 43 (Summer 2010)..

discuss the general non-tax parameters and conclude by focusing in on interesting case involving respondeat superior (vicarious liability) exposure in a professional practice.

Improper classification can have a negative impact on both the service recipient and the service provider. Some of those impact areas with regard to tax issues include:

- Social security taxes vs. self-employment taxes;
- Eligibility for fringe benefits offered by the employer; and
- Deductibility of unreimbursed business expenses incurred by the service provider.

Incorrect classification can result in tax deficiencies, penalties and interest.[2]

DETERMINING PROPER CLASSIFICATION • To determine the proper classification of a service provider by the recipient, it is important to examine the facts and circumstances related to their business relationship. In general, an individual is an independent contractor if the recipient of the services performed has the right to control or direct only the result of the work and not the means and methods of accomplishing the result.[3] The service provider will be classified as an employee if the recipient can control what will be done and how it will be done.[4] Revenue Ruling 87-41 provides 20 factors that can be used to help determine whether a service provider is a common law employee or an independent contractor. [5] As we will see, the IRS now focuses on the control aspect of this famous Revenue Ruling.

Businesses have incentives to classify service providers as independent contractors instead of as employees. First, they do not have to pay the employer match on FICA taxes and FUTA taxes, resulting in lower payroll taxes. In addition, the business is not required to withhold federal, state and local income taxes, resulting in a lower administrative burden. Independent contractors also do not need to be included in the business's fringe benefit programs (e.g. health insurance, group term life insurance, retirement programs, etc.).[6]

Classification as an independent contractor also has impacts on the service provider. Independent contractors are required to pay self-employment (SE) tax and file Form SE (Self-Employment Tax). One half of the SE tax paid is deductible as an above-the-line deduction for adjusted gross income (AGI) on form 1040. Also, payments the self-employed taxpayer makes for health insurance are deductible for AGI. Business expenses for self-employed taxpayers are deductible for AGI and are reported on Schedule C (Profit or Loss From Business) of Form 1040. In contrast, unreimbursed employee business expenses are deductible from AGI (to the extent those unreimbursed expenses exceed two percent of AGI) and are reported on Form 2106 (Employee Business Expenses) and Schedule A (Itemized Deductions) of Form 1040.

Given the importance to both the service provider and the recipient of the services, let's examine in more detail the general criteria that is used to determine the worker's proper classification. First, the facts related to the relationship between the worker and the business needs to be examined. It is important to examine all information that provides evidence about the degree of control and the degree of independence that exists. This information falls into three categories: behavioral control, financial control, and the type of relationship of the parties.

Behavioral control refers to whether the business has a right to direct and control what will be

2 Hoffman, William H., William A. Raabe, David M. Maloney, James C. Young, and James H. Boyd. "Chapter 9." *South-Western Federal Taxation: 2016 Edition: Comprehensive Volume*. Mason, OH: South-Western Cengage Learning, 2016. N. pag. Print.

3 IRS Publication 15-A (2016).

4 IRS Publication 15-A (2016).

5 Revenue Ruling 87-41.

6 Hoffman, William H., William A. Raabe, David M. Maloney, James C. Young, and James H. Boyd. "Chapter 9." *South-Western Federal Taxation: 2016 Edition: Comprehensive Volume*. Mason, OH: South-Western Cengage Learning, 2016. N. pag. Print.

done and how it will be done. An employee is generally subject to the control of the business regarding what will be done, when it will be done and how it will be done. Certain factors indicate an employer-employee relationship under the behavioral control standard:

- When and where to do the work;
- What equipment or tools to use;
- What workers to hire to assist with the work;
- Where to purchase supplies and services;
- What work must be must be performed by a specific individual; and
- What order or sequence to follow.[7]

Financial control refers to whether the business has a right to control certain business aspects of the service provider's job. One factor to be considered is the extent to which the service provider has unreimbursed business expenses. Typically, independent contractors will have unreimbursed business expenses whereas employees will not. Another factor to be considered is the extent of the service provider's investment. In many instances, an independent contractor will have a significant investment in the tools and facilities that are used to provide their services. Another factor to be considered is whether or not the worker makes their services available broadly to the relevant marketplace. Independent contractors are free to seek out other business opportunities, will often advertise their services and maintain an independent business location. Lastly, it is important to consider how the service provider is paid. Employees receive regular wages based on hours worked or a specific time period (e.g. weekly, monthly, etc.) whereas independent contractors are often paid a flat fee or on a time and materials basis for the work performed.[8]

7 IRS Publication 15-A (2016).

8 IRS Publication 15-A (2016).

The third control prong in determining the proper classification of the worker is the type of relationship that exists between the service provider and the recipient. Factors that should be considered include:

- Written contracts describing the relationship the parties intended to create;
- Whether or not the business provides the worker with employee-type fringe benefits;
- The permanency of the relationship; and
- The extent to which the services performed are a key aspect of the company's regular business activity.[9]

To determine the employment status of a service provider, each case must be reviewed on its own merits. The definitive test, however, is if the business has the right to control what, when and how the work will be completed.

In addition to the aforementioned tax-related issues, classification as an employee or an independent contractor can potentially have legal implications to the employer (as the principal) for negligent tortious acts committed by the service provider (as agent). This is vicarious liability of the principal for unauthorized acts of an agent. The liability of a principal for any unauthorized torts of an agent is largely dependent upon whether the agent is an employee or an independent contractor. Generally, a principal is not liable for physical harm caused by the tortious conduct of an independent contractor if the principal did not authorize or intend the result or the manner of performance. In contrast, a principal is liable for unauthorized torts committed by employees in the course of employment. There is also a possibility that the agent will make an unauthorized, yet intentionally tortious, misrepresentation when they are acting in their capacity as an agent. In these instances, if the representation would be reasonably perceived by the injured party as apparently authorized, the principal may be held liable regardless whether the agent was classified as an employee or an independent contractor.

9 IRS Publication 15-A (2016).

A real-life example may be illuminating. A son of one of the authors recently came to him with a tax reporting issue involving his rendition of services as a pilot to an aeronautical photography company. The employer treated the young pilot as an independent contractor in order to avoid the employer's share of payroll taxation and to avoid tax withholding responsibilities. The young pilot had not accommodated his tax liability in any way and was shocked when his father informed him that he would have an additional $3,000 of income tax and payroll tax liability on his meager wages. Frequently in these situations the worker will simply not accommodate the payroll tax liability (not in this case, however). Thus, the IRS is anxious to resolve this worker classification issue both in the case of lower compensated employees as well as professional employees that we will now address.

We most frequently encounter the worker classification issue in professional practices involving (a) a retiring professional who renders post-closing professional services, typically for six months to a year, following the practice sale to the new owner; and (b) professional and old professional form a limited liability company (LLC) through which professional services are rendered. Usually, each professional is also the sole shareholder of an existing C corporation or a newly-formed S corporation (the S corporation is a favored vehicle for avoiding payroll taxation as we detailed in our Winter 2012 Practical Tax Lawyer article)[10] that becomes a member of the LLC and through which professional services are provided. With limited exceptions, in both situations our conclusion is that the professional is an employee of the professional practice, the entity actually providing services to the public.

Practice consultants frequently question the audit risk in these scenarios where the independent contractor pays its, his or her applicable self-employment taxes, thereby making the government whole as to those combined taxes that would be paid in an employer/employee setting. The actuality is that the IRS can and will assess Federal income tax, FICA and FUTA, penalties and interest against the business or practice for misclassification and the deductions for the misclassified independent contractor would, for the most part, be lost.

The employment tax cases back up this conclusion and the government's claim against the practice to pay the worker's taxes. Assuming that the worker did pay his or her applicable taxes, the government's successful claim against the practice can result in double taxation with the government collecting the same tax twice. There may be a direct credit to the employer under Internal Revenue Code (I.R.C.) Section 3402(d) for the worker's income taxes that have already been paid by the worker.[11] Notwithstanding this, the economic impact of misclassification is very expensive to the practice not only in terms of unpaid taxes, fines and interest, but also due to the time, emotional expenditure and advisory costs of a defense. Misclassifying a worker(s) can also have very negative effects upon retirement plans, including disqualification, not to mention the ability to include the worker in the health insurance plan of the practice.[12]

From the worker's standpoint, business expenses of a reclassified employee would be generally non-deductible, subject to the two percent of adjusted gross income limitation under I.R.C. 67.[13] For example, in *Maimon v. Commissioner*[14], the court held that a doctor was an employee of a medical practice. The doctor sought to be recognized as an independent contractor once he was faced with a large expense resulting from an employment-related lawsuit. Because the doctor was found to

10 Mark P. Altieri, William P. Prescott, & Kelly A. VanDenHaute. *Payroll Taxable Wages Of An Owner And Employee Of An S-Corporation.* 26 Prac. Tax Law. 59 (Winter 2012).

11 Tax Management Portfolios, BNA, Inc., 391-4th *Employment Status–Employee v. Independent Contractor,* Helen Marmoll, Esq., p.A-160.

12 *Vizciano v. Microsoft Corp.* 120 F.3rd 1006 (9th Cir. 1997), *cert. denied,* 522 U.S. 1098 (1998).

13 *See also,* Independent Contractor or Employee? Training Materials, Department of the Treasury, Internal Revenue Service, October 10, 1996, Training 3320-102 (10-96) TPDS 84238I p. 1-5.

14 T.C. Summ. Op. 2009-53.

be an employee of the practice, he was forced to report his compensation on Form 1040, line 7 and was not entitled to deduct the claimed business expenses on Schedule C. Instead, the doctor was forced to claim the expenses on Schedule A as unreimbursed employee business expenses subject to the aforementioned two percent limitation for miscellaneous expenses. As noted, a worker who is reclassified as an employee cannot maintain an employer-sponsored retirement plan such as a Section 401(k) plan.

Now let's elaborate on the initial discussion of the control test with an emphasis on professionals.

In the IRS' 1996 Training Manual, the IRS recognized that the well-known 20 factor test is an analytical tool and not the legal test for determining worker status. Per the 1996 Training Manual and more recent IRS rulings and publications, it has been made clear that the legal test is whether there is a right to direct or control the means and details of the work.[15] This test divides control into three categories: behavioral control, financial control and relationship of the parties.[16]

Behavioral Control

The primary factor of behavioral control involves provision of training or instructions.[17] Treasury Regulations[18] provide that professional workers who are engaged in an independent trade, business or profession in which they offer their services to the public are independent contractors and not employees. However, most professionals are not providing services to the public independently, but on behalf of the practice where they work. While the instructions for professional services may be minimal, nearly all practices have policies covering operations that the worker is subject to. Types of instructions may include:

- When to do the work;
- Where to do the work;
- What tools or equipment to use;
- What workers to hire to assist with the work;
- Where to purchase supplies or services;
- What work must be performed by a specified individual; and
- What order or sequence to follow.[19]

Financial Control

Financial control considerations include the following:

- Does the worker have a significant investment in the business;
- Is he or she reimbursed for out-of-pocket expenses associated with the business;
- What is the method of payment to compensate the worker; and
- Will the worker directly share in the business profit and loss.[20]

As to a significant investment, few professionals individually own the equipment in their offices or rent the equipment from the practice at fair rental value.

Independent contractors almost always have unreimbursed expenses and are generally free to seek out business opportunities. As such, independent contractors typically advertise, maintain a visible business location that they directly pay for and are available to work in a particular market.[21] However, in professional practice settings, the professional is almost always subject to restrictive covenants that restrict the ability to work in a given market, other than for the particular practice, thus further illustrating an employer-employee relationship.

Professionals are frequently paid on a

15 IRS Publication 15-A (2016) p. 7-8; IRS Publication 1779 (Rev. Mar. 2012); Priv. Ltr. Rul. 200323022.

16 Priv. Ltr. Rul. 200323022, supra.

17 *Id.*.

18 26 C.F.R. § 31.3121(d)-1(c)(2).

19 IRS Publication 15-A (2016).

20 Priv. Ltr. Rul. 200323022, supra.

21 IRS Publication 15-A (2016).

commission basis (as a function of productivity) and this does support an independent contractor relationship. However, it is the practice that customarily sets the fee schedule and bills the clients. This shows financial control in support of finding an employer-employee relationship.[22]

If the worker is free to make decisions that affect the worker's profit or loss, the worker could be an independent contractor. Examples include types and quantities of supply inventory, the type and amount of monetary or capital investment and whether to purchase or lease the premises or equipment.[23] In professional practice settings, professionals do not often have the ability to directly realize a profit or loss considering these factors. While a professional can work longer or shorter hours which impacts profit, non-professional employees can do this as well. Therefore, this hourly point is not too significant.

In professional practices, the practice almost always maintains controls over all financial and business aspects of its operation, including setting fees, billing the clients, collecting the fees and paying operating expenses. While it is possible for the professional to be an independent contractor if the worker sets the fees, bills the patients or clients and pays rent for use of the premises and equipment, this in reality rarely happens.

Relationship of the Parties

A nominal independent contractor agreement, in and of itself, is not sufficient evidence for determining worker's status.[24] Under the Treasury Regulation[25], the designation or description of the parties is immaterial. Therefore, the substance of the relationship, not the label, governs the worker's status.[26]

Frequently, professionals will incorporate themselves and will further provide that the worker is an employee of his or her corporation and not the practice. Just because a worker receives payment through his or her corporation does not mean that the worker will be found to be an independent contractor relative to the practice.[27] Incorporation, therefore, provides no substantive help in establishing independent contractor status.

The ability of the worker to quit or the practice to freely terminate the services of the worker, no longer has, in and of itself, significant bearing on whether the relationship is one of an employee or independent contractor relationship. The term of the relationship may have an impact on worker classification. An indefinite term indicates an employer/employee relationship while a designation of long-term or temporary term that may indicate either.[28]

INTERESTING CASES[29] • Below are some interesting cases that are relevant to whether the professional can be properly classified as an independent contractor under the three categories of control.

Accountants

In *Youngs v. Commissioner*[30], an accountant for National Maintenance Contractors, Inc. was an independent contractor. The accountant had approximately 25 other clients in the years in question and was paid on a job-by-job basis.

22 IRS Publication 15-A (2016).

23 Independent Contractor or Employee? Training Materials, Department of the Treasury, Internal Revenue Service, October 10, 1996, Training 3320-102 (10-96) TPDS 84238I p. 2-21.

24 Independent Contractor or Employee? Training Materials, Department of the Treasury, Internal Revenue Service, October 10, 1996, Training 3320-102 (10-96) TPDS 84238I p. 2-22.

25 26 C.F.R. § 31.3121(d)-1(a)(3).

26 Independent Contractor or Employee? Training Materials, Department of the Treasury, Internal Revenue Service, October 10, 1996, Training 3320-102 (10-96) TPDS 84238I p. 2-22.

27 Independent Contractor or Employee? Training Materials, Department of the Treasury, Internal Revenue Service, October 10, 1996, Training 3320-102 (10-96) TPDS 84238I p. 2-23.

28 Priv. Ltr. Rul. 200323022, supra.

29 Tax Management Portfolios, BNA, Inc., 391-4th *Employment Status – Employee v. Independent Contractor, Helen Marmoll, Esq.* p.A-47-A-140.

30 1996 WL 583643 (9th Cir. Oct. 10, 1996).

In Revenue Ruling 58-504[31], an accountant who was not licensed as a CPA but who worked only for an accounting firm, was an employee. The work was done under the firm's name and for the firm's clients. The accountant had no clientele of his own.

In Revenue Ruling 57-109[32], the IRS found that an individual engaged in performing part-time bookkeeping and tax services for a company was an independent contractor. The bookkeeper determined his own hours, worked without supervision and was not guaranteed a minimum compensation. While permitted to use the corporation's business equipment without charge, the bookkeeper provided his own working papers and materials and paid his own expenses. The bookkeeper advertised his services in the city directory and newspapers and had other clients.

Anesthetists

In Revenue Ruling 57-380[33], an anesthetist was held to be an independent contractor who contracted with two hospitals to provide services personally or by assistants paid by him when the need for services arose. Neither hospital issued instructions or directions, other than to advise him of the time for which operations were scheduled.

In Revenue Ruling 57-381[34], an anesthetist who performed full-time and exclusive services during prescribed hours each week for a dental surgeon was an employee. The anesthetist worked in the office of the dental surgeon. Although she purchased her own supplies and kept separate records of her expenses and collections, the charges for her services were listed separately on the dentist's statements and constituted her sole remuneration. She did not maintain an office or make her services generally available to other practitioners. Her name did not appear on the dentist's letterhead or office door. The IRS found that the anesthetist was engaged by the dental surgeon to render professional services on a continuing basis, and such services were a necessary incident to the conduct of the dental surgeon's practice. Although the anesthetist was qualified to perform the services without detailed supervision, the dental surgeon retained the right to control the services rendered to his patients even though it was not necessary for him to direct and control such services.

Other Physicians

Under Revenue Ruling 72203[35], physicians paid by and working full-time for a hospital's pathology department were employees. Their services were completely integrated into the operation of the pathology department, they performed substantial services on a regular and continuing basis and the department had the right to fire them if they did not comply with the general policies of the pathology department.

Under Revenue Ruling 61178[36], a physician was found to be an employee. Although the physician maintained a private practice, he also regularly rendered medical treatment to the health care provider on its premises on a part-time basis, was required to conform to the company's policies and procedures, was subject to supervision by the company's head physician, worked a fixed schedule and was provided benefits consistent with the company's regular employees.

In *Dutch Square Medical Center Limited Partnership v. United States*[37], a physician/medical director was held to be an employee of an urgent care facility due to the facility's control over the medical director's activities dispute the fact that the medical director was paid through his own professional corporation. It did not help that the medical director's professional services corporation was not formed until after his employment commenced with the urgent care center. However, this would probably not have mattered due to the facility's control over his activities.

31 1958-2 C.B. 727.

32 1957-1 C.B. 328.

33 1957-2 C.B. 634.

34 1957-2 C.B. 636.

35 1972-1 C.B. 324.

36 1961-2 C.B. 153.

37 1994 WL 605850 (D.S.C. Sept. 6, 1994)

.

In *Azad v. United States*[38], a radiologist was held to be an independent contractor. The radiologist was not restricted to performance of services solely for one hospital and did work for other hospitals. Neither the head of the radiology department nor the hospital exercised any supervision over the professional services of the radiologist and the radiologist was not required to work set hours nor account for absences from work. Finally, none of the radiologists in the department were required to comply with any set policies, rules or regulations of the hospital.

In Technical Advice Memorandum 9443002[39], a radiologist and other physicians were found to be employees. The hospital contracted with the radiologist to provide services to patients, provided a fully equipped and staffed department and compensated all personnel. Although the radiologist billed the patients, the hospital collected the fees and compensated the radiologist, under a guaranteed minimum income, and paid two-thirds of the radiologist's family health insurance premiums. The radiologist was required to visit the hospital at least once per day and be on-call at other times. The radiologist and the other physicians devoted their primary efforts to serving the hospital's patients and were prohibited from competing with the hospital in its geographic area. It was concluded that the radiologist was under the hospital's control, was integrated into the hospital's business, had no investment in the business of the hospital or its buildings, had a continuing relationship with the hospital and did not work for unrelated firms or hospitals.

In *Professional & Executive Leasing, Inc. v. Commissioner*[40], management and professional workers were found not to be employees of the management leasing company that attempted to provide liberal retirement plans to the workers as employees. The Court found that the leasing company did not exercise control over the workers, had no investment in the facilities of the workers, had no opportunity for profit or loss except for set-up fees and monthly service rate payments, had no right to discharge the workers and had no employment relationship with them despite nominal employment agreements. The leasing company merely provided bookkeeping and payroll services. This case is interesting because the workers failed to obtain the favorable retirement plans that they were promised as they were not the leasing company's common-law employees.

Attorneys

Under Revenue Ruling 68-324[41], an associate attorney worked at a law firm and was paid a fixed annual salary. The attorney was furnished office space, stenographic help, was required to work daily hours and was engaged mostly in research work that was assigned by the firm. Even though the attorney handled certain assigned cases from the firm for which the attorney received additional fees, the attorney was an employee.

In *Van Camp & Bennion, P.S. v. United States*[42], the IRS concluded that one shareholder who handled the majority of corporate duties and whose name and reputation was instrumental in bringing in clients was an employee. The other shareholder who performed de minimis administrative duties, worked on a very limited basis, made no written reports to the practice and did not make time entries was an independent contractor.

Dentists

In *Queensgate Dental Family Practice, Inc., v. United States*[43], the dentists were independent contractors. The dentists set their own fees, determined their own schedules, directed staff and planned their own patient treatment. They ordered supplies separately, consulted and referred to other dentists as they deemed appropriate, separately determined how to handle patients that did not pay, maintained records separately, paid their own entertainment

38 388 F. 2d 74 (8th Cir. 1968).

39 Tech. Adv. Mem. 9443002 (Dec. 3, 1993).

40 89 T.C. 225 (1987), *aff'd,* 862 F. 2d 751 (9th Cir. 1998).

41 1968-1 C.B. 433.

42 1996 WL 529225 (E.D. Wash. July 17, 1996), *aff'd in relevant part,* 251 F. 3d 862 (9th Cir. 2001)..

43 1991 WL 260452 (M.D. Pa. Sept. 5, 1991), *aff'd without op.,* 970 F.2d 899 (3d Cir. 1992).

and travel expenses, paid for their own malpractice insurance and continuing education costs and risked the possibility of lost profits which were based exclusively upon the compensation received from each dentist's patients. If the government had inquired as to whether restrictive covenants existed between the dentists and the practice, the Court may have found the dentists to be employees.[44]

In Tech. Adv. Mem. 9321001, dentists were found not to be similar to the independent contractors in Queensgate and the taxpayer was not entitled to relief under Section 530 of the Revenue Act of 1978 with respect to employment tax liability arising from the services of the dentists.

COMMON SCENARIOS • Let's return to the two practice scenarios mentioned earlier.

The Retiring Professional

The retiring professional usually renders professional, consulting and administrative services to the new owner of the practice on those days, times and hours per week and for compensation as mutually agreed to by the parties, subject to the needs of the new owner. Often, the retiring professional will agree to remain in the practice for a period of six months or a year and by mutual agreement thereafter. However, the new owner should retain the ability to terminate the relationship at any time after the transfer of goodwill is complete. While there is a good argument that the retiring professional is an independent contractor because the new owner does not need to train the retiring professional, the practice typically maintains control over the retiring professional's activities. In this case, the new owner's practice bills the patients or clients, collects revenue, sets the fees, employs the staff, and provides the equipment to the retiring professional. The new owner's systems and policies are in place, which may or may not be the same systems and policies that the retiring professional utilized. Finally, the retiring professional will almost always be subject to a restrictive covenant which shows behavioral control.

44 Tech. Adv. Mem. 9321001 (Feb. 1, 1993).

The retiring professional usually would like to be an independent contractor so that business expenses not paid by the practice can be fully written off. For example, retiring professionals are usually paid more than an associate new professional, e.g., 35 percent of adjusted production or collections, versus 30 percent to an associate. As such, the practice may claim it cannot afford to pay the retiring professional's health insurance, malpractice, continuing education, professional dues and licenses, entertainment or other direct business expenses. Due to the control exercised by the new owner's practice over the provision of services by the retiring professional, it is unlikely that the retiring professional is an independent contractor. A more substantively correct and practical approach would be to have the retiring professional treated as an employee of the practice, have the practice directly pay the business expenses of the retiring professional and reduce or offset the retiring professional's compensation by the full cost of such expenses.

Three-Entity Method

Under the three entity method to co-ownership, the new owner purchases one-half of the old practice owner's tangible assets and the old practice owner's personal goodwill. Each owner is the sole shareholder of a professional corporation which contracts with a newly formed limited liability company, owned by the corporations, to provide professional services to the public. The limited liability company bills patients or clients, collects revenue, employs the staff, adopts the retirement and medical plans and pays the operating expenses. Profits are distributed to the respective professional corporations. The professionals are nominal employees of their respective corporations, but are they really employees of the limited liability company? Because the limited liability company bills the clients, pays expenses, employs staff, maintains fringe benefit plans and establishes fees and office policies and systems, the professionals may be employees of the limited liability company or deemed direct owners of it and the interposed corporations could be disregarded, with the consequence that net operating profits are paid from a partnership entity to its partner/members

and are self-employment income subject to FICA and FUTA taxation. The IRS is attempting to figure out what to do with this increasingly popular approach.

The three-entity method is also being promoted in an attempt to provide amortization for purchased goodwill by the incoming owner. There are, however, a number of issues to consider aside from worker classification. These include characterization of personal versus corporate goodwill and the valuation thereof, the anti-churning regulations under I.R.C. Section 197 that prohibit goodwill from being amortized by the new professional for a buy-in of a practice formed pre-1993, and the amortization for the buy-in and buy-out or complete sale of assets of a family member in a practice formed pre-1993. See our Practical Tax Lawyer article on the subject in the Spring 2016 edition.[45]

Focusing again on the worker classification issue, in order for a professional to solidify independent contractor status in the professional practice setting, the professional should bill the patients or clients that it, he or she provides services to, pay rent for use of the premises, perform administrative services, maintain the ability to control fees and hours, make an investment in equipment, not be subject to a restrictive covenant, not be subject to office policies and procedures, and schedule the independent contractor's patients or clients. While these factors are based on facts and circumstances and are a matter of degree, the more factors, the better the chances of a favorable finding. Obviously, not many professional relationships meet the criteria necessary for a finding that the professional is an independent contractor, a crucial finding in today's environment when the Internal Revenue Service audited approximately 6,000 U.S. companies to determine whether such companies pay all required employment taxes, including a determination of whether workers are classified correctly.[46] At this point, the results are being analyzed. Accordingly, except in rare circumstances, the advisor should be very cautious of a proper independent contractor relationship in professional practice settings because if the practice is audited, it has probably already lost due to the cost of defense.

Voluntary Classification Settlement Program

There is good news for those practices that have concluded that one or more professional workers are not independent contractors is the Voluntary Classification Settlement Program (VCSP). Under VCSP, the practice can reclassify the workers as employees for future tax periods by payment of 10 percent of the worker's federal income taxes for the preceding calendar year. Provided that the practice is not under an employment tax examination by the IRS and certain other requirements are met, VCSP is a useful tool to eliminate a future misclassification problem. The VCSP process is completed by the filing of a Form 8952 with the IRS. However, the VCSP does not apply to the DOL or the states in determining worker classification.

ANOTHER PROBLEM IN ADDITION TO THE IRS: THE DEPARTMENT OF LABOR • On July 15, 2015, the Department of Labor's Wage and Hour Division (WHD) issued Administrator's Interpretation No. 2015-1 (AI) on the application of the Fair Labor Standards Act (FLSA) in the identification of employees who are misclassified as independent contractors. The WHD has entered into a memorandum of understanding with many states, as well as the IRS, and has issued the AI to assist in ultimately curtailing misclassification.

The inquiry by the WHD under the FLSA is whether the worker is economically dependent upon the employer or truly in business for him or herself. If the worker is economically dependent on the employer, then the worker is an employee. If the worker is in business for him or herself and

45 Mark P. Altieri & William P. Prescott, *Professional Practice Transitions, Section 197, and the Anti-Churning Rules.* 30 Prac. Tax Law. 7 (Spring 2016).

46 Ryan J. Donmoyer, Bloomberg.com, IRS to Audit 6,000 Companies to Test Employment Tax Compliance (September 18, 2009), http://blog.myirstaxrelief.com/2009/09/irs-to-audit-6000-companies.html.

economically independent from the employer, then the worker is an independent contractor.

The FLSA's definition of employee includes a multifactor analysis in its economic realities test and provides a much broader scope of employee classification than the control test used by the IRS:

- Is the work an integral part of the employer's business? If the work is performed integral or the primary work of the employer's business, the worker is an employee. In a practice, work would include the Associate performing professional dental services.
- Does the worker's managerial skill affect the opportunity for profit or loss? The ability to work more hours does not separate employees from independent contractors. The focus is on managerial skill and a worker's decision to hire, purchase equipment, advertise, rent space and manage timetables reflect the worker's opportunity for profit or loss.
- How does the worker's relative investment compare to the employer's investment? The AI states that the worker's investment should be compared with the employer's investment to determine whether the worker is an independent business. The AI also states that the worker's investment should not be relatively minor when compared to the employer.
- Does the work performed require special skills and initiative? The AI states that technical or special skills do not indicate that workers are in business for themselves. Only a worker's business skills, judgment and initiative help to determine whether a worker is in business for him or herself.
- Is the relationship between the worker and the employer permanent or indefinite? The AI indicates that permanency or indefiniteness suggests that the worker is an employee. A worker's lack of a permanent or indefinite relationship with an employer shows independent contractor status if it results from the worker's own business initiative. The AI also indicates that independent contractors typically do not continuously or repeatedly work for one employer.
- What is the nature and degree of the employer's control? The AI provides that the worker must control meaningful aspects of the work performed so that it's possible to show that the worker is conducting his or her own business.

All the AI factors all relate to the worker owning his or her business or practice. At this point, we do not know whether the IRS or states will accept the AI's guidance, but if they do, there will be few instances in dentistry where independent contractor status will pass scrutiny.

The States

Notwithstanding the DOL's memorandum of understanding with states and the IRS, the IRS and 39 states have been sharing worker classification information for several years.[47] States each follow their own test to determine worker classification. New Jersey, for example, follows the ABC test,[48] ich is similar to the DOL's economic realities test. California follows a liberal application of the economic realities test.[49]

Non-Tax Vicarious Liability Dealings with Professional Employees

A very interesting case involving employer liability for the negligence of a professional worker was issued by the New Jersey Supreme Court in *Jarrell v. Kaul,* 123 A.3d 1022 (N.J. 2015). The facts involved the injury of a surgical patient by a physician who did not carry requisite malpractice insurance for the injury at hand and who was employed by his surgery center as an independent contractor.

47 American Bar Association, Section of Taxation, Meeting: "Worker Classification Challenges – The Hinge on Which So Many Tax and Businesses Turn", May 8, 2010, Washington, D.C.

48 *Hargrove v. Sleepy's, 106 A.3d 449* (N.J. 2015).

49 American Bar Association, Section of Taxation, Meeting: "Worker Classification Challenges – What's New is Old Again", January 29, 2016, Los Angeles, CA.

Thus, the Court accepted the fact that the doctor in question was indeed an independent contractor and not a common-law employee. The Court noted that a person who engages in independent contractor is generally not liable for the negligence of the contractor, but went on to reinstate and remand to the lower court the plaintiff's negligence claim against the surgical center finding the surgical center had a continuing duty to ensure that any physician granted privileges at its facility maintain the required insurance and withhold privileges to any physician who did not.

CONCLUSION • Apart from a vicarious nightmare scenario, as has been detailed, worker misclassification is costly from a tax standpoint. The IRS, DOL and states all have different tests for determining worker classification and all three agencies share information. To eliminate a costly misclassification finding, consider utilizing VCSP. Better yet, classify properly.

To purchase the online version of this article, go to www.ali-cle.org and click on "publications"

LawPassSOLO™

Face it—your problem isn't too little information—it's too much. How do you make sense of it all?

The answer is ALI CLE's LawPassSOLO. LawPassSOLO is an online subscription to ALI CLE live and on-demand webcasts. Our expert faculties take the mass of information that assaults lawyers each day and make sense of it—clearly and quickly.

We even have a premium level subscription that gives you unlimited live access to our acclaimed In-Person courses (held throughout the nation), our extensive library of course materials, and our thousands of forms.

Best of all, as the name implies, LawPassSOLO is priced so that an individual attorney (whether you are on your own or in a firm of 1,000) can afford it.

So master all that information today—with LawPassSOLO.

Find out more today at lawpasssolo.org

STANDARD SUBSCRIPTION

Standard Subscription gives you unlimited access to an extensive variety of live webcasts and our entire library of more than 600 on-demand programs.

PREMIUM SUBSCRIPTION

Premium Subscription delivers all the Standard Subscription benefits plus 12 months of unlimited attendance at our live courses (choose between on-site and webcast options), access to our online forms library, and more.