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# Legislation

## affecting your practice

**B**efore the economic downturn in late 2008, the Internal Revenue Service indicated that of the estimated \$346 billion of tax gap, 75% was attributable to small business, which includes your practice. Tax gap is the estimated difference between the amount of taxes collected and what the IRS believes it is owed. The Small Business/Self-Employed Division of the IRS has reported that the tax gap is primarily comprised, in order of importance, of unreported income, S corporation distributions, and worker classification. With federal spending still continuing to increase in 2011, it should be no surprise that four developing issues are imminent: Forms 1099, worker classification, S corporation distributions, and employment audits under the previously reported National Research Project (NRP).

### Forms 1099

Fortunately for you and your practice, on April 14, 2011, the President signed bill H.R. 4 to repeal Form 1099 reporting expansion. The Form 1099 reporting expansion was part of the health-care legislation signed into law in 2010. Had this legislation not been repealed, beginning in 2012, your practice would have been required to issue a Form 1099 to any vendor of services or property, including corporations, to which your practice has paid more than \$600 in any year, including payments to suppliers, airlines, hotels, rental cars, and restaurants.

Under existing law, a Form 1099 must be issued only to individuals who provide services above \$600 per year. The process of repealing the Form 1099 reporting expansion was certainly drawn out with at least 10 congressional votes. The difficulty of repealing the Form 1099 reporting expansion shows that repealing other components of the new health-care law will be very difficult.

Furthermore, the argument against the repeal of this reporting requirement was that it would have raised revenue significantly, estimated to generate \$19 billion over the next decade. The next question will be how will this estimated lost revenue be replaced and at whose cost? While the Form 1099 reporting expansion had nothing to do with

health-care reform, it was anticipated to be a revenue offset for its anticipated high cost.

### Worker classification

Practices sometimes attempt to classify associates, retired owners, and even hygienists as independent contractors in order to eliminate payroll taxes and exclude the doctor/worker from the retirement and health insurance plans. For the worker, an independent contractor relationship can be beneficial because direct business expenses can be deducted from income. However, the IRS is wary of independent contractor relationships, probably because it believes that the business — your practice — and not the doctor/worker should bear the responsibility of collecting the taxes.

Under a worker classification audit, your practice can use what is called Section 530 of the Revenue Act of 1978 relief as a defense, provided that all workers in the same class (e.g., doctors) are treated the same, all Forms 1099 are filed, and there is a reasonable basis for treating the worker as an independent contractor.

Last year, there were pending bills in the House and Senate that would have effectively rendered Section 530 unusable as a defense in most circumstances. They were not passed but we should expect further legislation in 2011.

Additionally, the IRS now has referral relationships with 37 states and the Department of Labor for worker classification purposes. These 37 states will share any and all information obtained in a state worker classification audit with the IRS and, conversely, the IRS will share its worker classification audit information with those 37 states, a number that is increasing.

Finally, the U.S. Department of Labor (DOL) proposed “right to know” legislation under the Fair Labor Standards Act that could require businesses, including your practice, to prepare and turn over to the DOL written analysis of a worker’s status as an independent contractor. This legislation is set for “Notice of Proposed Rule Making” as of April 2011, and is being proposed, in part, to assist in compliance and enforcement.

If worker misclassification is found under the significantly increased audits, the price is steep. Your practice would be

assessed all federal income tax, penalties, and interest, irrespective of whether the worker paid all applicable taxes. For the worker, those direct business expenses and benefits would, for the most part, be lost.

Where the practice bills the patients, sets and collects fees, and schedules patients — and especially where the associate or retired doctor is subject to a restrictive covenant — there is usually an employer/employee relationship, even though the work may be provided on a part-time basis. While incorporating, entering into a written independent contractor agreement, and working at more than one location are helpful, these factors do not determine worker classification.

Interestingly, one argument made by the IRS is that the retired doctor is an employee because the retired owner was an employee of his or her practice entity. Therefore, the retired doctor would be an employee, and not an independent contractor, of the purchasing doctor's entity irrespective of whether the retired doctor's corporation had entered into an employment agreement with the purchasing doctor's practice entity.

### **S corporation distributions**

The IRS also frowns upon S corporation distributions, which escape the Medicare tax, currently 2.9%, and are above the Social Security Wage Base, which is \$106,800 for 2011. Recently, the United States Government Accountability Office (GAO) reported that 68% of S corporation returns filed for tax years 2003 and 2004 were noncompliant with tax rules and unreported income. Its report also cites the recent growth of S corporations as well as the estimated revenue lost to the IRS due to noncompliance: \$23.6 billion estimated for tax years 2003 and 2004.

As a revenue raiser, the American Jobs and Closing Tax Loopholes Act of 2010 (HR 4213) was introduced, and while passing in the House last year, it failed in the Senate. Had this legislation passed, it would have eliminated S corporation distributions for excess profits that escape the Medicare tax for your practice.

If a version of this bill is passed in the future, which is possible in 2011 as another revenue raiser, every dollar of profit distributed by your S corporation would be treated as ordinary income. For those of you who practice through S corporations, ask your accountant what the economic effect of this situation would specifically mean for you.

### **NRP audits**

As stated previously, the IRS is conducting approximately 6,000 comprehensive employment audits, roughly 2,000 each for the years 2010, 2011, and 2012 for small businesses, including professional practices under the NRP. The purpose of the NRP audits is to provide the IRS with information about areas of concentration for future audits, elevate taxpayer compliance, and raise revenue.

To clarify, these audits will cover four areas: worker clas-

sification, Form 1099 compliance, executive compensation, and fringe benefits. Under the area of worker classification, the IRS will audit employee vs. independent contractor status for you (if you are retired and working part time), your associate, and your hygienists. The area of executive compensation includes auditing S corporation distributions for the period of audit, compensation shifts used in associate buy-ins (especially where your practice operates as a C corporation), deferred compensation compliance, and business expense reimbursements.

For the area of fringe benefits, there are 39 audit points. Included is the requirement of a written health plan for providing health insurance to you and your staff. The written plan — not just an insurance booklet — is required in order for your practice to deduct the health insurance premiums. Except for the selection of employers of various sizes — e.g., one to five employees, six to 15 employees, 16 to 50 employees, and larger — the NRP audits are supposedly random.

### **Summary and thoughts**

**Forms 1099** ► Unfortunately, getting legislation — even bad legislation — repealed is very difficult once it's signed into law. Count on Congress to find a way to make up the estimated \$19 billion loss, and then some, in the next decade.

**Worker classification** ► If you have a new or retired dentist or specialist working in your practice, this doctor is probably not an independent contractor. If you do or intend to classify this individual as an independent contractor, understand that except in rare circumstances, dentists, specialists, and hygienists should be classified as employees.

**S corporation distributions** ► S corporation distributions that currently escape the Medicare tax will probably be eliminated at some point. Thus, S corporation earnings will be taxed like any other entity. However, unlike C corporations, S corporation shareholders will not have to be concerned about the double taxation on the sale of practice assets upon their retirement. So, S corporations are still my preferred practice entity.

**NRP audits** ► The IRS is trying to figure out where to focus efforts in particular industries where it wants to both increase compliance and generate revenue. Don't take unnecessary risks and run your practice as your business.

I recommend that you meet with your accountant and attorney on a yearly basis and discuss these and any new issues, so that you operate your practice in compliance with the increasing administrative burdens under the law. **DE**

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