UPDATE ON WORKER CLASSIFICATION FOR PROFESSIONAL PRACTICES AND BUSINESSES

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Worker classification may refer to one of two scenarios: (i) classifying an employee as either exempt or non-exempt under federal and state wage and hour laws, which regulate minimum wage, overtime, recordkeeping, and child employment standards; and (ii) classifying a worker as either an employee or an independent contractor under applicable federal and state laws. Different rules apply for different purposes and jurisdictions.

Worker classification continues to be an ongoing problem for professional practices and other businesses. Dentistry is a good example for a professional practice. Proper classification continues to be problematic for associate dentists, as well as retired dentists (collectively Dentists) and specialists who continue to render professional services (collectively Associates). The Internal Revenue Service (IRS), the Department of Labor (DOL), and state agencies believe they are incurring a huge loss in revenue, while workers are being denied benefits from misclassification.[1] Each agency is auditing with different tests to determine worker classification.

A dental practice (Practice) cannot afford to pay an Associate well and also pay direct business expenses, insurances (including health insurance), and benefits (including retirement plan benefits)

(collectively Benefits). Consequently, the Practices often prefer to classify Associates as independent contractors (Contractors) to eliminate payroll taxes and Benefits. The Associates often prefer to be classified as a Contractor because the Associate can fully offset the Benefits against income and receive a higher rate of compensation than as an employee because the Practice has eliminated payroll taxes and Benefit costs. As a result, the Practice owner and Associate commonly think that so long as the Associate agrees to pay all applicable taxes, the Associate can be treated as a Contractor.

Dentists have asked, ''If the Associate, as a Contractor, and the Practice pay all applicable taxes, there's no harm, no foul, right?" Wrong. The IRS imposes steep penalties for worker misclassification. The Practice would be assessed all unpaid federal taxes, Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, fines, and interest.[2] The Associate would lose nearly all deductions and Benefits.

Except for limited situations in which a dental specialist renders specialty services for a general practice through a separate entity, all other associates are employees. In fact, the IRS has stated that when a retiring Dentist is an employee of his or her own Practice entity, it follows that the retiring Dentist is an employee of the purchasing Dentist's Practice.[3]

THE IRS

Control test

The IRS's well-known 20-factor test[4] for determining worker classification has evolved into the control test to determine if the Practice has a right, regardless of whether it's exercised, to direct or control the means and details of the work.[5] The control test involves an analysis of three categories: behavioral control, financial control, and relationship of the parties.[6]

Behavioral control considers whether the Associate is subject to Practice scheduling and patient assignment policies or subject to a restrictive covenant. Common law behavioral control factors include: (i) instructions to workers provided by the business; (ii) training; (iii) nature of occupation or business identification; (iv) evaluation systems for analyzing worker performance; and (v) work location.[7]

Financial control considers whether the Practice bills the patients, sets and collects the fees, compensates the dentist, or pays the operating expenses. Common law financial control factors include: (i) level of investment by the worker; (ii) responsibility for unreimbursed business expenses; (iii) whether the worker's services are available to the general market; (iv) method of compensation to the worker; and (v) decisions affecting profit or loss.

Relationship of the parties provides that a Contractor agreement between the Practice and the Associate is not sufficient evidence for determining a worker's status.[8] It is the substance of the relationship, not the label, that governs the worker's status. However, the IRS acknowledged that an athlete was a Contractor in one case in which the athlete had worked for his corporation, and his corporation entered into an agreement with the athlete's professional team and also entered into an employment agreement with his own corporation.[9] In a case like this, if the Practice and the Associate are attempting to justify contractor status, consider the following. First, the Associate should practice through his or her Scorporation as a separate entity formed prior to the Dentist working for the Practice.[10] A limited liability company is not a separate entity and is treated as a sole proprietor. Second, corporate formalities must be followed, meaning minutes must be prepared in accordance with state law. Third, the Associate should enter into a written employment agreement with his or her Scorporation. Finally, the Practice and S-corporation (through the Associate as the shareholder) should enter into a written Contractor agreement. While not "bulletproof," these steps may be helpful, but could prove unsuccessful.

Common law factors pertaining to relationship of the parties include: (i) intent; (ii) use of written contracts; (iii) ability to terminate the relationship; (iv) permanency of the relationship; and (v) whether

the services performed are a key aspect of the company's regular business activity.

Relief from worker misclassification: Section 530 Relief

A Practice may prevent the IRS from reclassifying workers if the Practice can prove it has consistently treated the worker as an independent contractor in wthe past and had a reasonable basis for doing so. This process is called Section 530 Relief.[11] Section 530 Relief almost always controls worker classification if it applies, even if the worker might otherwise be an employee under the common law or statutory employee rules. Therefore, Section 530 Relief can be applied before statutory employee and common law criteria.[12]

Section 530 is a relief provision that terminates a taxpayer's employment tax liability with respect to an individual not treated as an employee if three statutory requirements are met: (i) reporting consistency; (ii) substantive consistency; and (iii) reasonable basis. Section 530 does not extend to the worker, who may still be liable for the employee share of FICA taxes, not self-employment tax.[13]

To meet the statutory requirement of reporting consistency, a taxpayer must have timely filed the requisite information returns consistent with its treatment of the worker as a non-employee. For example, if the taxpayer claims the worker is an independent contractor, Forms 1099 must have been filed for the taxable years at issue.[14]

To meet the statutory requirement of substantive consistency, a taxpayer or predecessor must not have treated the worker, or any worker holding a substantially similar position, as an employee at any time after December 31, 1977.[15] This is a facts-and-circumstance determination.[16] A review of the day-to-day services performed and comparison of the job functions must be done.[17] The mere fact of similar job titles or categories alone is not sufficient.[18]

To meet the statutory requirement of reasonable basis, a taxpayer must have reasonably relied on one of the following three "safe harbors": (i) prior audit; (ii) judicial precedent; or (iii) industry practice. The taxpayer must have relied on the alleged authority at the time the employment decisions were being made for the periods at issue. The statute does not allow ex post facto justification. The taxpayer may demonstrate another form of reasonable basis. This requirement is to be liberally construed in favor of the taxpayer.[19]

Section 530 Relief applies to periods under audit and all future periods so long as requirements are met. Section 530 provides a permanent cure for an organization's employment tax liabilities relating to a particular group of workers.[20] It is not necessary for the business to claim Section 530 Relief for it to be applicable.[21] An examiner must first explore the applicability of section 530 even if the taxpayer does not raise the issue.[22]

Voluntary Classification Settlement Program/ Classification Settlement Program

There is good news for those Practices that have concluded that one or more Associates are not Contractors: The Classification Settlement Program (CSP) and the Voluntary Classification Settlement Program (VCSP).

The CSP permits resolution of worker classification cases as early in the administrative process as possible, reducing taxpayer burden.[23] The procedures also ensure that the taxpayer relief provisions under section 530 of the Revenue Act of 1978 are properly applied. Under the CSP, IRS examiners are able to offer taxpayers under examination a worker classification settlement using a standard closing agreement.[24] These CSP agreements bind the IRS and the taxpayer to prospective tax treatment for future tax periods.[25] IRS examiners must present a CSP offer to a taxpayer.[26]

The VCSP allows eligible taxpayers who are not under examination to obtain relief similar to that currently available through the CSP for taxpayers under examination. Under the VCSP, the Practice can reclassify associates as employees for future tax periods by paying 10 percent of the Associate'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 Form 8952 with the IRS. However, the VCSP does not apply to the DOL or the states in determining worker classification.

THE DOL

Administrator's Interpretation No. 2015-1

On July 15, 2015, the DOL's Wage and Hour Division (WHD) issued Administrator's Interpretation No. 2015-1 (AI), which provided guidance on applying the Fair Labor Standards Act (FLSA) in the identification of employees misclassified as Contractors. At the time, the WHD entered a memorandum of understanding with many states and the IRS to assist in curtailing misclassification.

While the interpretation was withdrawn on June 7, 2017,[27] on October 13, 2022, the WHD announced a Proposed Rule that would reinstate the "economic realities" test for analyzing whether a worker is an employee or an independent contractor under the FLSA.[28] Under the Proposed Rule, which would rescind a January 2021 rule, the ultimate inquiry would be whether, as a matter of economic reality, a worker is either economically dependent on an employer for work, or is in business for himself as an independent contractor, using a six-factor totality of the circumstances test.

The current inquiry by the WHD under the FLSA determines 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 economically independent from the employer, then the worker is a Contractor. The economic realities test involves consideration of the following:

Is the work an integral part of the employer's business?

If the work performed is integral to or the primary work of the employer's business, the worker is an employee. In a dental practice, the 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 Contractors. The focus is on managerial skill, so a worker's decision to hire, purchase equipment, advertise, rent space, or manage timetables affects the opportunity for profit or loss.

How does the worker's relative investment compare to the employer's investment?

The worker's investment should be compared with the employer's investment to determine whether the worker's investment constitutes an independent business. The worker's investment should also not be relatively minor when compared to the employer's.

Does the work performed require special skills and initiative?

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 the worker is in business for himself or herself.

Is the relationship between the worker and the employer permanent or indefinite?

Permanency or indefiniteness suggests that the worker is an employee. A worker's lack of a permanent or indefinite relationship with an employer shows Contractor status if it results from the worker's own business initiative. Also, Contractors typically do not continuously or repeatedly work for one employer.

What is the nature and degree of the employer's control?

The worker must control meaningful aspects of the work performed so that it is possible to show that the worker is conducting his or her own business.

The economic realities test factors all relate to the worker owning his or her business or Practice. At this point, we do not know whether the IRS or the states will accept the economic realities test, but if they do, there will be few instances in dentistry where contractor status will pass scrutiny.

Despite the DOL's memorandum of understanding with states and the IRS, which has not been withdrawn, the IRS and 39 states have been sharing worker classification information for several years.[29] States each follow their own tests to determine worker classification. For example, New Jersey follows the ABC test,[30] which is similar to the DOL's economic realities test, as does California.[31]

STATE LAWS AND THE ABC TEST

Another consideration is state law and, in particular, tax laws that govern worker status. While a number of states use a "common law" test similar to the IRS test discussed above, about half the states apply what is known as the "ABC" test. This test is most commonly used for purposes of unemployment insurance and other state payroll taxes, but some states, including California, Massachusetts, and New Jersey, also use it for wage and hour law purposes.

While the states have slight variations on the ABC test, at its basic level it states that an individual performing services as an employee under the employer can establish:

- **A**bsence of control: The individual must be free from direction and control in the performance of services, in both fact and under the contract. This is basically the common law test.
- **B**usiness is unusual: The services being performed must be outside the usual course of the business for which the service is performed or otherwise performed outside of all the places the business operates. Some states only use the first part of this test but not the second, including California.
- **C**ustomarily an independent contractor: The individual performing the services must be customarily engaged in an independently established trade, occupation, profession, or business.

Because the absence of control is necessary no matter what test is applied to determine whether an individual is an employee or independent contractor, the "A" must be met. If there is significant control, it does not matter whether the other factors can be satisfied. This has real implications for how work can be structured.

Assuming an absence of control, the "C" factor should be relatively easy to meet given that, historically, dentists are treated as engaged in an independent profession. For example, the Treasury Regulations state that "[i]ndividuals such as physicians, lawyers, dentists, veterinarians, construction contractors, public stenographers, and auctioneers, engaged in the pursuit of an independent trade, business, or profession, in which they offer their services to the public, are independent contractors and not employees."[32]

The problematic factor is the "B" factor, as it is hard to establish that a dentist working in a dental practice is either providing a service that is outside the usual course of business or performed at a location away from the business. This factor may be inescapable if there are no exemptions to the ABC test under state law.

Fortunately, in California, the ABC test does not apply to dentists. Rather, the old multi-factor Borello standard, which is similar to the IRS and DOL standards, applies instead.[33]

Another consideration and potential way to avoid the ABC test is to contract with professional corporations, which in turn provide the services of the dentist. A bona fide business to business relationship may be respected when properly structured. California's ABC test also contains an exemption for

bona fide business-to-business relationships provided a number of criteria are satisfied.[34]

CONCLUSION

The Labor Department's wage regulator and the National Labor Relations Board recently agreed to collaborate on investigations targeting independent contractor misclassification whereby businesses are wrongfully classifying workers as independent contractors rather than employees to reduce employer costs, to gain a competitive advantage, avoid legal liability/taxes such as social security, workers' compensation, unemployment insurance, payroll and employment taxes, as well as to eliminate worker protections, such as minimum wages, overtime, and meal and rest breaks.

The IRS is also targeting businesses who misclassify employees as independent contractors. If an employer-employee relationship exists, the earnings of the employee are subject to FICA (Social Security and Medicare) and income tax withholding. If the IRS determines that an individual has been misclassified, it may levy penalties against the employer, including, but not limited to, a $50 fine for each Form W-2 the employer failed to file on such employee, a penalty of up to three percent of the wages, plus up to 40 percent of the FICA taxes that were not withheld from the employee and up to 100 percent of the matching FICA taxes the employer should have paid. If the IRS determines that an employer misclassified its employees willfully, the penalties are even greater. These penalties can be costly and, in some cases, devastating for an employer.

The IRS, DOL, and states all have different tests for determining worker classification, and all three agencies share information. To eliminate a costly misclassification, Dentists should consider using Section 530 Relief, CSP, or VCSP or, better yet, classify properly.

Notes

1 Worker classification-what's new is old again. Talk presented at: American Bar Association Section of Taxation Meeting; Jan. 29, 2016; Los Angeles, CA.

2 Worker classification: Employee or Contractor? Talk presented at: IRS Office of Chief Counsel Meeting; August 13, 2008; Atlanta, GA.

3 American Bar Association Section of Taxation Meeting; September 24, 2010; Toronto, Canada; see also IRS Rev. Rul. 87-41 C.B. 296 § 3111(1987).

4 Contractor or Employee?, Internal Revenue Service, U.S. Dept. of the Treasury, IRS course 33201- 02, 1996.. See also Revenue Ruling 87-41 and IRM Section 4.23.

5 IRS Pub. Ltr. Rul. 200323022 (2003).

6 Prescott, et al., Worker Classification Issues: Generally and in Professional Practices. The Practical Tax Lawyer, Vol. 31, iss. 2, 17-28 (2017).

7 Performance of work offsite does not indicate independent contractor status, however.

8 Treas. Reg. 26 CFR § 31.3121(d)-1(a)(3).

9 Sargent v Commissioner, 93 TC. 572 (1989), 929 F.2d 1252(8th Cir 1991).

10 Dutch Square Medical Center Limited Partnership v United States, 74 AF.TR. 2d 1994-63569,4-2 USTC (DSC 1994).

11 IRM Section 4.23.5.3 Section 530 of the Revenue Act of 1978 (11-22-2017). Section 530 is not part of the IRC, though some publishers include its text after IRC Section 3401.

12 IRM Section 4.23.5.3.1.

13 See IRS Worker Reclassification—Section 530 Relief, available at https://www.irs.gov/government-entities/worker-reclassification-section-530-relief#:~:text=What%20is%20Section%20530%20relief,%3B%20and%203)%20reasonable%20basis.

14 Id.

15 Id. (citing Section 530(e)(6); Rev. Proc. 85-18; Rev. Rul. 83-16, Rev. Rul. 84-161).

16 Id.

17 Id.

18 Id.

19 Id.

20 Id.

21 Id.

22 Id. (citing Publication 1976, Do You Qualify for Relief under Section 530, IRM 4.23.5.3 (must be provided to the taxpayer for all instances when Section 530 is considered even though it is not applicable)).

23 IRM Section 4.23.6.1.1.

24 Id.

25 Id.

26 IRM Section 4.23.6.6 provides a list of eligible CSP Employment Tax Cases. IRM section 4.23.6.8. provides a list of excluded CSP Employment Tax Cases.

27 DOL withdraws joint employer and Contractor administrator's interpretations,

28 Hook SK Wage & Hour Law Update, June 9, 2017, available at http://www.wageandhourlawupadte.com/2017/06/articles/states/uncategorized/dol-withdraw-sjoint-employer-and-independent-contractor-administrators interpretations.

29 Employee or Independent Contractor Classification Under the Fair Labor Standards Act, 87 Fed. Reg. 197 (proposed Oct. 13, 2022) (to be codified at 29 CFR pts. 280, 288, and 795), available at https://www.dol.gov/newsroom/releases/WHD/WHD20221011-0.

30 Worker classification challenges - the hinge on which so many tax and businesses turn. Talk presented at Am. Bar Assoc. Section of Taxation Meeting, May 8, 2010.

31 Hargrove v Sleepy's LLC, 612 Fed.Appx. 116 (3rd Cir., May 12, 2015)

32 Cal. Lab. Code § 2750.3. In 2019, California passed the "AB 5" law which 5 requires the application of the "ABC test" to determine if workers in California are employees or independent contractors for purposes of the Labor Code, the Unemployment Insurance Code, and the Industrial Welfare Commission (IWC) wage orders. The California Supreme Court first adopted the ABC test in Dynamex Operations West, Inc. v. Superior Court (2018) 4 Cal.5th 903. Among other things, AB 5 and later AB 2257 added a new article to the Labor Code addressing these issues (sections 2775-2787).

33 26 C.F.R. § 31.3121(d)-1(c)(2).

34 Cal. Lab. Code, § 2783(b) (noting that the ABC test does not apply and "the determination of employee or independent contractor status for individuals in those occupations [identified below] shall be governed by Borello: … b) A physician and surgeon, dentist, podiatrist, psychologist, or veterinarian ….")

35 Cal. Lab. Code, § 2776.