Employee vs. Independent Contractor: *Establishing the Right Classification*

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interviewing WILLIAM P. PRESCOTT, EMBA, JD, ESQ.

Do you know the legal distinction between an employee classification and an independent contractor in the eyes of the IRS or state taxing authorities? Chances are you do not. Many dentists, including myself, harbored inaccurate assumptions regarding how the independent contractor status can be utilized in a dental practice for both the doctor and possibly the staff who work with them.

Similar to owning their own practice, a contractor is able to fully deduct all legitimate business expenses from their income. This is a major tax advantage of being an owner as compared to an employee. The classification also allows one greater independence, more predictable control of their work, and often, greater job security. But becoming an independent contractor is more complicated than simply declaring yourself as one. The IRS provides a 20-point checklist to help individuals determine if they should be paid on a W-2 or a 1099.[1] This document provides easy-to-understand information regarding the differences between employee and contractor status. It ultimately comes down to the specific work environment and who has control. But in the end, obtaining sound legal advice from a qualified attorney is your best avenue to avoid making a mistake that could cost you significant penalties and back taxes if you are misclassified.

I sought counsel years ago in my own situation from a recognized national expert, Bill Prescott. I recently reconnected with Bill to ask him to help clarify when one should classify a worker (or themselves) as an employee and when it makes more business sense to consider independent contractor status. I hope you find his responses to the questions I asked helpful in your own practices.

Why are the Internal Revenue Service, Department of Labor and the states so concerned about worker misclassification?

Worker classification continues to be an ongoing problem for associates and retired dentists who continue to render professional services post-retirement (collectively "Associates") because the Internal Revenue Service (IRS), Department of Labor (DOL) and the states believe they are incurring a significant loss in revenue, as well as workers being denied benefits from misclassification.[2]

The IRS conducted approximately 6,000 comprehensive employment audits, roughly 2,000 each for the years 2010, 2011 and 2012 for small businesses, including professional practices. While the findings have not been released yet, the purpose of the audits was to provide the IRS with information about areas of concentration for future audits, elevate taxpayer compliance and raise revenue.[3] The audits covered four areas: worker classification, Form 1099 compliance, executive compensation and fringe benefits.

Who does worker classification affect in a dental practice and why do practices and associates often prefer independent contractor vs. employee status?

A practice cannot afford to pay the Associate well and also pay the direct business expenses, insurances and benefits attributable to the Associate (collectively the "Business Expenses"). Therefore, the practice prefers to classify the Associate as an independent contractor to eliminate payroll taxes and business expenses. The Associate prefers to be classified as an independent contractor because the Associate can fully offset business expenses against income and also receive a higher rate of compensation as an independent contractor than as an employee because the practice has eliminated payroll taxes and the cost of the Business Expenses.

What are the consequences if worker misclassification is found?

Often, the practice and Associate think that so long as the Associate agrees to pay all applicable taxes, they can elect to treat the Associate as an independent contractor. I am often asked, "If the Associate, as an independent contractor, and practice pay all applicable taxes, no harm no foul, right?" No. The IRS has stated that where worker misclassification is found, the penalty is steep. The practice would be assessed all unpaid federal taxes, FICA, FUTA, fines and interest.[4] The Associate would lose nearly all deductions for the Business Expenses, subject to the two percent of adjusted gross income limitation.[5]

What are the tests for determining employee vs. worker classification status?

The well known 20-point test[6] for determining worker classification has evolved into the control test as to whether the business or practice has the right, even if not exercised, to direct or control the means and details of the work.[7] The control test is determined by an analysis of three categories: behavioral control, financial control and relationship of the parties.[8]

Behavioral Control: Considers whether the Associate is subject to the scheduling and patient assignment policies of the practice or is subject to a restrictive covenant.

Financial Control: Considers whether the practice bills the patients, sets and collects the fees, compensates the Associate or pays the operating expenses.

Relationship of the Parties: Provides that an independent contractor agreement between the practice and the Associate is not sufficient evidence for determining a worker's status.[9] It is the substance of the relationship, not the label, that governs the worker's status.[10] However, the IRS acknowledged in one case,[11] where a professional athlete had worked for his corporation and the athlete's corporation entered into an agreement with the athlete's professional team and also entered into an employment agreement with his own corporation, that the athlete was an independent contractor. Following the Sergeant case strategy may be helpful, but the IRS still can argue against it.[12]

On June 7, 2017, the Department of Labor's Wage and Hour Division (WHD) withdrew Administrator's Interpretation No. 2015 1 (A1).[13] When issued on July 15, 2015, A1 provided guidance on the application of the Fair Labor Standards Act (FLSA) in the identification of employees who are misclassified as independent contractors. At the time, WHD entered into a memorandum of understanding with many states, as well as the IRS, to assist in ultimately curtailing misclassification.

While A1 has been withdrawn, WHD has not released any further guidance on worker classification. Thus, there is no basis to believe that WHD's application of its "economic realities test" has changed. The economic realities test includes a multifactor analysis and provides a much broader scope of employee classification than the control test used by the IRS.

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

Is the Work an Integral Part of the Employer's Business? If the work performed is the primary work of the employer's business, the worker is an employee. In a dental practice, the primary work is providing dental treatment.

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

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 a worker is in business for him or herself.

Is the Relationship Between the Worker and the Employer Permanent or Indefinite? Permanency or indefiniteness suggests that the worker is an employee.

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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. Independent contractors also typically do not continuously or repeatedly work for one employer.

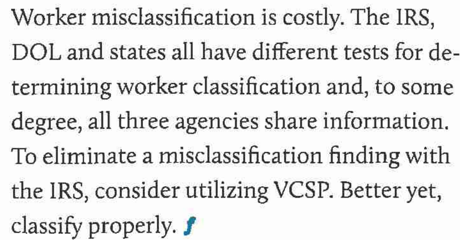
What is the Nature and Degree of the Employer's Control? The worker must control meaningful aspects of the work performed so that it's possible to show that the worker is conducting his or her own business.

The economic realities test factors all relate to the worker owning his or her business or practice, which means there are few instances in dentistry where independent contractor status gets a pass.

The IRS, DOL and the states do share information on worker classification.[14] For example, the IRS and 39 states have been sharing worker classification information for several years.[15] States each follow their own tests to determine worker classification. Because any worker classification analysis should include the state's test for misclassification, it is essential to have local counsel on the advisory team if the practice or Associate has engaged an out-of-state lawyer.

What if the practice desires to reclassify a worker from an independent contractor to employee status?

There is good news for those practices that have concluded that one or more Associates are not independent contractors under the Voluntary Classification Settlement Program (VCSP). Under VCSP, the practice can reclassify Associates as employees for future tax periods by payment of 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 possible misclassification finding. However, the VCSP does not apply to the DOL or the states in determining worker classification.


Worker misclassification is costly. The IRS, DOL and states all have different tests for determining worker classification and, to some degree, all three agencies share information. To eliminate a misclassification finding with the IRS, consider utilizing VCSP. Better yet, classify properly.

Practice Perspectives is contributed by Dr. David Thein, a periodontist and associate clinical professor at UMKC School of Dentistry. He is the course director for the practice management curriculum and advises students/residents and recent grads in professional career development. In each column, Dr. Thein provides an interview with industry experts on a variety of topics. He especially invites your feedback and suggestions for future columns at 816-835-7480 or drthein@drthein.com.

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