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Worker classification: A continuing problem

William P. Prescott, JD, EMBA

WORKER CLASSIFICATION continues to be an ongoing problem for associating dentists, as well as for retired dentists and specialists who continue to render professional services (hereafter collectively referred to as associates). The Internal Revenue Service (IRS), the Department of Labor (DOL), and the states believe they are incurring a huge loss in revenue, and workers are being denied benefits from misclassification.[1] Three agencies are auditing, and three different tests determine worker classification.

A dental practice cannot afford to pay an associate well and also pay direct business expenses, insurances (including health insurance), and benefits (including retirement plan benefits) (hereafter collectively referred to as benefits). Consequently, the dental practice prefers to classify the associate as an independent contractor to eliminate payroll taxes and benefits. The associate prefers to be classified as an independent contractor because the associate can fully offset benefits against income and receive a higher rate of compensation than as an employee. This is because the practice has eliminated payroll taxes and benefit costs. As a result, the practice owner and associate think that as long as the associate agrees to pay all applicable taxes, the associate can be treated as an independent contractor.

Not so! I am often asked, "If the associate, as an independent contractor, and the practice pay all applicable taxes, there's no harm, no foul, right?" No. The IRS has stated that the penalty for worker misclassification is steep. 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 for benefits, subject to the 2% of adjusted gross income limitation.[3]

Except for limited situations in which a 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 or specialist's practice.[4] The IRS further stated that it believes it can win this argument.[4]

THE IRS: CONTROL TEST

The well-known 20-point test[5] for determining worker classification has evolved into the control test to determine if the business or practice has a right, regardless of whether it's exercised, to direct or control the means and details of the work.[6] The control test involves an analysis of three categories: behavioral control, financial control, and relationship of the parties.[7,8]

Behavioral control—Behavioral control considers whether the associate is subject to practice scheduling and patient assignment policies or subject to a restrictive covenant.

Financial control—Financial control considers whether the practice bills the patients, sets and collects the fees, compensates the dentist, or pays the operating expenses.

Relationship of the parties—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.[6] It is the substance of the relationship, not the label, that governs the worker's status.[9] However, the IRS acknowledged that an athlete was an independent 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.[6,10]

In a case like this, if the practice and the associate are attempting to justify independent contractor status, consider the following. First, the associate should practice through his or her S corporation as a separate entity formed prior to the dentist working for the practice.[11] A limited liability company is not a separate entity and is treated as a sole proprietor. Second, corporate formalities must be followed,[6] meaning minutes must be prepared in accordance with state law. Third, the associate should enter into a written employment agreement with his or her S corporation. Finally, the practice and S corporation (through the associate as the shareholder) should enter into a written independent contractor agreement. While not bulletproof, these steps are helpful.

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THE IRS: VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM

There is good news for those practices that have concluded that one or more associates are not independent contractors: the Voluntary Classification Settlement Program (VCSP). Under VCSP, your practice can reclassify associates as employees for future tax periods by paying 10% of the associate's federal income taxes for the preceding calendar year. Provided that your 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 AND THE ECONOMIC REALITIES TEST

On June 7, 2017, the Department of Labor's Wage and Hour Division (WHD) withdrew Administrator's Interpretation No. 2015-1.[12,13] When it was issued on July 15, 2015, the interpretation provided guidance on applying the Fair Labor Standards Act (FLSA) in the identification of employees misclassified as independent 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 has been withdrawn, the WHD has not released any further guidance on worker classification. Thus, there is no basis to believe that the 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 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 an independent 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 independent 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 independent contractor status if it results from the worker's own business initiative. Also, independent contractors typically do not continuously or repeatedly work for one employer.

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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. 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 independent contractor status will pass scrutiny.

THE STATES

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.[14] States each follow their own tests to determine worker classification. For example, New Jersey follows the ABC test,[15] which is similar to the DOL's economic realities test, and California follows an application of the economic realities test.[1]

SUMMARY AND THOUGHTS

Worker misclassification is costly. The IRS, DOL, and states all have different tests for determining worker classification, and all three agencies share information. To eliminate a costly misclassification, consider using VCSP. Better yet, classify properly. **DE**

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WILLIAM P. PRESCOTT, JD, EMBA, of the law firm Wickens, Herzer, Panza, Cook, & Batista Co. in Avon, Ohio, is a practice transition and tax attorney and a former dental equipment and supply representative, whose upcoming book, *Joining and Leaving the Dental Practice* (3rd edition), is scheduled for release in January 2018. For this and his other publications, visit PrescottDentalLaw.com. Contact him at (440) 695-8067 or WPrescott@WickensLaw.com.