

Quarterly Supplement To

**Business, Legal,**  
**And Tax Planning**  
**for the Dental Practice**

Second Edition

The purpose of the Quarterly Supplement is to continually update the material contained in **Business, Legal, And Tax Planning for the Dental Practice**, Second Edition, as "free-standing" articles relative to current business, legal, tax and pending legislative matters that affect your practice. These Quarterly Supplements also reflect my ongoing experiences as an attorney representing dental and dental specialty practices. At times, articles will be written by friends who consist of tax attorneys, accountants, actuaries and dentists. The articles contained in the Quarterly Supplements are consistent with the chapters contained in my book, which you may download at [www.wickenslaw.com](http://www.wickenslaw.com) at no charge.



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**In This Supplement**

**Who's The Boss?**

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## WHO'S THE BOSS?

This article discusses under what circumstances a dentist or dental specialist is properly classified as an employee or independent contractor for federal income tax purposes. On August 13, 2008, I participated on a panel of the first Office of Chief Counsel Continuing Education Program held by the Internal Revenue Service (the "IRS") for its roughly 1,400 lawyers, in Atlanta. Our panel was comprised of four IRS representatives and me, as a practicing lawyer. As current Chair, Closely Held Businesses Committee, American Bar Association Section of Taxation, I was asked to participate on this panel to represent the private practitioner's perspective on worker classification. My portion of our presentation was the discussion of whether the dentist or dental specialist can be properly classified as an independent contractor in the following three situations:

1. The new dentist or dental specialist forming a new entity, typically an S-corporation, and rendering professional services to the practice owner's entity.
2. The retiring dentist or dental specialist rendering post-closing professional services, typically for six months to a year, following the practice sale;
3. The three-entity associate buy-in/ owner buy-out approach for "partnerships", whereby the doctors are members of a limited liability company ("LLC") and each member is also the sole shareholder of a newly formed S or existing C-corporation that provides professional services, through the shareholders, to the LLC as independent contractors.

In each situation, my conclusion was that the dentist or dental specialist is an employee, except in rare circumstances.

Consultants often ask, "What's the problem if the dentist /specialist as an independent contractor pays his or her applicable taxes?" The answer is irrespective of whether the alleged independent contractor paid his or her taxes, the IRS can and will assess Federal income tax, FICA, FUTA, penalties and interest against the business or practice for misclassification. Not good! My advice, don't take unnecessary risks. Yes, there is limited relief to businesses and practices under Section 530, but technical requirements must be met and if you get to a Section 530 defense, haven't you have already lost?<sup>1</sup>

The employment tax cases represent the government's claim against a business or practice to pay the worker's taxes. Assuming that the worker did pay his, her or its applicable taxes, the government's successful claim against the business or practice can result in double taxation or the government collecting the same tax twice. As such, under Internal Revenue Code ("IRC") Section 3402(d), there may be a direct credit to the employer, as well as some other

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<sup>1</sup> TAM 9321001

relief, for the worker's income taxes that have already been paid by the worker.<sup>2</sup> Notwithstanding this, the economic impact of misclassification is very expensive to the business or practice 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 affects upon retirement plans, including disqualification, not to mention including the worker in the health insurance plan of the business or practice.<sup>3</sup> For example, Microsoft Corp. found itself with an employee benefit problems in 1998 as a result of worker misclassification.

From the worker's side, business expenses would be generally non-deductible, subject to the two percent limitation under IRC 67.<sup>4</sup> Additionally, a worker who is reclassified as an employee cannot maintain a retirement plan.

In its 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. The legal test is whether there is a right to direct or control the means and details of the work.<sup>5</sup> It divides control into three categories; behavioral control, financial control and relationship of the parties.<sup>6</sup>

### **Behavioral Control**

A primary factor of behavioral control is instructions. Granted, Treasury Regulation 31-3131(d)-1(c)(2) provides 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 dentists or dental specialists 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, all practices have policies covering operations. 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 (including the ability to hire assistants);

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<sup>2</sup> Tax Management Portfolios, BNA, Inc., 391-3rd Employment Status – Employee v. Independent Contractor, Helen Marmoll, Esq., p.A-160.

<sup>3</sup> Microsoft Corp. v. Vizciano, 118 S. Ct. 899 (1998).

<sup>4</sup> Independent Contractor or Employee? Training Materials, Department of the Treasury, Internal Revenue Service, October 10, 1996, Training 3320-102 (10-96) TPDS 842381 p. 1-5.

<sup>5</sup> Ibid. p. 2-3.

<sup>6</sup> Ibid. p. 2-5.

What routines or actions must be used; and  
What order or sequence to follow.<sup>7</sup>

Prior approval, training, suggestions v. instructions and evaluation systems are also factors of behavioral control.

### **Financial Control**

Financial control considers included the following:

Significant investment;  
Unreimbursed expenses;  
Services available to the relevant market;  
Method of payment; and  
Opportunity for profit or loss.<sup>8</sup>

As to a significant investment, how many dentists or dental specialists own the equipment in their treatment rooms or rent the equipment from the practice at fair market value? Not many.

While dentists and dental specialists as independent contractors almost always have unreimbursed expenses, they do not include many of the items described in the Training Manual that include rent and utilities, tools and equipment, advertising, wages, repairs and maintenance, postage, supplies, leasing of equipment or depreciation.

Independent contractors are generally free to seek out business opportunities. As such, independent contractors typically advertise, maintain a visible business location and are available to work in a particular market.<sup>9</sup> In dentistry and its specialties, dentists and dental specialists are almost always subject to restrictive covenants that restrict their ability to work in a given market, other than for the particular practice.

Dentists and dental specialists are usually paid on a commission basis and this does show evidence of an independent contractor relationship. However, it is the practice that customarily sets the fee schedule and bills the patients, which shows a degree of financial control.

If the worker is free to make decisions which affect the worker's profit or loss, the worker could be an independent contractor. Examples include types and qualities of supply inventory, the type and amount of monetary or capital investment and whether to purchase or lease the premises or equipment.<sup>10</sup> In dentistry and its specialties, I do not often see the ability of the

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<sup>7</sup> Ibid p. 2-9.

<sup>8</sup> Ibid. p. 2-16

<sup>9</sup> Ibid. p. 2-19

<sup>10</sup> Ibid. p. 2-21

alleged independent contractor to realize a profit or loss considering these factors. While a dentist or dental specialist can work longer or shorter hours which impacts profit, so can non-doctor employees. Therefore, this factor is not too significant.

In dentistry and its specialties, the practice maintains controls over all financial and business aspects of its operation, including setting fees, billing the patients, collecting the fees and paying operating expenses. While it is possible for the dentist or dental specialist to be an independent contractor if the worker sets the fees, bills the patients and pays rent for use of the premises and equipment, this does not often happen.

### **Relationship of the Parties**

An independent contractor agreement, in and of itself, is not sufficient evidence for determining worker's status.<sup>11</sup> Under Treasury Regulation 31.3121(d)-1(a)(3), the designation or description of the parties is immaterial. Therefore, the substance of the relationship, not the label, governs the worker's status.<sup>12</sup>

Incorporation can provide that the worker is an employee of his or her corporation and not the practice, provided that the corporate formalities are followed and at least one non-tax business purpose exists. However, 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.<sup>13</sup> So, do not rely on incorporation for a finding of independent contractor status.

The ability for the worker to quit or the business or 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, versus a long-term or temporary term that may indicate either.<sup>14</sup>

### **Facts of Lesser Importance**

While full versus part-time employment used to be an important factor in determining worker classification, in today's environment, it is a neutral factor.<sup>15</sup> Other factors include place of work, one or more locations and hours of work.<sup>16</sup>

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<sup>11</sup> Ibid. p. 2-22.

<sup>12</sup> Ibid. p. 2-22.

<sup>13</sup> Ibid. p. 2-23.

<sup>14</sup> Ibid. p. 2-25.

<sup>15</sup> Ibid. p. 2-29.

<sup>16</sup> Ibid. p. 2-29, 2-30.

## Interesting Cases<sup>17</sup>

Below are some cases that are relevant, in my view, as to whether the dentist or dental specialist can be properly classified as an independent contractor under the three categories of control.

### Accountants

In *Young v. Comr.* 98 F .3d 1348, 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.

In Rev. Rul. 58-504, an accountant who was not licensed as a CPA, but who worked 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 Rev. Rul. 57-109, 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 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 Rev. Rul. 57-380, 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 Rev. Rul. 57-381, 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

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<sup>17</sup> Tax Management Portfolios, BNA, Inc., 391-3rd Employment Status – Employee v. Independent Contractor, Helen Marmoll, Esq. p.A-47-A-140.

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.

### **Athletes**

In TAM 8625003, professional athletes established "PSCs" through which services were made available to a professional "Team". The PSCs and the Team entered into contracts in exchange for exclusive services. The IRS reviewed the following factors to determine that the Team was the employer of the athletes; instructions, training, integration of a person's services into the business operation of the employer, whether the services must be rendered personally, the payment in increments measured by time (hourly, monthly, etc.), payment of travel expenses, furnishing of tools (uniforms and equipment), the party investing in and furnishing the facilities used by the worker to perform the services (locker room and the back-up equipment needed to play), control over availability of appearances and the right to discharge.

The IRS noted that the payment by the Team to the PSCs rather than to the athletes did not negate the existence of an employer-employee relationship between the Team and the player. The PSCs were merely the agent for the receipt of compensation. The IRS concluded, despite the existence of the PSCs, that the Team exercised sufficient control over the athletes to be their common law employer. As such, the Team was liable for employment taxes, and subject to withholding, on all sums paid.

### **Attorneys**

Under Rev. Rul. 68-324, 1968-1 C.B. 433, an associate attorney works at a law firm and is paid in a fixed annual salary. The attorney is furnished office space, stenographic help, is required to work daily hours and is engaged mostly in research work that is assigned by the firm. Even though the attorney handles certain assigned cases from the firm for which the attorney receives full fees, the attorney is an employee.

In *Van Camp & Bennion P.S. v. U.S.* 78 A.F.T.R. 2d 96-5843 (E.D. Wash. 1996), the IRS concluded that one shareholder who handled the majority of corporate duties and whose name and reputation brought in the 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.

### **Barbers and Hair Stylists**

A barber who rents a chair for a fixed weekly fee, furnishes his own barbering tools, determines his own work routine, is not required to perform a minimum amount of work or be on duty a specified number of hours, retains all fees collected by him, is not required to make an accounting to the barbershop owner and where either party could terminate the rental agreement at any time, was an independent contractor. Rev. Rul. 57-110, 1957-1 C.B. 329.

A beautician who rents a booth in a beauty shop for a fixed monthly fee, sells and styles wigs that she purchases herself, retains the proceeds, is not guaranteed a minimum amount, is free to select her own customers and set her work schedule, is not required to adhere to the salon's rules, is required to clean her own work area, furnish her own uniforms and maintain her own tools was an independent contractor. Rev. Rul. 73-592, 1973-2 C.B., 338.

However, compare Rev. Rul. 73-591, 1973-2 C.B. 327, where the beautician was held to be an employee. Here, the beautician leased space from the beauty salon, was required to be at her chair at 8:00 a.m. on days scheduled to work and was paid a percentage of the fees taken in by her where such fees were set by the beauty salon. The percentage of fees were based upon daily receipts furnished to the beauty salon.

### **Consultants**

The taxpayer was engaged by municipalities to perform services as a consulting engineer. Because the taxpayer was free to accept other engagements and was left to use his own judgment, discretion and professional skill to bring the desired result without direction or control of the municipalities that engaged him, he was an independent contractor. Fuller v. the Comr., 9 B.T.A. 708 1927 WL 165 (B.T.A.).

### **Dental Hygienists**

A hygienist was paid 50% of production under an oral contract, did not secure patients but arranged recall visits, completed charting, worked for other dentists and either party could terminate the services at any time. While qualified to provide the services without instructions and used her own discretion with respect to treatment methods, the dentist paid for all expenses, provided office space and furnished all supplies and equipment. Under the facts, the dental hygienist was an employee. Rev. Rul. 58-268, 1958-1 C.B. 353.

### **Dentists**

In Queensgate Dental Family Practice, Inc., v. U.S. 68 A.F.T.R. 2d 91-5679, 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, consulted and referred to other dentists as they deemed appropriate, determined how to handle patients that did not pay, maintained records, paid their own entertainment 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 patients. It looks to me like the "right" questions were not asked by the government, such as whether restrictive covenants existed and what was the nature of the relationship with Keystone Health Services, Inc. and Colonial Family Dental Practice, Inc.

In TAM 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 with respect to employment tax liability arising from the services of the dentists.

## Physicians

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. Rev. Rul. 72-203, 1972-1 C.B. 324.

A physician is an employee when the physician maintains a private practice and also renders medical treatment to employees of a company on its premises on a part-time basis, is required to conform to the company's policies and procedures, is subject to supervision by the company's head physician, works a fixed schedule and is provided benefits consistent with company's regular employees. Rev. Rul. 61-178.

Physician/ medical director was an employee of an urgent care facility due to control over the medical director's activities, irrespective that the medical director was paid through the medical director's professional services association. It did not help that the professional services association was never formed until after his employment commenced with the urgent care center. However, this would probably not have mattered due to control over the activities. Dutch Square Medical Center Limited Partnership v. U.S., 74 A.F.T.R. 2d. 94-6356.

In *Azad v. U.S.*, 338 F.2d. 74, 21 A.F.T.R. 2d 486, 68-1 USTC P 9162, the radiologist was an independent contractor. The radiologist was not restricted to performance of services solely for one hospital and did not work for other hospitals. Neither the head of the radiology department nor the hospital exercised any supervision over the professional services of the radiologist's work. The radiologist was not required to work certain hours or account for absences from work. Finally, none of the radiologists were required to comply with any set policies, rules or regulations of the hospital.

In TAM 99443002, a radiologist and other physicians were 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 radiologists and the physicians were under the hospital's control, were 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*, 89 T.C. No. 19, 89 T.C. 225, management and professional workers were found to be employees of the management leasing company that attempted to provide liberal fringe benefits and retirement plans to the workers. It was 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, no right to discharge and had no employment relationship with the worker despite employment agreements as it merely provided bookkeeping and payroll services. Here, the workers were either self-employed or employees of the business or practice. This case is interesting because the workers failed to obtain the favorable retirement plans that they were promised, although this fact pattern is not similar, fortunately, to how most dental and dental specialty practices operate.

## **CONCLUSIONS**

### **The New Professional**

The new professional's forming of an entity, typically an S-corporation, does not mean that the new doctor is not an employee of the practice. Typically, the practice and its owner retain a substantial degree of control, including mentorship, over the services rendered by the new doctor, including setting fees, billing patients, providing patients and referral sources, establishing practice systems and scheduling. Almost always, the new doctor has a covenant not to compete, which arguably, in and of itself, shows behavioral control. Equipment is always provided by the practice, hours and patients are scheduled by the administrative staff, the new doctor has no investment in the practice facility and no risk of loss. Finally, the parties often contemplate future ownership of the practice, in whole or in part.

### **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 doctor 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 should the transition of goodwill no longer be necessary. 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 dentist or specialist, the practice typically maintains some degree of control over the retiring doctor. In this case, the new owner's practice bills the patients, collects revenue, sets the fees, employs the staff, provides the equipment to the retiring doctor and the new owner's systems and policies are in place, which may or may not be the same systems and policies that the retiring dentist or specialist utilized. Finally, the retiring doctor will be subject to a restrictive covenant which again shows behavioral control.

The retiring dentist or specialist usually would like to be an independent contractor so that business expenses not paid by the new doctor's practice can be written off. For example, retiring dentists are usually paid more than an associate new dentist, e.g., 35% of adjusted

production or collections, versus 30% to an associate. As such, the practice cannot afford to pay the retiring dentist or specialist's health insurance, malpractice, continuing education, professional dues and licenses, entertainment and other direct business expenses. However, due to the control exercised by the new owner's practice over the provision of services by the retiring dentist or specialist, I believe that it's risky to attempt to assert that the retiring dentist or specialist is an independent contractor. As a planning tip, the practice could, arguably, pay the "direct business expenses" of the retiring dentist or specialist and reduce and offset the retiring dentist's or specialist's compensation by the full cost of such direct business expenses.

### **Three Entity Approach**

Under the three entity approach to co-ownership, the new owner purchases one-half of the practice owner's tangible assets and arguably, the practice owner's personal goodwill. The two owners then practice through a limited liability company or partnership in California or Hawaii. Each owner is the sole shareholder of the professional corporation which contracts with the limited liability company or partnership to provide services. The limited liability company or partnership bills patients, collects revenue, employs the staff, adopts the retirement and medical plans and pays the operating expenses. Profits go to the respective corporations, e.g., an S-corporation for the new doctor and sometimes an S or existing C-corporation for the founding owner. The doctors are employees of their respective corporations, but are they really employees of the limited liability company or partnership? Because the limited liability company or partnership bills the patients, pays expenses, employs staff, maintains fringe benefit plans and establishes fees and office policies and systems, that the doctors/ owners may be employees of the limited liability company or partnership. It is my understanding that the IRS is attempting to figure out what to do with these increasingly popular business and tax structures of several variations, which sometimes include independent contractor relationships.

The three-entity approaches are being promoted in an attempt to provide amortization of purchasing assets by the incoming owner. There are, however, a number of issues/ problems to consider aside from worker classification. These include characterization of personal goodwill and the valuation thereof, the Anti-Churning Regulations under IRC Section 197 that prohibit goodwill from being amortized by the new doctor for a buy-in of a practice formed pre-1993, the amortization for the buy-in and buy-out for a family member in a practice formed pre-1993 and the unavailability of reasonable S-corporation distributions because all profits generated through a limited liability company or partnership are earned income.

### **A Way Around This**

To establish independent contractor status in the dental or dental specialties, the doctor should bill the patients he or she treats, 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, not be planning to purchase the host's dental or specialty practice and schedule the independent contractor's patients. While these factors are based upon facts and circumstances and are a matter of degree, the more factors in the alleged independent contractor's favor, the better the chances of a

favorable finding. However, in my view, not many host dentist or dental specialist relationships meet the criteria necessary for a finding that the dentist or dental specialist is an independent contractor. Except in rare circumstances, I would be very cautious of an independent contractor relationship in dentistry and its specialties because if the practice is audited, it has probably already lost due to the cost of defense. The risk is just not worth the reward!