MEMORANDUM

FROM: Horty, Springer & Mattern, P.C.

SUBJECT: Independent Contractor vs. Employee Status of Physicians

This memorandum will discuss the Internal Revenue Service ("IRS") Pronouncements and judicial opinions that have examined the issue of whether a physician or other health care worker who provides services to an entity on an ongoing basis will be considered to be an independent contractor or an employee.

This issue is one that is continuously under scrutiny by the IRS. The IRS rulings in this area are constantly evolving and the determination of an individual's status is dependent on a review of all of the facts and circumstances involved. While the IRS has revised the test that it will use to determine this issue in IRS Publication 15-A (January 2006), historically IRS rulings have evidenced a trend toward a finding of employee status for physicians and other workers who provide ongoing services to any entity.

The federal courts have been more lenient in finding independent contractor status, often disagreeing with the IRS's classification of a worker as an employee. The IRS has stated that one reason that it has established the new test in Publication 15-A was so that its determinations will be more consistent with court opinions on this issue. However, only time will tell whether the IRS will interpret its new test in a manner that is consistent with court opinions.

A consistent history of contracting with similarly situated workers on an independent contractor basis provides a basis for continuing to do so in the future. Furthermore, the independent contractor status of the relationship may best be preserved by contracting with a corporation or other entity that employs the worker.

In the event any entity were to decide to reclassify any physician from an independent contractor to an employee, prior to making that reclassification, the entity must consider: (i) whether all physicians who provide similar services are also classified as employees; (ii) the effective date of that reclassification; and (iii) the fringe benefits, especially pension benefits, to which any physician so reclassified may be entitled.

IRS POSITIONS

1. The IRS Matching Program

The IRS uses an audit program dubbed "the Matching Program." The Matching Program relies on computer matching of independent contractor tax returns with forms 1099 filed by the contracting entity. The Matching Program, which began in January 1991, first identifies all independent contractors who worked for only one entity. Any entity thus identified is then targeted for an IRS audit.

2. Potential Liability

An IRS audit typically includes a review of at least three past years of tax returns, but it may cover earlier years as well. Back taxes, penalties, and interest can be collected from a corporation and/or from its responsible persons, including officers and directors. Potential assessments include the following: (1) the employer share of social security ("FICA") taxes that should have been paid with regard to the worker; (2) one-fifth of the worker's share of FICA taxes that should have been withheld from his or her wages; (3) one and one-half percent of total compensation paid to the worker, in lieu of the federal income tax withholding that should have taken place; and (4) any payments that should have been paid under the Federal Unemployment Tax ("FUTA"). However, a tax-exempt employer may be exempt from FUTA. These amounts, to which interest and penalties can be added, total approximately 11 percent of the total wages paid to the individual during the years audited. If the IRS determines that the decision to treat an employee as an independent contractor was intentional, the employer's liability can be doubled. There may also be additional amounts due as a result of the failure to withhold state income tax.

3. IRS Test to Determine Employee Status

Historically, the IRS relied on a 20-factor "Right to Control" test in determining whether an individual is an employee or an independent contractor. *See*, IRS Rev. Rule 87-41. This test listed 20 elements that have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. In January 2006, the IRS has stated in IRS Publication 15-A that rather than utilize the Twenty Factor Right to Control test, the IRS will analyze 11 factors in three main groups: (1) Behavioral Control; (2) Financial Control; and (3) Relationship Between the Parties, in order to determine whether an employment relationship has been created.

IRS Publication A-15 describes the new test as follows:

> **Common-Law Rules**
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> To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.
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> Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties. These facts are discussed below.
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> **Behavioral control.** Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

Instructions that the business gives to the worker. An employee is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work.

When and where to do the work.

What tools or equipment to use.

What workers to hire or to assist with the work.

Where to purchase supplies and services.

What work must be performed by a specified individual.

What order or sequence to follow.

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Training that the business gives to the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control. Facts that show whether the business has a right to control the business aspects of the worker's job include:

The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their business.

The extent of the worker's investment. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.

The extent to which the worker makes his or her services available to the relevant market. An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

How the business pays the worker. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

The extent to which the worker can realize a profit or loss. An independent contractor can make a profit or loss.

Type of relationship. Facts that show the parties' type of relationship include:

Written contracts describing the relationship the parties intended to create.

Whether or not the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.

The permanency of the relationship. If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.

The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

While the IRS has changed the test that it uses to determine employee status, the IRS has not changed its position that the IRS's test will apply regardless of the preference of the parties or the terms of an agreement between the parties. Workers and their employers have no legal right to agree to independent contractor status if in fact the employer has the right to control the manner in which the individual carries out his or her duties. Therefore, if the IRS's 11 factor test determines that an employment relationship has been created, it is irrelevant that the agreement between the parties describes the individual as an independent contractor.

A White Paper on this issue that was developed by the IRS in the early 1990s recognized the difficulty in applying the IRS's test to physicians and the Service has instructed its agents that "the factors should be weighted differently for physicians (and other professionals)...." The case law supports the fact that the extent of control necessary to find employment status is less for a professional as opposed to a non-professional. *See Azad v. United States*, 388 F.2d 74 (8th Cir. 1968); *Weber v. Commissioner*, 103 T.C. 378 (1994); *Kentfield Medical Hospital Corp. v. United States*, 615 F.Supp. 1064, 1070 (DC N.D.Ca. 2002). If an organization is in doubt and wants a ruling from the IRS as to how to characterize a particular worker, the IRS has a process that will determine whether or not a worker is an employee by filing Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding," with the IRS.

It is thought that the new Eleven Factor test that is described in IRS Pub. 15-A will be more straightforward and easier to apply. However, since the new test, like the old, was based on the IRS's interpretation of the manner in which those Eleven Factors are applied to specific facts, we believe that the IRS's past rulings on this issue will continue to guide future enforcement, although the IRS is likely to pay greater deference to the federal court cases that have considered this issue.

For example, the IRS may change the manner in which it has historically viewed the effect of a state corporate practice of medicine doctrine in determining whether a worker is an employee. In

1991, the IRS took the position that a physician may be found to be an employee for federal income tax purposes despite a state law prohibiting employment due to the "Corporate Practice of Medicine Doctrine." Private Letter Ruling 9149001 (July 23, 1991); GCM 39862 Fn.3 (December 2, 1991). However, not all courts have agreed with the IRS's position and at least one court has found the corporate practice doctrine to be a reason supporting the classification of a physician as an independent contractor. (*See Western Neuro Residential Centers, Inc. v. U.S.*, 2002 WL 1008253.) In addition, a state's corporate practice doctrine may be considered by a court in determining whether relief under Section 530 of the Code is appropriate. (*See VTA Management v. United States*, 2004 WL 3199677 at 16.)

Therefore, it is impossible to ascertain in advance how the IRS would view any particular contractual relationship. As a general rule, though, certain factors do make it more likely than not that the IRS will determine that an independent contractor relationship has been created. Independent contractor status is more likely when the physician providing the services: (1) provides the services as an employee of a corporation or LLC rather than directly; (2) is placed at economic risk; (3) is required to employ all of the other physicians or other ancillary personnel necessary to provide the service; (4) is responsible for all of his/her fringe benefits; (5) is billing separately for professional services; and (6) the Agreement is considered for renewal at the conclusion of each contract term.

4. IRS Rulings and Judicial Cases

The IRS has issued a number of rulings involving physicians which show a recent trend toward finding employment relationships in arrangements that have traditionally been considered to be independent contractor arrangements. However, there have also been several revenue rulings and other pronouncements that continue to support the independent contractor status of certain types of relationships, a position that the Service has not thus far challenged on audit. Also, any decision made prior to January 2006 must be evaluated in light of the new 11 factor, three category test described in IRS Publication 15-A.

There have also been a number of federal courts that have decided the issue of whether a physician providing services to a hospital is an independent contractor or employee. The courts have disagreed with the IRS on a number of occasions and in certain areas such as medical directors providing services in a for-profit rehabilitation hospital have consistently ruled in favor of independent contractor status. It is thought that the new 11 factor test that is described in IRS Pub. 15-A will bring the IRS determinations in this area more in line with court decisions than had been the case under the 20 Factor Right to Control Test. However, it remains to be seen whether the IRS will do so.

(a) Decisions Finding an Employment Relationship

In Revenue Ruling 61-178, 1961-2 C.B. 153, a physician performed services on the premises of a company on a part-time basis by rendering medical treatment to the employees of the company. The physician was required to conform to the company's policies and procedures, was subject to supervision by the company's head physician, worked a regular fixed-hour schedule six days a week, and was extended all the benefits and privileges of the company's regular employees, such as vacations, sick pay, etc. The IRS found that the physician was an employee.

In Revenue Ruling 70-629, 1970-2 C.B. 228, associate physicians rendered full-time professional services to a clinic that was operated by a partnership. The partnership furnished the physicians with private offices, equipment, and supplies, and had the right to direct and control them in the performance of their services. The IRS found that the physicians were employees of the clinic.

Revenue Ruling 72-203, 1972-1 C.B. 324 provided that associate physicians who were paid by and worked full time for a hospital's pathology department director, who was an independent contractor with the hospital, were employees of the director.

In Revenue Ruling 73-417, the IRS ruled that a pathologist who provided services directly to the hospital was subject to the direction and control of the hospital, and thus was a hospital employee.

In Private Letter Ruling 9149001 (July 23, 1991), the IRS ruled that physicians who provided medical services at four family health clinics that were affiliated with a hospital were employees of the clinics despite the fact that the physicians were not guaranteed any minimum salary because they could collect only a percentage of collected charges, the physicians were obligated to obtain and pay for a replacement if they could not perform medical services at a specific time, the clinic's general manager had to operate around the personal schedules of the physicians, the physicians received no vacation time or any fringe benefits, and the clinic was barred from employing the physicians under the state's "corporate practice of medicine" doctrine.

In Private Letter Ruling 9208012 (February 21, 1992), the IRS determined that registered nurses, physical and occupational therapists, a social services counselor, a speech therapist, and a dietary consultant who provided services to a home health firm were an integral part of the services offered by the home health firm. As such, these individuals were determined to be employees of the firm.

In Private Letter Ruling 9219020 (February 6, 1992), a hospital contracted with a professional corporation, which then employed one physician to provide services as the Chief of Anesthesiology. The IRS ruled that this arrangement created an employment relationship between the Chief of Anesthesiology and the hospital, despite the fact that the hospital's contract was with the professional corporation and not directly with the physician. This Private Letter Ruling does not appear to have involved an exclusive agreement. Furthermore, the other anesthesiologists and other personnel working at the hospital's anesthesia department appear to have been hospital employees. Finally, the agreement at issue prohibited the hospital from employing any anesthesiologist without obtaining the Chief of Anesthesiology's approval, and

the Chief of Anesthesiology was granted the authority to determine when it was necessary to discharge a hospital employee.

In *Dutch Square Medical Center v. United States*, 74 AFTR2d, par. 94-5425 (D.S.C. 1994), the medical center contracted with a physician to provide full-time services as the medical center's Medical Director. The agreement between the parties provided that the Medical Director was an independent contractor. The Medical Director's responsibilities under the agreement included the following duties: (1) supervise the nursing and ancillary staff; (2) review the professional and medical services provided by the physicians who worked at the medical center; (3) direct, implement, and manage the quality assurance programs; and (4) be responsible for all related patient care matters. The Medical Director also had the authority to make routine operational decisions. The Medical Director was required to work a minimum of 42 hours a week and was precluded from any other medical practice except for hospital emergency room work. The Medical Director received an annual salary and was eligible for additional incentive income based upon the medical center's gross hourly charge. The medical center also reimbursed the Medical Director for costs of his medical malpractice insurance.

The district court, using a common law analysis, found the Medical Director to be an employee of the medical center. The court stated the "medical director's duties were those of a fully integrated employee who had a substantial amount of authority and worked on a continuous and regular basis."

In Technical Advice Memorandum (TAM) 9443002 (October 28, 1994), the IRS found an employment relationship where a radiologist was guaranteed a specified income each year, four physicians provided professional services in a clinic that was owned by a hospital, and a physical therapist was paid a monthly salary.

TAM 9535001 and 9535002 (September 1, 1995) further illustrate the recent tendency of the IRS to find that workers are employees rather than independent contractors. The first ruling

examined relationships between a nursing home/outpatient surgery center and various providers. The other ruling dealt with a hospital. Both organizations had treated individuals under contract with them as independent contractors and did not withhold federal taxes or make FICA payments on their behalf. For 9 out of the 10 relationships examined, the IRS ruled that the contractual relationships were employment relationships. Thus, taxes should have been withheld and FICA contributions should have been made.

The decision in the first ruling regarding the status of an EKG reading panel reflects the willingness of the IRS to find that an employment relationship exists. Panel members were paid $13 per interpretation. They maintained their own liability insurance coverage, arranged for another physician in the event of their unavailability, and were solely responsible for determining when to interpret the EKGs. The physicians also maintained their own private office practices as cardiologists or internists, were permitted to provide similar services for other hospitals, did not receive any benefits from the hospital, such as vacation pay, sick pay, or retirement, and paid the hospital a three-dollar-per-scan fee in order to reimburse the hospital and the nursing home for administrative and collection costs. Despite all this, the IRS found that the EKG panel members were employees, not independent contractors.

The first ruling also addressed the relationship between the nursing home/outpatient surgery center and several other contractors, including a nursing home construction manager, a medical director, and utilization review physicians. In each case, except for the utilization review physicians, the IRS found that there was an employment relationship.

In the second ruling, the contracts between the Hospital and its EKG panel members, echocardiogram interpreters, pulmonary function interpreters, the medical director of respiratory therapy, Lamaze instructors, and employee health physicians were found to constitute employment relationships. The contract between the Hospital and outside medical records transcriptionists was found to constitute an employment relationship for FICA purposes only, but not for the purposes of income tax withholding.

In Private Letter Ruling 9737012 (September 12, 1977), an audiologist providing services to patients of a government hospital was found to be an employee of the hospital. The audiologist was required to perform services personally, was supplied space and equipment by the hospital, used the hospital's support staff, reported to a hospital representative biweekly, provided services under the hospital's name, and did not provide services elsewhere. In addition, both the hospital and audiologist were able to terminate the contract without incurring liability.

In *Kevin and Bridget Naughton v. Commissioner*, 2002 WL 2018567 (Tax Court 2002), the tax court ruled that the physician was an employee where the physician was paid a salary, did not bill patients for medical services that he performed, performed services only for one entity, and the entity issued a Form W-2 and paid the employer's share of Social Security.

In *Kentfield Medical Hospital Corp. v. United States*, 215 F.Supp. 1064 (N.D. Cal. 2002), psychologists who were paid a salary, received office space, supplies, clerical support, and CME reimbursement from a hospital, were classified as hospital employees despite the fact that they were required to obtain their own health insurance and malpractice insurance.

(b) Decisions Finding an Independent Contractor Relationship

Revenue Ruling 57-380, 1957-2 C.B. 634 involved an anesthetist who provided anesthesia services to two hospitals pursuant to separate agreements. The agreements stated that he would furnish his services as needed, and the services could be rendered by the anesthetist personally or by individuals engaged, paid, and supervised by him. One hospital included the anesthetist's fee in its bills and collected the fee for the anesthetist. The anesthetist furnished all of his own equipment and supplies. The second hospital furnished all the necessary equipment and supplies and paid the anesthetist a fixed monthly amount. The anesthetist maintained an office in connection with his work and provided anesthetist services to doctors and other hospitals. The IRS held that the anesthetist was not an employee of either hospital but was rather an independent contractor.

Revenue Ruling 66-274, 1966-2 C.B. 446 provided that a physician who performed services as a director of a hospital's department of pathology was not an employee of the hospital for federal employment tax purposes. The physician received as compensation for the professional services provided to the hospital's patients a percentage of the department's income, paid the remuneration of his associate or substitute, was permitted to engage in the private practice of medicine, and was not entitled to certain employee fringe benefits.

In Private Letter Ruling 9541032 (July 17, 1995), a hospital had an exclusive agreement with a corporation for the provision of emergency services. Since 1988, the corporation had provided emergency services only to the hospital. The hospital did the billing for the professional and technical component of the emergency services and paid the corporation a fixed amount for providing emergency services. However, the corporation was responsible to schedule, hire and fire the physicians, pay the physicians' salaries and fringe benefits, and set the physicians' terms of service. The IRS determined that the physicians who provided services to the corporation were employees of the corporation, but were not employees of the hospital.

As stated above, in TAM 9535001, the IRS examined a number of contractual relationships, including one between a nursing home and its utilization review physicians. The IRS said that the service offered by those physicians was "similar to that offered by a physician engaged in a private medical practice, which is generally the diagnosis and treatment of medical conditions." The fact that the utilization physicians were required to certify that a proper level of care was being given to patients was considered to be part of the independent business that these physicians offered to the public. Therefore, according to the IRS, these physicians were considered to be independent contractors.

In *Cilecek v. Inova Health Sys. Servs.*, 115 F.3d 256 (4th Cir. 1997), a physician contracted with a limited liability corporation that had a contract with a health system to provide emergency physicians to two of the system's hospitals. The United States Court of Appeals for the Fourth

Circuit noted that, because of the unique relationship between hospitals and physicians, "it is less productive to debate the control over the discharge of professional services in the medical context than it might be in other service relationships." Id. at 260.

Therefore, the court set forth the following factors for consideration in determining whether an employment or independent contractor relationship exists:

> (1) the control of when the doctor works, how many hours he works, and the administrative details incident to his work; (2) the source of instrumentalities of the doctor's work; (3) the duration of the relationship between the parties; (4) whether the hiring party has the right to assign additional work to the doctor or to preclude the doctor from working at other facilities or for competitors; (5) the method of payment; (6) the doctor's role in hiring and paying assistants; (7) whether the work is part of the regular business of the hiring party and how it is customarily discharged; (8) the provision of pension benefits and other employee benefits; (9) the tax treatment of the doctor's income; and (10) whether the parties believe they have created an employment relationship or an independent contractor relationship.

Id. at 261.

In finding the physician to be an independent contractor, the court noted that the hospital scheduled the physician's shifts, but the physician determined how many hours and/or shifts he was willing to work each month. In addition, the court mentioned that the physician's contract stated that he was an independent contractor, the physician worked at other hospitals from time to time, the physician was not subject to a noncompetition agreement and the physician did not receive any benefits. Also, the physician was not supervised in the providing of care and was not required to be on call.

In making its determination, the court rejected the doctor's claims that, because he was paid hourly and used the hospital's equipment, he was an employee. The court cited the fact that all emergency physicians, whether employed or contracted, must use the hospital's equipment.

Also, the court said that "independent contractors are...often paid by the hour" and the fact that the physician was paid hourly "is not indicative of whether the physician was an independent contractor or an employee." Id. at 262.

In *Linkous v. United States*, 142 F.3d 271 (5th Cir. 1998), the United States Court of Appeal for the Fifth Circuit held that a physician providing OB/GYN services to an army hospital was an independent contractor, and not an employee of the hospital. The court's decision was based on many factors, including: the practice of OB/GYN is a distinct occupation that requires a high degree of skill, the physician was reimbursed on a fee-for-service basis, the parties intended to enter into an independent contractor relationship, and the doctor obtained her own professional liability insurance. The court found that those factors outweighed the facts that the physician used the army's facilities and equipment, the physician worked at the hospital for several years, and the physician provided services of the type customarily offered by the hospital. Id. at 277.

In *Duplan v. Harper*, 188 F.3d 1195 (10th Cir. 1999), the United States Court of Appeal for the Tenth Circuit held that a physician working at an Air Force clinic, through his contract with a medical services company, was an independent contractor. Significant facts include that: the physician was paid by the medical services company rather than by the government, the physician wore a tag stating "Contract Physician," the physician purchased his own liability insurance, and the contract identified the parties as independent contractors. Id. at 1200.

The court balanced those factors against the fact that the government (the hospital): maintained and controlled patient records, retained the right to conduct quality reviews of the physician, imposed minimum standards for the physicians who could provide services to its facilities through the medical services company, required a dress code, supplied all of the equipment and support personnel at the clinic, and required the physician to be present at the clinic during certain hours. The court found these factors insufficient to establish that the physician was an employee.

In *Ferraro v. Bd. of Trustees of Labette County Med. Ctr.*, 28 Fed. Appx. 899 (10th Cir. 2001) (unpublished), the Tenth Circuit Court of Appeals held that a registered nurse anesthetist working at a medical center was an independent contractor. The court noted that the nurse anesthetist's services were provided for patients, not for the hospital itself. Also, the nurse anesthetist's services were paid for by insurers or patients, not the hospital (although the hospital conducted billing on the nurse anesthetist's behalf).

Likewise, in *Chadha v. Hardin Mem'l Hosp.*, 202 F.3d 267 (6th Cir. 2000), the United States Court of Appeal for the Sixth Circuit held that an anesthesiologist who had an exclusive contract to perform anesthesiology services at a hospital was an independent contractor. The court noted that anesthesiology requires specialized skill and the physician exercised independent judgment when providing patient care. Also, the physician employed his own support staff, although the hospital participated in the hiring process, he paid for his own malpractice insurance, and he was responsible for his own billing. Lastly, the physician decided which employee would cover any given surgery, and was not paid a salary (although he was provided with an income guarantee).

In *Western Neuro Residential Centers, Inc. v. United States*, 2002 WL 1008253 (C.D. Cal.), the federal district court ruled in an unpublished opinion that a for-profit rehabilitation hospital had correctly characterized its medical directors as independent contractors.

The court relied on the fact that characterizing medical directors as independent contractors was a longstanding practice in the for-profit rehabilitation industry. The court also ruled that it was reasonable to characterize the physicians as independent contractors due to the advice of the Group's legal counsel and the state corporate practice doctrine. The court also found that the fact that the hospital exercised virtually no direction or control over the manner by which the medical directors performed contractual services was also consistent with their status as independent contractors.

In *Select Rehab, Inc. v. United States*, 205 F.Supp. 376 (M.D. Pa. 2002), the Federal District Court for the Middle District of Pennsylvania reached a similar result in a case that also involved the status of two physicians who performed medical director services in a for-profit rehabilitation hospital.

5. Safe Harbor

Regardless of whether the IRS's application of the Right to Control test would determine that physicians are hospital employees, there is a "safe harbor" which was created by Section 530 of the Tax Code. Pursuant to the safe harbor, individuals who under the Right to Control test would be treated as employees can nonetheless continue to be treated as independent contractors if all of the following criteria are satisfied:

(1) the employer has never treated the worker as an employee in the past;
(2) the employer has filed all federal tax returns on a basis consistent with the designation of the worker as an independent contractor;
(3) the employer has never treated any other individual holding a substantially similar position as an employee; and
(4) the employer has a "reasonable basis" for treating the individual as an independent contractor.

Congress enacted Section 530 to alleviate what it perceived as "overly zealous pursuit and assessment of taxes" against those who in good faith classified their workers as independent contractors. *Ewens and Miller, Inc. v. Commissioner*, 117 T.C. 263, 1001 WL 1575671 (2001); *see also, Boles Trucking, Inc. v. United States*, 77 F.3d 236 (8th Cir. 1996).

In asserting that there was a "reasonable basis" for treating the individual as an independent contractor, an employer may point to any of the following:

(1) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

(2) a past IRS audit; or

(3) a long-standing recognized practice of a significant segment of the industry in which the worker was engaged.

However, a taxpayer does not have to rely on one of these three methods to prove that he had a "reasonable basis" for classifying a worker as an independent contractor. "A taxpayer who can demonstrate a reasonable basis for the treatment of an individual in some other manner" is entitled to relief under Section 530. *Critical Care Register Nursing, Inc. v. U.S.*, 776 F.Supp. 1025, 1027 (E.D.Pa. 1991). That reasonable basis could include a factor such as a state corporate practice doctrine. *See VTA Management Services, Inc. v. United States*, 2004 WL 3199677 at 16 (E.D. N.Y. 2004).

Several decisions by the IRS suggest that it takes a narrow view of the protections afforded by the safe harbor of Section 530. While the IRS did not prevail, *Medical Emergency Care Associates SC v. Commissioner of Internal Revenue*, 120 T.C. 436 (2003), showed that the IRS will attempt to use the failure to file all required forms on a timely basis as a reason not to apply Section 530.

In *Medical Emergency Care Associates, Inc. v. Commissioner of Internal Revenue*, 120 T.C. 436 (2003), a medical service corporation provided emergency services to hospitals by contracting with physicians to staff hospital emergency rooms. The corporation treated the physicians as independent contractors for tax purposes. However, the corporation failed to file the necessary federal tax forms by their due date. The IRS concluded that the physicians were in fact employees of the corporation. It further determined that, because of its delinquent filing, the corporation was not subject to Section 530 relief, as it did not meet the filing requirement of Section 530(a)(1)(B).

The Tax Court held that the corporation's late filing was not fatal to its application for relief under Section 530. It noted that the plain language of the statute denied relief only if the

required filing was not made or if the required filing was made on a basis not consistent with treatment of individual workers as employees. Other provisions of the Internal Revenue Code were more appropriate to deal with late filing of required information. *See* I.R.C. §§ 6721-24.

In Private Letter Ruling 9149001, the IRS stated that "the corporation has consistently treated the physicians as independent contractors since the corporation began operations." Therefore, the safe harbor should have applied to the physicians discussed in this Private Letter Ruling. However, the IRS did not mention it in its analysis. Similarly, the safe harbor was not discussed in either Private Letter Ruling 9208012 or Private Letter Ruling 9219020. More recently, the safe harbor was specifically rejected in TAM 9535001 and 9535002.

In TAM 9535001 and 9535002, the hospital and the nursing home each raised the safe harbor as a defense of its decision to treat the physicians on its EKG reading panel as independent contractors. The hospital and the nursing home then introduced two recent surveys in support of its position that treating EKG panel members as independent contractors was a long-standing, recognized standard in the industry. However, the IRS categorically rejected this contention, stating "no evidence was submitted establishing that the industry practice revealed in the survey was the practice at the time the taxpayer's practice was established, nor could taxpayer's counsel identify anyone who could attest to the practices of the taxpayer's competitors."

Historically, the IRS has taken the position that the safe harbor does not apply unless the entity was audited, this issue was specifically involved in the audit, and the status of an individual was not challenged at that time. This historical position should be considered prior to making a decision to rely on this safe harbor.

The safe harbor may also be raised as a defense to the IRS's imposition of the penalties described above. For example, in *Critical Care Register Nursing, Inc. v. U.S.*, supra, the taxpayer was a company that contracted with hospitals to supply nurses according to hospitals' requests for certain shifts. The taxpayer then contracted with nurses to work those shifts. The court ruled

that the taxpayer had a "reasonable basis" for treating the nurses as independent contractors because the taxpayer did not direct the nurses in their performance of duties or provide any training except for a brief orientation. Moreover, the nurses were free to choose to accept or reject assignments, and were permitted to register with other agencies.

It is important to point out that the safe harbor can only be used when all similarly situated workers are treated in the same manner. Therefore, before any entity changes a physician's status from an independent contractor to an employee, it must examine all similarly situated physicians to ensure that each such physician is classified in the same manner. For example, in *Kentfield Medical Hospital Corp. v. United States*, 215 F.Supp. 1064 (N.D. Ca. 2002), when the hospital tried to claim that it was entitled to rely on the safe harbor in Section 530 of the Tax Code, the court ruled that since during the period at issue the hospital treated all psychologists but one as independent contractors, the hospital did not treat all of the psychologists consistently and, as such, was not entitled to relief under Section 530.

6. Practical Considerations

It is impossible to state with any certainty the manner in which the IRS would treat any particular transaction or whether a court will uphold that determination. However, each entity that contracts with physicians should carefully consider the recent trend of the IRS to find employee status when a physician provides ongoing services for one entity.

Furthermore, while the IRS is likely to challenge an entity that attempts to rely on the safe harbor protection described in Section 530 of the tax code, that code section may be applicable to certain types of arrangements and may be asserted in an attempt to mitigate any penalties assessed by the IRS. However, in order to take advantage of this section, all similarly situated workers must be classified in the same manner. Therefore, we do not recommend that the entity reclassify any physician, without careful consideration of any similarly situated workers. Furthermore, if the entity decides to reclassify a worker as an employee, consideration must be given to whether that individual will then qualify for fringe benefits, especially pension benefits.

We also recommend that the entity carefully consider the timing of any decision to reclassify any worker as an employee. We recommend that any decision to reclassify a physician currently providing services from an independent contractor to an employee take effect on January 1. A January 1 effective date will eliminate the possibility that the physician will receive an IRS Form 1099 (given to independent contractors) and an IRS Form W-2 (given to employees) in the same year, for the same services, which could trigger an audit. Changing the physician's status mid-year could also have an adverse tax effect on the physician.

7. Alternative Dispute Mechanism

Some entities have chosen to continue to classify workers who provide any form of services as independent contractors, until such time as that classification is challenged by the IRS. If the IRS requires such a change in any worker's status, and the entity disputes that reclassification, the entity should consider taking advantage of the Service's Classified Settlement Program (CSP).

On March 6, 1996, the IRS announced that it would establish a CSP, which is an alternative dispute resolution procedure designed to provide a taxpayer undergoing an audit and the IRS a forum to resolve the issue of whether a particular worker is an employee or an independent contractor.

If, during an audit, an IRS agent challenges the classification of a particular worker, the taxpayer may choose to take advantage of the CSP in order to resolve the dispute rather than challenge the classification in court. Participation in the CSP is voluntary and the CSP is currently limited to taxpayers who are involved in a worker classification audit. Since the CSP is a relatively new program, it is too early to tell whether it is a viable means of resolving this dispute. On one hand, the CSP is administered by the IRS and may tend to favor the IRS' classification. On the other hand, the Service may be more inclined to reach a reasonable resolution of the dispute,

since resorting to the CSP will not affect a taxpayer's right to go to court to challenge the reclassification.

8. Application to the Stark Bill and the Anti-Kickback Statute

The tax code is separate and apart from either the Stark bill or the Anti-Kickback Statute. Nonetheless, when interpreting the applicability of the Stark employment exceptions and the Anti-Kickback employment safe harbors, CMS and the OIG, respectively, will use the new test that is described in IRS Pub. 15-A. Therefore, if the IRS would consider a physician to be an employee, then the OIG and CMS will follow the employment-related provisions when interpreting their respective laws.

Hospitals should consider this fact prior to characterizing any worker as an independent contractor since the OIG and CMS provide greater flexibility in the compensation arrangements that may be used with employees than the regulations permit when contracting with an independent contractor. Physician groups should consider that characterizing a physician as an independent contractor may have billing implications (See 42 C.F.R. §424.80 and Section 3060.3 of the Medicare Provider Manual). In addition, the use of independent contractors, who are not owners of the group, to provide more than 25% of the group's total patient care services will adversely affect the group's ability to satisfy the Stark definition of a "physician group" (See 42 C.F.R. §411.352 (d)(1)).