



What's Up Doc? Employee or Not?

© 2009 Edward K. Zollars, CPA
Ed Zollars' Tax Update
April 25, 2009

The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.

The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.

This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.

I. Is a Professional An Employee?

This week we look at the Tax Court's ruling in the case of *Maimon v. Commissioner*, TC Summary Opinion 2009-53 where a physician facing significant legal expenses he paid personally argued that, despite reporting in prior years, he was not truly an employee of the professional corporation of which he held shares. The case is somewhat unique because Dr. Maimon was not an officer of the organization, which most often is what torpedoed such claims before the case even begins—but it still in the end didn't save Dr. Maimon, as the Tax Court walks through the various criteria to determine if Dr. Maimon is an employee or not.

The Court outlines all of the general criteria to be considered when the issue of whether or not someone is an employee arises.

II. Why the Issue Matters

The tax law has a number of factors that can make being an independent contractor rather than employee attractive to an individual. In today's case, the major problem facing our physician is the different treatment of trade or business deductions that are incurred as employee.

Both employees and nonemployees generally qualify for deductions for business

expenses under §162. However §62, which defines what is included in adjusted gross income immediately makes a distinction between these two classes of individuals:

(a) General rule

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions

The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

So an employee, unlike others, cannot take trade or business deductions as a deduction in computing adjusted gross income. But matters get worse than that quickly, as this deduction falls into the less than optimal category known as miscellaneous itemized deductions.

In §67 we find the 2% haircut on miscellaneous itemized deductions. Miscellaneous itemized deductions are defined by what they are not. In §67 there is a list of itemized deductions that aren't considered miscellaneous itemized deductions—and employee business expenses aren't in that list. As well, since it only affects itemized deductions, anything "blessed" in §62 to be allowed in computing adjusted gross income also doesn't get impacted—but, again, employee's trade or business expenses are not so blessed.

And to add insult to injury, we find in IRC §56(b) the following issue related to computing alternative minimum taxable income:

(b) Adjustments applicable to individuals

In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax):

(1) Limitation on deductions

(A) In general

No deduction shall be allowed--

(i) for any miscellaneous itemized deduction (as defined in section 67(b))...

Thus employee business expenses face the following basic problems compared to expenses incurred by a non-employee:

- They do not reduce adjusted gross income, which impacts a number of phase-outs and limitations in the tax law
- The taxpayer must be able to itemize deductions to get any benefit. If the taxpayer otherwise has insufficient itemized deductions, a portion or all of the employee business expenses that would be deductible will be used to absorb the standard deduction the taxpayer would otherwise get regardless of the expenses being incurred
- The expenses are subject to the 2% haircut on miscellaneous itemized deductions. If the taxpayer does not otherwise have enough miscellaneous itemized deductions to clear the 2% limit, then some of the employee business expenses are lost getting to that 2% limit
- The taxpayer may find that the expenses, if significant enough to clear the prior two hurdles may cause him/her to bump into the alternative minimum tax. That's especially true for taxpayers coming from high tax states.

These were the issues facing our physician in today's case.

III. Lawsuits are Costly...

Dr. Maimon ran into certain legal difficulties relating to his medical services, requiring him to obtain legal services that were not paid for by the practice and eventually to pay a significant settlement. The facts are outlined by the Tax Court:

During 2004 petitioner paid legal fees of \$22,155 in connection with a lawsuit filed against him, among others, for medical negligence. In 2004 petitioner settled the lawsuit for \$1.4 million with his malpractice insurer's agreeing to pay \$400,000 and petitioner's agreeing to pay \$1 million. Petitioner paid the \$1 million settlement during 2005. During 2004 petitioner paid membership dues of \$440 to the American College of Surgeons Professional Association. Petitioner reported total expenses of \$24,615, consisting of legal fees of \$24,175 and professional dues of \$440, on the Schedule C.

In September 2006 petitioner requested that DHN issue an amended Form W-2 for 2004. DHN's business manager informed petitioner that the issuance of an amended Form W-2 was not appropriate, and petitioner did not receive the requested amended Form W-2 from DHN. For the years 2001 to 2003 and 2005 to 2006 petitioner received Forms W-2 from DHN reporting his compensation as "Wages, tips, other compensation" and the withholding of Federal, State, and local income taxes and Social Security and Medicare taxes. For 2001 to 2003 petitioner reported the compensation received from DHN on Form 1040, line 7, "Wages, salaries, tips, etc.", on Form 1040 and did not file a Schedule C with his returns. For 2005 petitioner reported the compensation received from DHN on line 7 "Wages, salaries, tips, etc." and attached a Schedule C to the return. The Schedule C did not report any gross receipts or sales but claimed expenses of over \$1 million, including the \$1 million

settlement payment for the medical negligence lawsuit. For 2006 petitioner attached a Schedule C to his return and reported gross receipts and sales of \$507,944, which is \$50 less than the amount shown as compensation on his Form W-2 from DHN and claimed expenses of \$992. Petitioner checked the box on line 1 of the 2006 Schedule C to incorrectly indicate that his Form W-2 identified him as a statutory employee.

While somewhat inconsistent in reporting, the goal was move the expenses up above the line, which the doctor did for each year from 2004 through 2006, despite the fact that the practice did not agree with him that a W-2 was inappropriate.

You may wonder about this being a Summary Opinion case—that's because only 2004 is at issue in this particular decision. But clearly the treatment of our physician as an employee or not has implications for his other years. So it's useful to look at the conclusions the Court came to when looking at 2004.

IV. What is An Employee?

The Tax Court outlines the basic tests for what is an employee as follows:

Factors that are relevant in evaluating whether a worker is a common law employee or an independent contractor include: (1) The degree of control the principal exercised; (2) which party invests in work facilities the worker used; (3) the worker's opportunity for profit or loss; (4) whether the principal can discharge the worker; (5) whether the work is part of the principal's regular business; (6) the permanency of the relationship; and (7) the relationship the parties believed they were creating. *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263, 270 (2001); *Weber v. Commissioner*, supra at 387. All of the facts and circumstance of each case are considered, and no single factor is dispositive. *Ewens & Miller, Inc. v. Commissioner*, supra at 270.

The doctor did get one break right way—corporate officers are, by definition, employee of the corporation they perform services for as an officer [§3121(d)(1), §3401(c)]. The Tax Court didn't buy the IRS claims that Dr. Maimon was an officer:

Although petitioner agreed in his employment and shareholder agreements to serve as an officer, petitioner credibly testified that he did not in fact serve as an officer during 2004. Neither the shareholder nor the employment agreement assigned any official responsibilities to petitioner. Respondent has not identified any such duties assigned to petitioner.

So the Tax Court took a look at various aspects of the common law test to determine whether Dr. Maimon was an employee.

A. Degree of Control

The Court started with the first test it outlined to determine Dr. Maimon's status.

It first looked at the degree of control exercised by DHN (the professional corporation) over Dr. Maimon's work. The court explained:

While no single factor is dispositive, the degree of control the alleged employer exercised over the details of the work is the "crucial test" in determining employment status. *Weber v. Commissioner*, supra at 387. An employment relationship exists where the principal has the right to control the details, manner, or method of the individual's work. Sec. 31.3121(d)-1(c)(2), Employment Tax Regs. In contrast, an independent contractor is hired to accomplish a specific result, and the principal has the right only to specify the result it desires. Id. It is not necessary for the principal to actually exercise control; it is sufficient if the principal has the right to control. *Weber v. Commissioner*, supra at 387; *Potter v. Commissioner*, T.C. Memo. 1994-356. The employer need not stand over the individual and direct every detail of the individual's work. *Weber v. Commissioner*, supra at 388.

Dr. Maimon complained that state law prevented the corporation from exercising control over him. He noted:

Petitioner maintains that Ohio State law prohibits DHN from exercising control over him in matters relating to patient care and treatment. See Ohio Rev. Code Ann. sec. 1785.03 (LexisNexis 2004). DHN did not control or supervise petitioner's medical judgment, including patient diagnoses, what medications to prescribe, or what treatments or procedures to perform. Petitioner had discretion to schedule the length of his patient appointments, to consult with physicians outside of DHN, and to determine whether to continue to treat a patient. Petitioner also maintained the ability to choose outside pathologists, laboratories, and other medical services and to choose the hospitals or surgical centers where he would maintain hospital privileges. Petitioner also chose the hospital personnel to assist him, but neither petitioner nor DHN paid the hospital staff.

However, the Court noted that the level of control isn't specified in its test, and the level of control has to be adapted to deal with the specific type of services being rendered.

The degree of control necessary to find employee status varies with the nature of the services the worker provides. See *Ewens & Miller, Inc. v. Commissioner*, supra at 270; *Youngs v. Commissioner*, T.C. Memo. 1995-94, affd. without published opinion 98 F.3d 1348 (9th Cir. 1996). The threshold level of control necessary to find employee status is lower when applied to professional services than when applied to nonprofessional services. *Profl. & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 234 (1987), affd. 862 F.2d 751 (9th Cir. 1988); *James v. Commissioner*, 25 T.C. 1296, 1301 (1956). An alleged employer's control over professional services "must necessarily be more tenuous and general than the control over nonprofessional employees." *James v. Commissioner*, supra at 1301.

And, applying that test, it found that DHN exercised control sufficient to have this test fall into the "employee" category.

We do not agree that petitioner was not subject to DHN's control. Petitioner was required to work 4-1/2 days during office hours DHN set. Although petitioner chose his half-day off, he did not have the flexibility in his schedule that is indicative of an independent contractor. The employment agreement provided that petitioner would render medical services "under the supervision of the physician members" of DHN. Petitioner agreed that all patients belonged to DHN and was required to submit patient records to DHN for billing and insurance purposes. Petitioner did not provide medical services outside of his relationship with DHN.

Although petitioner exercised his medical judgment when rendering medical services, his methods were directed by professional standards set by the medical community. Because of the lower measure of control applicable to professionals, the fact that DHN did not control his patient diagnoses and treatments does not preclude a finding that DHN exercised sufficient control over petitioner to establish an employment relationship. See *James v. Commissioner*, supra; *Chaplin v. Commissioner*, T.C. Memo. 2007-58. We find that DHN had a right of control over petitioner sufficient to find an employment relationship.

B. Investment in Facilities

DHN appeared to have made a significant investment in the facilities and supporting staff necessary for Dr. Maimon's medical practice. The Court noted:

The fact that a worker provides his own equipment indicates independent contractor status. *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. at 271. Petitioner provided medical services only at offices DHN leased and at hospitals or surgical facilities where he had staff privileges. The employment agreement provided that DHN would pay for petitioner's hospital staff dues. Petitioner did not provide medical services outside of facilities provided or paid for by DHN. DHN also provided clerical, central billing, and purchasing staff.

Dr. Maimon did claim that the situation wasn't totally one sided, but the Court continued:

Petitioner testified that he provided some specialized equipment that he used to treat patients. However, DHN also leased medical, communications, and computer equipment and other fixtures for use in its office locations. Similarly, the hospitals and medical centers where petitioner performed procedures provided necessary equipment. Petitioner did not quantify his investment in equipment relative to DHN's. Any investment by petitioner is offset by DHN's investment in office locations and equipment and payment of hospital dues. Moreover, petitioner did not use the equipment to provide medical services for a fee outside of his relationship with DHN.

This factor supports employment status.

So this factor again leans in favor of finding that Dr. Maimon was an employee of the corporation.

C. Opportunity for Profit or Loss

Individuals who are in business for themselves, as opposed to being an employee, face a real opportunity both to enjoy the profits of their work and risk bearing the brunt of losses. As the Court notes:

An opportunity for profit or loss indicates nonemployee status. *Simpson v. Commissioner*, 64 T.C. 974, 988 (1975). On the other hand, earning an hourly wage or fixed salary indicates an employer-employee relationship exists. *Kumpel v. Commissioner*, T.C. Memo. 2003-265.

The Court found this factor actually weighed in favor of finding that Dr. Maimon was an independent contractor—remember he got nailed for a \$1 million award so he truly had a risk of loss.

Pursuant to the employment agreement, petitioner agreed that DHN was entitled to any fees arising from his medical services. The employment agreement guaranteed petitioner a base salary regardless of the number of patients he saw or the amount of medical fees he generated. There was no requirement to generate a certain level of patient fees to receive a bonus or an increase in base salary. Rather, petitioner received bonuses based on the annual net profits of DHN and not on the amount of medical fees he personally generated. The employment agreement provided that each shareholder physician would receive the same amount of total annual compensation. If petitioner increased the amount of medical fees he generated, the increase would be shared equally by all the doctors at DHN. His opportunity for profit was as a shareholder of DHN rather than from rendering medical services. Further, petitioner did not perform any medical services for a fee outside of his relationship with DHN where he could have an opportunity for profit.

Petitioner had some risk of loss as a shareholder of DHN if DHN operated at a loss. The fact that petitioner incurred an individual loss on the settlement was a business decision he made, but it supports a finding that he held a risk of loss. Therefore, this factor on the whole favors independent contractor status.

D. Right to Terminate the Relationship

Generally, the right of either party to terminate the relationship at will suggests an employment relationship. The Court explains:

In determining employment status, courts consider the manner in which the

relationship can be terminated; i.e., by one or both parties, at any time, with or without notice. *Ewens & Miller, Inc. v. Commissioner*, supra at 273. The right to discharge a worker, and the worker's right to quit, at any time indicate employee status.

The Court went on to look at the relationship between Dr. Maimon and DHN.

Under the terms of the shareholder and employment agreements DHN had the right to discharge petitioner by vote of all except one of the shareholders with or without cause and without notice. Upon termination, DHN would be required to pay petitioner a "wage continuation payment" of \$120,000 for his prior services to DHN. Similarly, petitioner could terminate his relationship with DHN with or without cause although he was required to give 60 days' notice of his resignation. A unilateral notice requirement on the part of the worker does not support independent contractor status. *Chaplin v. Commissioner*, supra (notice requirement did not indicate employee status). But see *Levine v. Commissioner*, T.C. Memo. 2005-86 (notice by alleged employer supports independent contractor status).

Petitioner's right to receive a wage continuation payment upon termination is at best a neutral factor. The employment agreement provided that the payment would be for past services. It would not constitute a payment for breach of contract or petitioner's right to perform future services under the contract. Both parties to the employment agreement had the right to terminate the relationship with or without cause, and DHN could terminate the relationship without notice. This factor supports a finding of employment status.

The fact that Dr. Maimon could be terminated by the other members of the firm without notice (albiet, only with a unanimous vote to oust him) made this look like a standard employment at will situation, rather than a contractual arrangement that a truly independent contractor would have entered into.

E. Integral Part of the Business

This factor was one that the Court deals with very quickly, since it's fairly clear that physicians are somewhat important to handle a medical practice.

Integration of a worker's services into the business operations of the alleged employer indicates employee status. DHN is in the business of providing medical services. Petitioner, as a physician member, is integrally involved in that business. This factor supports a finding that petitioner was an employee of DHN.

The situation might have been different if, say, the individual was an accountant in the medical practice.

F. Permanency of the Relationship

Those of us in practice know that clients come and go, and we don't necessarily expect a permanent relationship with each client (even though some may be with us for years). Many clients come in to handle a specific problem, and once the problem is addressed there's no expectation the client will continue to provide work. Employees do expect the relationship to be at least somewhat permanent—the employee will work, generally exclusively, for the employer on a continuing basis.

In this case, the Court found such an expectation of a permanent relationship:

A continuing relationship indicates an employment relationship while a transitory relationship weighs in favor of independent contractor status. *Ewens & Miller, Inc. v. Commissioner*, supra at 273. The parties' contemplation of a continuing relationship indicates an employment relationship. *Ellison v. Commissioner*, 55 T.C. 142, 155 (1970). In contrast, a relationship established to accomplish a specified objective is indicative of an independent contractor relationship. *Id.*

In his pretrial memorandum petitioner acknowledged that the doctors at DHN intended a long-lasting relationship but argues this fact is not significant. Petitioner had a long-term relationship with DHN. He joined DHN as a shareholder in 1999. The employment agreement contemplated an initial 3-year term with automatic 1-year renewals thereafter. Given the continuing nature of the relationship, this factor supports a finding of employee status.

G. Intent of the Parties

In this case, until the expenses arose both Dr. Maimon and DHN believed this was an employer/employee relationship. DHN continued to consistently operate under that belief and the Court notes:

The parties clearly intended to create an employment relationship. The employment agreement expressly identified petitioner as an employee of DHN. DHN reported petitioner's compensation on Form W-2 and withheld income, Social Security, and Medicare taxes consistent with this expressed intent. Petitioner did not make quarterly estimated tax payments. For the years 2001 through 2003 DHN similarly reported petitioner's compensation on Forms W-2 and withheld taxes. For these years petitioner reported his compensation from DHN as wages on line 7 of his Forms 1040 and did not report the income or his expenses on Schedule C as he did for 2004.

DHN provided employment benefits to petitioner, including paid vacation and holidays, medical and disability insurance, participation in a retirement plan, and malpractice insurance. DHN also agreed to reimburse petitioner for the cost of continuing education classes. Petitioner did not include in gross income DHN's contributions to his retirement account. DHN refused to issue an amended Form W-2 to petitioner to

indicate that he was a statutory employee. This factor supports a finding of an employment relationship.

As was noted, even Dr. Maimon in many aspects continued to act as if he was an employee.

H. Conclusion

Not surprisingly, the Court found that Dr. Maimon was an employee:

We find that petitioner is a common law employee of DHN. Petitioner entered into a contract with DHN that expressly identified him as an employee. Consistent with that intent, petitioner received a fixed salary without regard to the medical fees he generated, received paid vacations, employee benefits, and reimbursement for expenses, participated in an employee retirement plan, and received Forms W-2 reporting his compensation. Petitioner was required to work normal office hours, maintained a long-term relationship with DHN, and did not perform medical services for a fee except for his DHN patients. DHN provided his office space, paid for hospital staff privileges, and provided a substantial portion of his medical equipment. Petitioner accepted his employee classification with DHN for prior years as defined in the employment agreement but sought to change that treatment once faced with the enormous expense from the employment-related lawsuit and settlement in 2004 and 2005. The fact that petitioner was a medical professional with discretion to exercise his professional judgment in patient care and treatment does not negate the strong evidence that shows that he was a common law employee of DHN.

As a common law employee, petitioner must report his compensation from DHN on Form 1040, line 7 and is not entitled to deduct the claimed business expenses on Schedule C. He must claim the expenses on Schedule A as unreimbursed employee business expenses subject to the 2-percent limitation for miscellaneous itemized expenses.

In his case, the key issue was the fact that he was going to lose the entire deduction for legal fees in 2004, but as noted earlier there can also be issues with taxpayers who face the alternative minimum tax and will lose any benefit.

V. Lessons

This case probably represents a case that had extremely bad facts for the good doctor, but was interesting because the Court did not simply dismiss his claim out of hand but rather actually analyzed the claim in its full detail.

That said, a number of bad facts did present themselves here, not the least of which being that Dr. Maimon had not previously objected to being treated as employee in prior years, took advantage of benefits only open to employees and then ended up

reporting on his return as a “statutory employee” at one point, even though he clearly failed to meet those requirements. Tax positions that are inconsistent from year to year and seem driven primarily by the tax benefit of the moment (or, in last week’s appellate decisions in *United States v. Fletcher*, CA7 and *Bassing v. United States*, CA-FC, changed views of transactions with the benefit of hindsight) don’t tend to fare well in court.

As well, the fact that the corporation itself refused to revise its information reporting for Dr. Maimon also did not bode well—but does seem to indicate that someone noticed that if the corporation had gone along with his request, it would have had its own potential exposures.

The court doesn't go into much detail about why Dr. Maimon was paying these fees, though it hints he did so based on a “business decision” that, it might be inferred, was “suggested” by the other physicians in the group. Clearly, ignoring the tax aspects, it would not seem normal to expose oneself to the expense of litigation and ultimate settlement voluntarily, so there likely are other facts that may also have entered into the corporation's unwillingness to go along with the good doctor's proposed treatment.

So how do we solve this problem?

Well, if the parties had agreed to have the corporation handle the defense and pay for the eventual settlement, the tax result would have been much better. Employers are allowed to pay for business expenses legitimately incurred by employees in handling the business of the employer (a working condition fringe [IRC §132(a)(3)]). As well, under an accountable plan the employer could have reimbursed the expenses even if the doctor had originally paid for the expense himself [IRC §62(c)].

Note that neither type of benefit is subjected to any nondiscrimination requirement in the IRC, so the benefit could have been limited to the owners in general or even just the one doctor in particular. However, care must be taken not to handle this the equivalent of a cafeteria benefit, where the worker defers taking salary in a dollar for dollar reduction of salary. Crossing over that line runs afoul of the constructive receipt doctrine that is only sidestepped for the specific benefits listed in §125.