



# What's News in Tax

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## Employee or Not—Understanding and Appreciating the Common Law Test in a New Tax Paradigm

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The common law test for determining whether an individual is an employee or independent contractor is relevant for a variety of purposes extending well beyond the withholding of employment taxes. Now the reach of the test is further, affecting the new 20 percent deduction, tax on exempt organization excess executive compensation, and global intangible low-taxed income calculation.

Following changes made by the law referred to as the Tax Cut and Jobs Act of 2017 (“TCJA”)<sup>1</sup>, the common law test has become relevant to the application of a variety of new tax paradigms, including, but not limited to, sections 199A and 4960<sup>2</sup> as well as the extension of U.S. rules to the calculation of GILTI (“global intangible low-taxed income”) under section 951A. In particular, the new rules under section 199A, which permit an owner of a sole proprietorship, S corporation, or partnership to deduct up to 20 percent of the income earned by the business, and section 4960, which imposes an excise tax on certain remuneration and excess parachute payments, both incorporate the definition of common law employee.

For additional information related to section 199A, see [“KPMG report: Analysis and observations of final section 199A regulations”](#) and section 4960 see [“Interim Guidance on Taxing “Excess” Executive](#)

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<sup>1</sup> P.L. 115-97.

<sup>2</sup> Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

[Compensation of Exempt Organizations](#)” by Robert W. Delgado, Preston J. Quesenberry, and Randall S. Thomas. As the federal income tax treatment under these provisions is linked to the common law definition of employee, it is important to understand the common law employment rules.

This article summarizes existing guidance used to determine whether an individual is an employee or independent contractor under the common law test. This guidance is also used to determine if a particular entity is an employer as well as which entity receives a deduction and/or is subject to a deduction limitation or excise tax in certain scenarios.

## What Is the Common Law Test?

As noted by the Supreme Court, when a statute uses the term “employee” without defining it, Congress is presumed to have intended to apply the common law test.<sup>3</sup> However, the common law test has been incorporated into a number of different provisions of the Internal Revenue Code. For example, with respect to social security tax withholding for employees, section 3121(d)(2) defines an employee as any individual who, under the common law rules applicable in determining the employer-employee relationship, has the status of an employee. Although section 3401, which defines terms related to federal income tax withholding, does not contain a definition, the regulations under section 3401 incorporate the common law test.<sup>4</sup>

Generally, an individual is an employee if, under the common law test, the relationship between the individual and the person for whom the services are provided is the legal relationship of employer and employee.<sup>5</sup> The employer-employee relationship exists if the person for whom the services are rendered has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the work is accomplished.<sup>6</sup> It is not necessary that the employer actually direct or control the manner in which the services are performed, it is sufficient that he or she has the right to do so.<sup>7</sup> Whether an individual is an employee or independent contractor is determined based on all the facts and circumstances.<sup>8</sup>

## What Facts are Relevant to the Common Law Test?

Following a number of court cases involving the determination of an individual’s status as an employee and an entity as an employer, the IRS developed a list of 20 factors to use in analyzing a particular situation.<sup>9</sup> No one factor is determinative, and the importance of a particular fact may depend on the occupation and factual context.<sup>10</sup> Generally, all facts and circumstances are taken into account.

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<sup>3</sup> [Nationwide Mutual Ins. V. Darden](#), 503 U.S. 323 (1992).

<sup>4</sup> See section 31.3401(c)-1.

<sup>5</sup> Section 31.3121(d)-1(c)(1).

<sup>6</sup> Section 31.3121(d)-1(c)(2).

<sup>7</sup> *Id.*

<sup>8</sup> Section 31.3121(d)-1(c)(3).

<sup>9</sup> Rev. Rul. 87-41.

<sup>10</sup> *Id.*

The 20 factors identified by the IRS are illustrated by the following questions:

20 Factors under the Common Law Test	
Instructions	Is the worker required to comply with employer's instructions about when, where, and how to work?
Training	Is training required? Does the worker receive training from or at the direction of the employer? (This includes attending meetings and working with experienced employees.)
Integration	Are the worker's services integrated with activities of the company? Does the success of the employer's business significantly depend upon the performance of services that the worker provides?
Services Rendered Personally	Is the worker required to perform the work personally?
Hiring, Supervising, and Paying Assistants	Does the worker have the ability to hire, supervise, and pay assistants for the employer?
Continuing Relationship	Does the worker have a continuing relationship with the employer?
Set Hours of Work	Is the worker required to follow set hours of work?
Full-time required	Does the worker work full-time for the employer?
Work on Employer's Premises	Does the worker perform work on the employer's premises and use the company's office equipment?
Order or Sequence	Does the worker perform work in a sequence set by the employer? Does the worker follow a set schedule?
Oral or Written Reports	Does the worker submit regular written or oral reports to the employer?
Payment	How does the worker receive payments? Are there payments of regular amounts at set intervals?

Payment of Business and Travel Expenses	Does the worker receive payment for business and travel expenses?
Tools and Materials	Does the worker rely on the employer for tools and materials?
Significant Investment	Has the worker made an investment in the facilities or equipment used to perform services?
Profit or Loss	Is the payment made to the worker on a fixed basis regardless of profitability or loss?
Working for More Than One Firm	Does the worker provide services for one employer at a time?
Availability to the General Public	Are the services offered to the employer unavailable to the general public or does the worker offer services to the general public?
Right to Discharge	Can the worker be fired by the employer?
Right to Quit	Can the worker quit work at any time without liability?

More recently, the IRS has grouped the 20 factors into three categories.<sup>11</sup> These three categories include the following:

### *Behavioral Control*

The right to control under the common law requires only such supervision as the nature of the work requires.<sup>12</sup> The key fact to consider is whether the business retains the right to direct and control the worker in how the worker performs the specific tasks for which the worker is hired, regardless of whether the business actually exercises that right.<sup>13</sup> Facts that show behavioral control include the type and degree of instructions given to the worker and the training the business gives the worker.<sup>14</sup>

### *Financial Control*

The financial control factor concerns whether an entity retains the right to direct and control how the business aspects of the worker's activities are conducted.<sup>15</sup> Financial control is demonstrated by

<sup>11</sup> Gen. Info. Ltr. 2012-0069; FSA 200127004; Department of the Treasury, Internal Revenue Service, Independent Contractor or Employee? Training Materials, Training 3320-102 (10-96).

<sup>12</sup> FSA 200127004.

<sup>13</sup> *General Investment Corp. v. United States*, 823 F.2d 337, 341 (9th Cir. 1987).

<sup>14</sup> FSA 200127004.

<sup>15</sup> *Id.*

whether the worker has a significant investment, whether the worker incurs significant unreimbursed expenses in the business, whether the worker provides services to the relevant market, the method of paying the worker, and the worker's opportunity for profit or loss.<sup>16</sup>

### *Relationship of the Parties*

This factor is demonstrated by how the parties perceive their relationship.<sup>17</sup> Relevant facts include information showing the intent of the parties with respect to their relationship, such as the specific contracts, and whether the parties were free to terminate their relationship at will.<sup>18</sup> A mere contractual designation, in and of itself, is not sufficient evidence to determine worker status.<sup>19</sup> In close cases, however, the intent of the parties is an effective way to resolve the issue.<sup>20</sup>

## Are There Any Special Situations Involving Employment Status?

There are a number of special situations involving employment status worth a few comments:

### *Officers*

Corporate officers are generally considered statutory employees for purposes of withholding for federal income tax, social security, and Medicare unless they perform no or very minor services and receive no remuneration.<sup>21</sup>

### *Partners*

Whether an individual is an employee with respect to a partnership for whom the individual performs services is determined under the common law test.<sup>22</sup> However, the IRS view is that a partner cannot be both an employee and a partner of the same entity.<sup>23</sup>

### *Multi-Party Arrangements and Affiliated Groups*

In some situations, there may be more than one entity that controls different aspects of the employment relationship. For example, one entity within the group may control the payment of wages, whereas another entity within the group may direct day-to-day activities of the workers. In these types of situations, the entity that operates the withholding and reporting be the statutory employer under section 3401(d)(1) or an agent appointed by the employer, but may not be the common law employer, and the particular factual situation may need to be examined to determine the employment relationship.<sup>24</sup>

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Professional & Executive Leasing v. Commissioner*, 89 T.C. 225 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988).

<sup>20</sup> *See Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216 (Ct. Cl. 1965).

<sup>21</sup> *See* sections 3121(d), 3306(i), and 3401(c); section 31.3121(d)-1(d)-1(c). *See also* CCA 200009043.

<sup>22</sup> *See* sections 31.3401(c)-1(e); 31.3121(d)-1(a)(3).

<sup>23</sup> *See, e.g.*, Rev. Rul. 69-184, GCM 34173, and CCA 200117003.

<sup>24</sup> *See* section 3401(d)(1). An agent is appointed by using Form 2678. *See also* Rev. Proc. 2013-39, Gen. Info. Ltr. 2005-0211.

## Conclusion

The determination of whether an individual is an employee, or which entity is the employer, is an important determination for a variety of different federal income and employment tax purposes. As noted above, this determination is often made by using the common law test and a thorough examination of the relevant facts and circumstances is necessary to reach a conclusion under the common law test with an impact extending well beyond withholding taxes in the new tax paradigms of sections 199A, 4960, and GILTI.

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