Administrative Bulls in the Delicate China Shop of Motor Carrier Operations — Revisited

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I. INTRODUCTION

In 1966, an extensive analysis of the actions of the National Labor Relations Board[1] in determining whether certain personnel engaged by motor carriers in their operations[2] were employees or independent contractors in the context of the National Labor Relations Act[3] was undertaken.

The title "Administrative Bulls in the Delicate China Shop of Motor Carrier Operations" was chosen because research and reflections led to the belief that the NLRB was charging into the industry's operations in such a manner as to cause considerable confusion, concern, and in some instances havoc.

The recent decision in *North American Van Lines, Inc. v. National Labor Relations Board*[4] indicates that the "China Shop" is still being visited by the NLRB. Of more concern in the industry today, however, are the recent activities of the Internal Revenue Service[5] as they address the same issues in the context of employment taxes.[6]

While many in the industry believe this activity to be new, it is more appropriate to characterize it as reinvigorated.[7] The issue of "employee" v. "independent contractor" has a long and controversial history and there are numerous decisions and/or rulings by courts[8] and the

1. Hereinafter, "NLRB".

2. The personnel situation studied was that of "owner-operators" who for purposes of that article and this paper can be defined as a driver who controls or owns and drives a tractor or a tractor-trailer unit which is leased to the motor carrier and who provides incidental service thereto. Singer and Hardman, *Administrative "Bulls" In The Delicate China Shop of Motor Carrier Operations*, 17 LAB L. J. 584 (1966).

3. 49 Stat. 449 (1935), 20 U.S.C. §§ 155-166 (1958), as amended, 61 Stat. 136 (1947), 29 U.S.C. §§ 141-144 (1958).

4. 869 F.2d 596 (D.C. Cir. 1989).

5. Hereinafter, "IRS".

6. The issue also arises in other areas of the law, including employee fringe benefits, unemployment compensation, workers' compensation, wage and hour laws, immigration law, and civil rights. In respect to the last area, *see* Dowd, *The Test of Employee Status: Economic Realities in Title 7*, 26 WM & MARY L. REV. 75 (1984).

7. *See*, I.R.S. News Release IR-88-45 announcing the intent to focus on this issue.

8. *See*, the discussion in United States V. Webb, 397 U.S. 179 (1969).

IRS[9] which deal specifically with the relationship within the motor carrier industry.

Many excellent papers have recently been written on the substantive aspects of the legal problem,[10] and legal counsel specializing in motor carrier and tax law have been making an effort to acquaint the motor carrier industry with the issues involved.[11]

It is essential that this type of preventive law be undertaken as the decision of the IRS to reinvigorate its program of auditing individual companies can lead to adverse findings which can have serious consequences.

II. CONSEQUENCES OF MISCLASSIFICATION

A. STATUTORY LIABILITY

If an employee has been erroneously classified as an "independent contractor" the carrier-employer will generally be liable for the full amount of FICA[12] (both employee's and employer's share), FUTA,[13] and income tax withholding.[14]

Liability can be high as the IRS can go back three years when seeking such taxes and can assess penalties and interest in determining the total tax liability.[15]

It has been reported that one major motor carrier was faced with a potential tax liability of $15 million in back taxes. Other carriers have faced more than $1 million in back tax liability. A handy gauge of potential liability is between $25,000 and $50,000 per driver.[16]

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9. *See*, for example, Rev. Rul. 70-441, 1970-2 C.B. 210 and Rev. Rul. 76-226, 1976-1 C.B. 332.

10. *See for example*, Clark, *Independent Contractor-Employee, What Are They — Why?*, a paper delivered at the 1989 Conference Professional Program, Transportation Lawyers Association; and Moore, *Definition of "Employee" — Common Law Rules*, a paper delivered to the 1988 Safety Council Meeting of the Interstate Truckload Carrier Conference of the American Trucking Association.

11. The present paper, for example, is adapted from a speech the author presented to the 1989 Safety Council Meeting of the Interstate Truckload Carrier Conference of the American Trucking Associations.

12. "FICA" refers to taxes due under the Federal Insurance Contribution Act, 26 U.S.C. §§ 3111, 3101, and 3102 (1989).

13. "FUTA" refers to taxes due under the Federal Unemployment Tax Act, 26 U.S.C. § 3301 (1989).

14. *See*, 26 U.S.C. § 3402(a) (1989).

15. *See*, 26 U.S.C. § 3509 (1989).

16. *See*, Schultz, *IRS Crackdown on Carrier Focuses on Owner-Operators*, TRAFFIC WORLD Jan. 21, 1989, at 34.

B. Relief Provisions

1. Safe Harbor Provision

There are, however, certain relief provisions which minimize the extent of exposure a motor carrier may face. Under Section 530 of the Revenue Act of 1978,[17] a safe harbor exits for purposes of FICA, FUTA, and income tax withholding.

An individual may be treated as an independent contractor if these three requirements are met:[18]

1. The individual has been treated consistently as a non-employee;
2. The taxpayer has a reasonable basis for not treating the individual as an employee;[19] and,
3. The taxpayer must not have treated any individuals holding substantially similar positions as employees for purposes of employment taxes for any period after December 31, 1978.

2. Erroneous Classification Relief

The Tax Equity and Fiscal Responsibility Act of 1982 also contains a relief provision for the erroneous classification of individuals as independent contractors.[20]

The Act attempts to see that the tax assessment in a misclassification case is closer to the amount of lost revenue to the Treasury after considering the average tax paid by misclassified workers.[21]

To accomplish this purpose, set percentages are applied to determine the employer's liability for income tax withholding[22] and the employee's share of FICA.[23] No relief is provided for FUTA and the employer's share of FICA nor if the liability is due to the intentional disregard of the requirement to withhold and deposit the taxes.[24]

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17. Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885 (1978).

18. Id. § 530(a)(1). For guidelines interpreting this section see Rev. Proc. 85-18, 1985-1 C.B. 518.

19. This standard is to be liberally construed in favor of the taxpayer. Ridgewell's, Inc. v. United States, 81-2 U.S.T.C. ¶ 9583 (Ct.Cl. 1981) and Rev. Proc. 85-18, 1985-1 C.B. 518. Generally a reasonable basis exists if reliance is based on (1) judicial or administrative precedent including a private IRS letter ruling; (2) a previous audit upholding the classification; or (3) long standing industry practices. The American Institute of Family Relations v. United States, 44 AFTR2d ¶ 79-5042 (D.C. Cir. 1979).

20. 26 U.S.C. § 3509 (1982).

21. Joint Committee on Taxation, *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982*, 385 (1983).

22. 26 U.S.C. §§ 3509(a)(1), 3509(b)(1)(A) (1982).

23. 26 U.S.C. §§ 3509(a)(2), 3509(b)(1)(B) (1982).

24. 26 U.S.C. § 3509(c) (1982).

3. ABATEMENT OF TAX LIABILITY

There are also two provisions for potential abatement of an employer's liability due to a misclassification. Section 3402(d) provides that an employer may offset any income tax paid by the individual against the income tax which should have been withheld and deposited.[25]

Section 6521(a) provides that if the employer paid self-employment tax and the employee is barred from recovering the tax paid, the employer may offset the employee's share of FICA otherwise due the amount paid by the employee.[26]

The abatement procedures, however, do not apply if Section 3509[27] applies.[28]

III. COMPLEXITY OF SUBSTANTIVE LAW ISSUES

The issue of "independent contractor" v. "employee" is not one of minor complexity nor are there any "quick fixes". The principle of law can be boiled down to a simple and brief statement. The difficulty arises in applying it to specific factual situations.

An employee may simply be defined as an individual who performs services for another who has the right to control and direct the individual as to the results desired as well as the details and means by which the results should be accomplished.[29] An independent contractor, on the other hand, is an individual who performs services under an oral or written agreement to benefit another party and to achieve a specified result, but who is not subject to the control or direction of the other party in respect to the details or means by which the result is achieved.[30]

These definitions appear simple enough until one starts to ask questions such as "What does the right to control mean?", and "What type of directions are we concerned with?". The answers to these and other questions are not simple.

Legislators, courts, and administrative agencies have grappled with the distinction between "independent contractor" and "employee" since the early days of administrative regulations.

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25. 26 U.S.C. § 3402(d) (1982).

26. 26 U.S.C. § 6521(a) (1982).

27. 26 U.S.C. § 3509 (1982).

28. 26 U.S.C. § 3509(d)(1)(C) (1982).

29. The definition of an "employee" for federal employment regulation is set forth in IRS Regulations, 26 C.F.R. § 31.3121(d)-1(c) (1988).

30. In IRS Regulations, 26 C.F.R. § 31.3121(d)-1(c) (1988), an independent contractor is differentiated from an employee. In United States v. Webb, 397 U.S. 179, 194 (1969), the Court cautioned the Regulations merely provided a summary or initial guide to the issue and were not intended to displace the common law rules.

A. THE COMMON LAW TEST

The original Social Security Act,[31] when adopted in 1935, defined employees by merely specifying that the term included an "officer of a corporation."[32] Thus, it was thought that the term "employee" was to be given its usual common law meaning.[33]

Various courts, however, in recognizing that the legislation addressed social problems or areas attempted to broaden the coverage to include any individuals who as a matter of economic reality were dependent upon the business to which they rendered service.[34]

The administrative agency also attempted to broaden the scope of coverage until it was stopped by the so-called Gearhart Resolution.[35] The present Federal Employment Tax Regulations,[36] as a result, now embrace the common law test.

B. THE IRS REGULATIONS

Under the Regulations:[37]

1. Each individual is an employee if under the usual common law rules the relationship between him and the person for whom he performs service is the legal relationship of employer and employee.

2. The relationship generally exists when the person for whom the services are performed has the right to control and direct the individual performing the service not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished.

The Regulations refer to some specific factors to consider such as the right to discharge and the furnishing of tools and a place of work.[38] As the Supreme Court cautioned in *United States v. Webb*, however, the Regulations are a brief sketch or summary of relevant factors and were not intended to displace the common law rules themselves.[39]

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31. 49 Stat. 620 (1935)

32. 49 Stat. 620, 647 (1935).

33. *See*, United States v. Webb, 397 U.S. 179 (1969) for a full discussion of the common law rules and the definition of "employee".

34. *See*, United States v. Silk, 331 U.S. 704 (1947) and Bartles v. Birmingham, 332 U.S. 126 (1947).

35. H.R.J. Res. 296, 62 Stat. 438, 1948-2 C.B. 317.

36. Employment Taxes and Collection of Income Tax at Source, 26 C.F.R. Pt. 31 (1988).

37. *See*, 26 C.F.R. § 31.3121(d)-1(c) (1988).

38. *Id.*

39. Webb, 397 U.S. 179 at 194.

C. *Miscellaneous Common Law Criteria and Problems Peculiar to the Motor Carrier Industry*

1. *Right of Control*

If the right of control of the matter or means of performing the work is in the person or entity for whom the service is performed, the relationship almost certainly will be found to be an employment relationship. Under the common law this criterion definitely carries more weight than all the others.[40]

In the context of motor carrier operations, this factor would be evidenced in part by the necessity to comply with operations manuals, to follow certain routes, requiring reports, requiring services to be performed personally, the establishment of set hours of work, and "forced" dispatch.[41]

While the control necessitated by federal regulations such as the Leasing Rules and Regulations[42] and the Safety Regulations[43] has generally not caused difficulties in the area of federal employment taxes,[44] the questions which motor carriers still face evolve around the imposition of service requirements by customers.

The motor carrier industry is highly competitive and in particular segments of it, pickups and deliveries are not only scheduled in terms of the day, the portion of the day involved, *i.e.*, a.m. or p.m., but in terms of a specific hour or portion of it. Missing a scheduled delivery, for example, can subject the carrier to damages for any production downtime incurred by a receiver who does not carry an inventory.

Thus, it is difficult to conduct a business where the individual driving the vehicle has the unfettered right to accept or reject a load which is under customer imposed time restraints and the driver is the only individual with the present ability to handle the load.

Similarly, shippers want to be able to trace their loads while in transit. Carriers must know the position of the vehicles to plan ahead in terms of

40. *See*, Hoosier Improvement Co. v. United States, 350 F.2d 640 (7th Cir. 1965) and Barrett v. Phinney, 278 F.Supp. 65 (S.D. Tex. 1968) (Workers Compensation.)

41. *See*, Rev. Rul. 70-441, 1970 C.B. 210 and Rev. Rul. 69-349, 1969-1 C.B.261. "Forced" dispatch is the practice of requiring a driver to haul a specific load as opposed to giving the driver a choice between loads to be hauled.

42. *Lease and Interchange of Vehicles*, 49 C.F.R. Pt. 1057 (1988).

43. *See*, for example, *Hours of Service of Drivers*, 49 C.F.R. Pt. 395 (1988).

44. Difficulties, however, exist in other areas of the law as courts have not consistently treated governmental regulations in the employee-independent contractor equation. Compare Local 77 v. NLRB, 603 F.2d 862 (D.C. Cir. 1979) (government regulation constitutes supervision by state and not alleged employer) and Transport Motor Express v. Smith, 262 Ind. 41, 311 N.E.2d 424 (1974) (inconsistent to have control required by ICC Regulations and to assert worker is an independent Contractor).

accepting loads, to be available when the equipment unloads, or to be assured that the load in transit has not been hijacked or diverted.

Yet the requirement that a driver handle a load in the circumstances above and/or make daily or periodic reports have traditionally been construed to evidence control.

The smart carrier will recognize that it must meet the competitive realities of the market place or the issue of "employee" or "independent contractor" will be a moot one. Agencies and courts must do likewise.

If "control" is necessitated because of customer demands, and assuming the individual independent contractor is willing to contract to provide certain reports or to handle certain "required" loads, it appears that these factors should not bear on the "employment issue" any more so than government imposed regulations.

2. *Independent Business*

A second factor in the common law test of "employment" is whether the independent contractor is actually operating a viable trade or business.

This involves such questions as whether there is an investment of a substantial sum in equipment or tools, whether the individual bears a risk of loss attributable to the operation, whether the business serves multiple accounts, and whether the business engages employees or helpers in conducting operations.

In terms of motor carrier operations, the IRS probably considers the most significant question to be whether the person has a significant investment in equipment and facilities used in performing services for another.[45]

Individuals who own and furnish trucks they own have no problem meeting this criterion. A relatively new phenomena, however, has been occurring in the motor carrier industry, *i.e.*, carrier assisted equipment acquisitions.

The rising cost of tractors[46] has made it difficult for some individuals to acquire new equipment which is basically required to survive economically. This problem is compounded by the fact that little credit is available to independent contractors because so many have traditionally been poor businesspersons, the success of the business is so dependent upon the individual,[47] and the assets are constantly moving making it difficult to

45. R.L. Moore, Technical Assistant to the Assistant Chief counsel of Employee Benefits and Exempt Organizations, Internal Revenue Service, stated that in his opinion this was probably the most significant factor for the motor carrier industry. Moore, *supra*, Note 10, at 16-17.

46. A new over-the-road tractor will cost from $75,000 to $125,000.

47. Many independent contractors will not allow any other person to drive his or her vehicle.

foreclose, inspect, or otherwise feel "secure".[48]

Carriers, on the other hand, can secure lower prices because of mass purchasing, may have better knowledge of the credit worthiness of the individuals,[49] have an incentive to modernize the fleet,[50] an can feel more secure as they will know if the vehicle is, in fact, being used in potentially profitable operations and generally where it is if repossession is necessary.[51]

A dilemma, however, may exist. The IRS may not feel that the individual's investment is real or adequate.[52] The mere fact that a carrier may finance the equipment, however, should not lead to this conclusion. The real issue is whether the relationship created, whether a conditional sale, a lease-purchase option, or even a true lease, is, in fact, a bona-fide one.

If the carrier is making a reasonable return on its investment, charging commercially reasonable rates of interest and/or lease payments, and, in practice, operating this aspect of its business in a manner similar to an independent dealer or finance company, the independent contractor relationship should not be in jeopardy.

This issue was raised in *North American Van Lines, Inc. v. National Labor Relations Board.* While the agency gave considerable weight to it in deciding the individuals were employees,[53] the Court found that while the practice, as well as some other supportive efforts, had the potential to lead to "control", the facts did not lead to this conclusion nor support the inference of control. The Court noted that financing was done at competitive rates and that the finance contracts were frequently sold to third

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Thus, if an illness occurs, the vehicle may sit idle and few have adequate insurance to cover such business contingencies. *See* Hardman, *Owner-Operator — Do You Have Insurance To Survive a Business Interruption?* TRANSPORTATION TOPICS, 2814, p. 36 (July 10, 1989).

48. A tractor may be operated in any of the 48 contiguous states or Canada and be away from its home base for extended periods of time. A financier has little opportunity to inspect it and to know if it is still operable and operating.

49. As part of the driver certification process, the carrier is obligated to secure information on past driving records, past employment, health information, and references. See generally, *Qualifications of Drivers*, 49 C.F.R. Pt. 391. This information all bears on the issue of credit worthiness.

50. Generally, newer tractors have fewer breakdowns and are available to haul more loads. Normally, the vehicles are more fuel efficient and thus the operator can make a greater net profit in his or her operations and is more satisfied with the contractual relationship.

51. A carrier will know if the equipment has no pickup or delivery scheduled and for business purposes will investigate immediately. An independent financier will not be put on notice until a scheduled payment is missed and may have little information to start a search for the equipment thereafter.

52. *See*, Moore, *supra*, note 10 at pp.17-18.

53. North American Van Lines, Inc., 288 N.L.R.B. No. 11 (1988), 869 F.2d 596 (D.C. Cir. 1989).

parties.[54]

Another criterion in determining whether an independent business exists is whether the individual has control over the factors which will determine whether he or she can make a profit or loss.[55]

In terms of revenue, it is clear that an employee may have the opportunity for higher income based on a piecework or commission basis. Therefore, the test should be a two pronged approach, *i.e.*, the ability to determine to a significant extent how much revenue or income will be deprived, and how much the individual's ingenuity, initiative, and judgment will control costs affording the opportunity for a profit or a resultant loss.

Factors to be considered include whether the individual; (1) has the prerogative to hire and direct helpers or assistants, (2) is responsible for his or her own expenses on the road and determining what expenses will be incurred, (3) has the right to determine what loads will be handled, or how many loads will be hauled, (4) has the right to determine what maintenance will be done on equipment and by whom, and other similar factors.

The issue of serving multiple accounts is also a criterion which arises and is a difficult one motor carriers must face since it is frequently said that a continuing singular relationship indicates that an employer-employee relationship exists.

Yet, motor carriers are faced with market conditions in which a shortage of independent contractors exist. Considerable time and money is spent in advertising and searching for independent contractors.[56] Thus, motor carriers have a substantial interest in establishing an environment in which independent contractors can succeed financially and enjoy contractual relationships with carriers on a continuing basis.

Compounding the problem is the fact that governmental regulations basically preclude "contract hopping". In *North American Van Lines Inc.*, for example, one of the factors discussed was the carrier's restriction on "trip leasing".[57] The Court rightfully found that some of the limits im-

54. 869 F.2d 596 at 604.

55. Moore considers this the second most significant factor. Moore, *supra*, note 4, at pp. 19-20.

56. Dart Transit Company, one of the largest, if not the largest, motor carrier utilizing independent contractors has approximately 15 employees who devote either full or part time efforts to independent contractor relations including recruiting. There are numerous publications which exist only to carry advertisements of carriers for independent contractors and employee drivers. See, for example, "Pro Trucker", a monthly magazine published by Ramp Enterprises, P.O. Box 549, Roswell, GA 30077-0549.

57. North American Van Lines, Inc., 869 F.2d 596 at 604, "Trip" leasing is a procedure whereby a motor carrier with operating authority from the Interstate Commerce Commission can sublease the equipment and operator of that equipment to another similarly authorized motor

posed resulted from government regulations.[58]

The real issue is not whether the individual under contract with a particular carrier can serve multiple accounts with the same vehicle or vehicles under lease, but whether he or she may expand the business and use other equipment in the service of other carriers. If no prohibition exists in respect to the latter alternative, it should be an indication of an independent contractor relationship.

3. INTEGRATION

Closely related to the issue of an "independent business" is the question of whether the motor carrier is so dependent upon the services of the individual under contract that the individual is necessarily subject to control establishing "employment".

In *Morish v. United States*,[59] the Court of Claims found such integration to exist where the plaintiff carrier had a direct financial interest in the diligence and competency of drivers in that the success of his business depended on the driver's success in getting towing jobs and in handling such jobs in a proper manner.

This test, however, is essentially the reverse of the economic reality test used more extensively in other areas of the law[60] and which led to the Gearhart Resolution.[61]

In any business situation, two or more entities which work on a common cause are going to have an integration of interest. If each individual to a business arrangement does a good job, any businessman will argue that the chances of each profiting are maximized.

If it does not work out that way, obviously either party can terminate

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carrier to haul a load or make a "trip". Although prior regulations limited such practices to a single trip, under the present regulations, the lease need not be limited to a single load or trip. See 49 C.F.R. § 1057.22 (1988). Many motor carriers do not engage in trip leasing because of the administrative and operational problems associated with it. For example, a written lease must be executed, an inspection made of equipment, insurance coverage investigated, revenue splits negotiated, miscellaneous paper work exchanged, and ultimately frequent disputes arise between the carriers regarding cargo claims, and motor carriers frequently claim that they have difficulty receiving their share of the revenue.

58. The Interstate Commerce Commission precludes an independent contractor from providing services to any other party while under lease to an authorized motor carrier, 49 C.F.R. § 1057.12(c)(1) (1988) except if the carrier is a household goods carrier. In such instance, the independent contractor and the motor carrier may agree that the contract applies only during the time equipment is operated by or for the authorized carrier lessee. 49 C.F.R. § 1057.12(c)(3) (1988).

59. 555 F.2d 794 (Ct. Cl. 1977).

60. *See*, for example, Secretary of Labor, U.S. Dep't of Labor v. Lauritzen, 835 F.2d 1529 (7th Cir. 1987) (FLSA Action).

61. H.R.J. Res. 296, 62 Stat. 438, 1948-2 C.B. 317.

the relationship after the contract work in question and seek out new joint ventures or opportunities.

While the relationship exists both parties obviously want to induce the other party to do his or her best or as the court stated in *North American Van Lines, Inc.*, ". . . to persuade, convince, and jaw bone drivers into hauling more loads. . . ."[62] This cannot be equated to control creating an employment situation.

As noted in *North American Van Lines, Inc.*, a motor carrier can control an individual's overall performance as opposed to control over the means and manners of performing the task involved without creating an employment relationship.[63]

4. *Right of Discharge*

The right of discharge is also frequently considered an important factor in determining the employment issue.

Allegedly the ever present threat of dismissal would cause an individual to obey instructions and accept control.[64]

Thus, it is frequently cautioned that an agreement attempting to create an independent contractor relationship should be for a specific term, have restraints upon termination, and impose liabilities for termination without cause.[65]

One question which must be raised in the present context of motor carrier operations, however, is whether the carrier's right to terminate a contract "at will" constitutes any real threat since the independent contractor has so many alternative contract opportunities.

The problems a carrier faces with a "long term"[66] contract is that it is basically non-enforceable,[67] the probability of recovering damages for a breach are virtually null,[68] and severe legal or business consequences could arise if the independent contractor could continue to operate during a "notice of cancellation" period.[69]

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62. North American Van Lines, Inc., 869 F.2d 596 at 603.

63. *Id.* at 601.

64. *See*, Moore, *supra*, note 10 at pp.20-21.

65. *See*, Clarke, *supra*, note 10 at pp.7-8.

66. In the motor carrier industry, a "long term" contract was considered one for 30 days or more because the Interstate Commerce Commission in the past required vehicle lease to be for a minimum 30 day period.

67. If an independent contractor breaches the contract, he or she is so mobile it is difficult to trace their presence or, if so, to convince any court that their service is so unique as to require specific performance. It would also be difficult to establish damages or that such damages would be significant enough to justify the cost of litigation.

68. Few independent contractors have any assets which are attachable to satisfy a judgment and because of their mobility, it would frequently be difficult to discover such assets.

69. A discontent independent contractor desiring to terminate the contract could hurt the

The business realities are such that carriers and independent contractors at the present time essentially think of each load as a distinct contract job. The written contract, which sets forth detailed terms and conditions, is thought of as a master agreement which governs the individual agreements to tender and transport a load. Thus, the parties essentially feel that when a trip is completed, either may make the decision whether the relationship should continue.

The above concept is really not inconsistent with an independent contractor relationship assuming it is understood and agreed to by the parties. At the same time, however, it must be recognized that it may be a difficult one for the IRS to accept.

While the above discussion does not touch upon all factors which might be considered in any particular factual situation, the more significant factors have been addressed. It can be seen that they are difficult to apply unless one understands the motor carrier business.

IV. PRESENT IRS APPROACH TO RESOLVING ISSUE

A. THE TWENTY QUESTION TEST

The IRS trains its auditors and its revenue agents to utilize the "Twenty Common Law Factors" compiled by the Social Security Administration in determining whether the requisite control and employment exists.[70] While these factors are helpful in making the determination, one who studies the factors will obviously recognize that some are ambiguous and overlapping and they can be misleading when applied to a particular factual situation. When you finish the "twenty questions", you will also see that in most, if not all instances, factors exist which point to both status and that a judgment factor of significant degree is frequently warranted after all criteria are considered.

These problems are the ones which are of greatest concern to trucking executives. Contrary to what many believe, the IRS has a legitimate reason to be concerned with the issue and, when appropriate[71] to utilize the audit system as a means of carrying out the legitimate mandate it has

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motor carrier's business during such period by making late pickups or deliveries, causing problems at dock locations, and bad mouthing the company among other contractors. If the attitude influenced the independent contractor's driving, accidents and attendant legal consequences to the motor carrier could arise.

70. Rev. Rul. 87-41, 1987-1 C.B. 296. Form SS-8 sets forth the criteria in question form.

71. If tax collection is the predicate of the IRS' reinvigorated audit program, it appears that a carrier which issues and files IRS Form 1099 MISC, 26 U.S.C. 6041A should not be the target of an audit solely related to the issue of employee versus independent contractor. The IRS' remedy for the collection of taxes, if not paid, should lie with the recipient of income. Except for the withholding requirement, the use of IRS Form 1099 MISC is essentially the same as filing W-2 or W-4 forms covering employees in terms of disclosing or identifying tax liability to the IRS.

to collect taxes. There are obvious abuses in industry generally as well as within the trucking segment of it.[72]

The major concern is that the IRS is attempting to use criteria which, because of their general applicability, may, in fact, hinder a fair and effective audit from being achieved.

IRS auditors generally have been young, aggressive, and well meaning individuals, but who lack private work experience and any degree of knowledge about the various industries they audit. Yet, a basic understanding of the industry being audited may be the key to a meaningful and correct audit.

B. Improving the Effectiveness of Audits Through Specific Industry Criteria

Recognizing that the problem of inexperienced auditors is one which is probably insoluble, it would behoove the IRS to attempt to establish criteria based on specific industries which would give more guidance to its auditors and at the same time to the industries involved.

The job is not a monumental one. In fact, much of the work has already been done by some state agencies.[73] In Minnesota, the Department of Labor and Industry has done an excellent job in setting forth guideline criteria for different industries under the Workers' Compensation Act.[74]

The criteria for "Truck Owner/Drivers" reads as follows:[75]

> Subpart 1. DEFINITION. A truck owner-driver is any individual, partnership, or corporation (hereinafter referred to as "individual") who owns or holds a vehicle as defined in Subpart 2 under a bona fide lease and who leases that vehicle together with driver services to an entity which holds itself out to and does transport freight as a for-hire or private motor carrier.
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> Subpart 2. INDEPENDENT CONTRACTOR. In the trucking industry, an owner-operator of a vehicle that is leased and registered as a truck, tractor, or truck-tractor by a governmental motor vehicle regulator agency is an in-

72. It is reported that 98% of the taxes due on traditional businesses which file W-2 and W-4 forms are collected whereas only 15% of taxes are collected from the "underground economy" which includes independent contractors in the trucking industry. Schultz, *IRS Crackdown on Carrier Focuses on Owner-Operators*, TRAFFIC WORLD Jan. 23, 1989 at 24. Similarly, surprising figures exist in other segments of society. In New York, nearly 10% of the 15,745 partners in law firms had not filed state income tax returns for at least one of three years. Only 0.5% of low level employees in the same firms had not done so. *Tax Briefing*, INSIGHT ON THE NEWS, Vol. 5, No. 16, April 17, 1989, at 45.

73. The agencies dealing with unemployment compensation in Minnesota and Wisconsin, for example, have promulgated criteria applicable to specific industries. *See* Department of Economic Security, Employee Taxes, MINN. R. 3315 (1987) and Relationship of Carrier and Contractor Operators, WIS. ADMIN. CODE, § ILHR 105 (1985-1986).

74. Independent Contractor, MINN. R. 5224 (1989).

75. Independent Contractor, MINN. R. 5224.0290.

dependent contractor, not an employee, while performing services in the operation of his or her truck, if each of the following factors are substantially present.

A. The individual owns the equipment or holds it under a bona fide lease arrangement.
B. The individual is responsible for the maintenance of the equipment.
C. The individual bears the principal burden of the operating costs, including fuel, repairs, supplies, vehicle insurance, and personal expenses while on the road.
D. The individual is responsible for supplying the necessary personal services to operate the equipment.
E. The individual's compensation is based on factors related to the work performed including a percentage of any schedule of rates or lawfully published tariff and not on the basis of hours or time expended.
F. The individual generally determines the details and means of performing the services, in conformance with regulatory requirements, operating procedures of the carrier, and specifications of the shipper.
G. The individual enters into a contract that specifies the relationship to be that of an independent contractor and not that of an employee.

Subpart 3. EMPLOYEE. An owner operator of a vehicle as defined in Subpart 2 is an employee, not an independent contractor, while performing services in the operation of the individual's truck, if all of the following criteria are substantially met.

A. The individual is paid compensation for his or her personal services:
   (1) Based solely on wage by the hour or a similar time unit that is not related to a specific job or freight movement.
   (2) on a premium basis for services performed in excess of a specified amount of time; and
   (3) from which FICA and income tax is withheld.
B. The individual is treated as an employee by the firm with respect to fringe benefits offered to employees by the firm.
C. The individual usually works defined hours.
D. The employer requires that the individual must perform the work personally and cannot change drivers.
E. The individual has no choice in the acceptance or rejection of a load.
F. The individual and firm have no written contract; or, if there is a written contract, it does not specify the individual's relationship with the firm as being that of independent contractor.

While no set of criteria can define a person's status definitively, it would give industry personnel a greater comfort level if an audit had the direction given by the Minnesota criteria as opposed to the more generalized twenty question test.

One with experience in governmental affairs knows that it is improba-

ble that the IRS will, in fact, modify its practices and procedures because of its workload and the press of matters pending before it or that if it agreed to do so, that it would occur promptly.

V. Implementing a Preventative Law Program

A. Preaudit Principles

Legal counsel, therefore, should prepare their clients for a "twenty question" audit and recommend that any preventative law program be based on the following principles:

1. *The Commitment of Top Management Must be Secured.* Top management must make the commitment that if the company is to utilize independent contractors, it must accept the status with its disadvantages as well as its advantages. If it wants to have certain controls or be able to give certain directions which are inconsistent with the independent contractor status, it must and should recognize this. Further, it must make its commitment to use independent contractors and the maintenance of such status known to managers and employees. A written policy is an asset, if not a necessity.[76]

2. *The Commitment of Line Management Must be Secured.* The line managers who deal with the independent contractors must not only understand the company policy, but be committed to its implementation.

3. *The Company Community Must be Educated.* All persons, from top management to the lowest level employee must know the basic concepts of an independent contractor relationship and why certain individuals are within that status and how that status affects their dealings.

4. *The Independent Contractor Should be Educated.* Individuals who have assumed the status as an independent contractor must understand what or what not he or she can expect from the company and why various procedures are followed.

5. *An Internal Auditor Should be Appointed.* One individual should

76. The policy of Dart Transit Company, a for-hire motor carrier based in St. Paul, Minnesota, reads as follows:

> Dart Transit Company has a basic belief in the entrepreneurial spirit and feels that its use of independent contractors in the conduct of its business is consistent with that belief.
>
> By adoption of the independent contractor system, Dart intends to create opportunities for individuals to operate their own businesses.
>
> Dart respects the independent contractor and is committed to dealing with them in a fair and equitable manner.
>
> Dart shall seek to assist the independent contractor in achieving economic success and to provide a working relationship which will prove mutually rewarding.
>
> We still subscribe to this policy.
>
> We not only desire to create by contract an independent contractor relationship based on sound, fundamental principles, but we are willing to work diligently to preserve such a meaningful relationship in practice.

be appointed who has the primary responsibility to see that company policy is implemented, to oversee the educational functions, to review forms, procedures, etc., and to monitor day-to-day operations. This individual should be the liaison person with legal counsel.

Over a period of time, employees of the motor carrier will or should inherently deal with independent contractors in a proper context. "Driver" will become "contractor", "pay" will become "contract payment", "discharge" will become "decertification" or "contract termination". These verbal expressions will reflect substantive changes in attitudes and dealings and not a superficiality and the motor carrier client will be well on the way to creating, maintaining, and confirming an independent contractor status.

B. Audit Principles and Procedures

If an audit comes, the motor carrier should be prepared. But there are some additional steps which should be considered:

1. *An official spokesperson for the company should be designated.* This should be a knowledgeable, articulate individual, probably the internal auditor assisted by legal counsel. Other members of the carrier's staff and employees should be instructed to refer inquiries to the designatee and not to answer questions unless requested or authorized to by the company designatee.

2. *Be prepared.* Legal counsel should advise the client what questions it can anticipate will be asked and what documents should be available. The "twenty questions" should be answered and copies of the written answers should be available for reference. When certain things are done in the carriers operation because of government regulations, etc. copies and citations to such regulations should be available.[77] Samples of shipper instituted instructions should also be accumulated and be available[78] if such instructions affect the direction and control imposed on the independent contractor.

3. *Accumulate relevant documents.* Counsel should assure that a sample set of the forms and documents used in conjunction with independent contractors are accumulated and available if an audit occurs.

77. Typical regulations which govern or bear on the relationship between motor carriers and independent contractors include, Lease and Interchange of Vehicles by Motor Carriers, 49 C.F.R. Pt. 1057 (1988); Identification of Motor Vehicles, 49 C.F.R. Pt. 1058 (1988); Minimum Levels of Financial Responsibility for Motor Carriers, 49 C.F.R. Pt. 387 (1988); and, Hours of Service of Drivers, 49 C.F.R. Pt. 395 (1988).

78. These instructions and/or requirements may appear in written contracts between a motor carrier and the shipper. They may also appear on bill of lading, shipping memo, dispatch records, etc. Typical instructions would include scheduled pickups and deliveries of freight, calls for delivery appointments, etc.

It would also be sage to review the documents for possible revision if they are inconsistent with the client's practice or use inappropriate terminology.

4. *Be prepared to explain procedures.* Have procedures manuals and/or descriptions of the functions performed by each department which deals with independent contractors available and also have available a knowledgeable, experienced manager and/or employee from each department who can attest to the day-to-day operations of the department. The opportunity should also be taken to audit the practices and recommendations should be made to the client regarding any changes which appear to be warranted from a legal standpoint.

5. *Make the client aware of it's rights.* Make sure the client understands it should try to accommodate each reasonable request of the auditor, but not to give him or her carte blanche access to records or personnel. If legal counsel is not present during the initial audit, arrangements should be made to ensure that legal counsel is available for consultation as to the rights and powers of the auditor.[79]

6. *Request an informal review.* Legal counsel should request a meeting with the auditor prior to his or her making or filing any written official report so that if a misunderstanding has occurred there is an opportunity to clarify it or present additional evidence.

VI. Aftermath of an IRS Audit

While the issue hopefully will be resolved correctly at the audit level, the client should be made aware of his/her rights to appeal an adverse ruling.[80] In some instances, it may mean correcting an error, settling an obligation to the government, and starting afresh. Basically a ruling only covers a particular factual situation on a particular day. For this reason, it is also important to warn a client that a favorable finding does not mean that it does not have to maintain the program which led to such ruling. Although the odds may widen, there can always be another audit.

VII. Conclusion

The use of independent contractors in motor carrier operations has had a long history and despite the hurdles which have been created, they will be used for a long time in the future. Legal counsel, therefore, must warn "China Shop" operators to look out for the "Bulls".

79. *See generally*, 26 U.S.C. §§ 7602-7611 (1982) for the authority of the IRS to examine books, records and witnesses for specific purposes.

80. *See*, Wilkens and Matthews, *A Survey of Federal Tax Collection Procedures; Rights and Remedies of Taxpayers and Internal Revenue Service*, 3 Alaska L. Rev. 269 (1986).