

Paying Unemployment Insurance for Owner-Operators Considered Employees by State Finding

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Courtesy of Scopelitis, Garvin, Light, Hanson and Feary, P.C.

Comments by attendees at the March 25, 2008 meeting of the National Accounting and Finance Committee indicate that initiatives announced by the IRS last year may be beginning to take effect. In 2007, the IRS revealed its Questionable Employment Tax Practices (“QETP”) initiative designed to “provide a centralized, uniform means for the IRS and state employment officials to exchange data.” Through this initiative, focusing, among other things, on the reclassification of what the IRS and state unemployment tax officials view as improperly classified independent contractors, the IRS and state unemployment tax agencies coordinate and share information concerning worker classification audits. This initiative signals the potential for increased audit activities focusing on independent contractor status, both by the IRS and state unemployment tax agencies.

Discussions at the NAFC meeting demonstrate that motor carriers are feeling the effects of state unemployment tax agencies’ audit efforts in a number of states. Reclassification of owner-operators from independent contractor to employees for state unemployment tax purposes were noted in, among other states, Arkansas, Kentucky and North Carolina. In addition, attendees highlighted the efforts of state unemployment tax agencies to assess tax based upon the interstate driver’s state of residence regardless of where the motor carrier is located. These efforts reflect increasingly aggressive behavior on the part of state unemployment agencies in their efforts to increase tax revenue to offset rising unemployment and corresponding unemployment benefit claims.

In making the determination of an owner-operator’s status as an independent contractor or an employee, states either rely upon a statutory test that is commonly referred to as the “ABC” test or a common law approach. “ABC” tests are drafted such that the owner-operator is deemed to be an employee unless the motor carrier can show that all parts of the test for determining independent contractor status are met. The common law approach will utilize a number of factors to make the determination depending upon the law of the particular state. Of these approaches, the “ABC” test has traditionally been the more difficult of the two to satisfy for purposes of maintaining independent contractor status.

Both Kentucky and North Carolina use the common law approach, while Arkansas maintains a typical “ABC” test. Both tests rely heavily on an examination of the level of direction and control exercised by the motor carrier over the owner-operator. The direction and control element is commonly found in the “A” prong of the “ABC” test, while the “B” prong typically examines whether the owner-operator’s service is outside the usual course of the motor carrier’s business or performed outside of all places of the motor carrier’s business. The “C” prong focuses on whether the owner-operator is engaged in an independently established trade or business. Some states compress the three prong analysis into a two-part “AB” test. These “ABC” test factors are usually contained among the common law factors used in roughly half of the states.

Activities in Arkansas, Kentucky and North Carolina reflect what is occurring across the country by way of independent contractor reclassification for unemployment tax purposes, regardless of whether states are utilizing the “ABC” or common law tests. While Kentucky law contains little in the way of motor carrier cases to provide guidance, its unemployment tax agency has recently stepped-up its enforcement and owner-operator reclassification cases are pending at the administrative level. North Carolina law does provide favorable guidance for motor carriers in the unemployment tax context, although those cases are relatively old. Due to the fact-sensitive nature of the analysis, North Carolina and other states are demonstrating a willingness to reclassify owner-operators as employees in spite of favorable precedent. The law in Arkansas, utilizing an “ABC” test, has not been favorable over the years and, as recently as December, 2007, the Arkansas court of appeals upheld the reclassification of owner-operators as employees. The court found that the motor carrier failed the “B” prong of the test concluding that the motor carrier’s “place of business” included the roadways upon which the driving services were performed.

Efforts to combat these unfavorable decisions in these and other states, including through legislative initiatives to establish owner-operator exemptions, are ongoing. In the meantime, however, motor carriers that have had owner-operators reclassified as employees for unemployment tax purposes are left with the need to comply with state directives to begin paying unemployment tax on purported “wages” earned by the owner-operators. When appeal rights have been exhausted or a motor carrier simply chooses not to contest the reclassification of owner-operators as employees, states will require payment of unemployment tax based upon the amount paid, or a portion of the amount paid to owner-operators up to a wage cap that varies depending upon the state. In such circumstances, motor carriers should certainly argue that only a portion of the Form 1099 settlement should be attributable to “wage,” typically in a one-third/two-thirds ratio with one-third reflecting wage or

income and two-thirds reflecting equipment rent and operating expenses.

Unfortunately, where states have reclassified owner-operators as employees, motor carriers will likely be prevented from charging back the unemployment tax expense to the owner-operator even where the Independent Contractor Agreement makes clear that the owner-operator is responsible for payment of employment-related expenses, including unemployment tax. This is because most states prohibit the chargeback of unemployment tax to what are otherwise determined to “employees.” For example, North Carolina Code § 96-9(a) sets forth the requirement to pay unemployment tax contributions based upon employee wages and goes on to say that such contributions “shall not be deducted in whole or in part from the remuneration of individuals in [the employer’s] employ.” Of course, where an owner-operator provides more than one truck to a motor carrier as a fleet operator, or where the owner-operator hires a driver to operate his equipment, it is arguable that it is the owner-operator that is responsible for any unemployment tax assessment based upon his driver’s services and, pursuant to the Independent Contractor Agreement, would be responsible for any unemployment tax assessed against the motor carrier.

As noted above, reclassification and assessment by state unemployment tax agencies may very well invite examination by the IRS for federal tax purposes under the QETP initiative. As such, it is important to challenge state unemployment tax reclassification efforts even where the unemployment tax liability amounts may seem relatively insignificant in comparison to the cost of appealing an employment reclassification. Efforts to enact statutory unemployment tax exemptions in problematic states should likewise be considered. There are approximately fourteen states that currently maintain owner-operator unemployment tax exemption statutes in various forms.

Importantly, while the QETP initiative may garner the interest of the IRS after a state unemployment tax agency reclassifies an independent contractor, the state’s finding of employment status does not mandate a similar finding by the IRS for federal tax purposes. The IRS utilizes a separate multi-factor common law right to control test to determine worker status. It is also important to note that should a motor carrier face examination by the IRS with respect to worker classification for federal employment tax purposes, Section 530 Safe Harbor Relief may be available to protect the independent contractor status of owner-operators. In order to be eligible for Section 530 Safe Harbor Relief, motor carriers must be able to demonstrate a reasonable basis for treating the owner-operator as an independent contractor, must have treated the owner-operator and similar workers as independent

contractors (substantive consistency) and must have consistently reported settlement payments on Form 1099 (reporting consistency). Section 530 Safe Harbor Relief has proved to be a very effective shield against IRS reclassification efforts and any ATA member faced with an IRS reclassification attempt should contact the ATA for assistance in the development of a Section 530 defense.

Regardless of whether involving reclassified owner-operators or motor carriers utilizing the services of employee-drivers, states such as Kentucky are also attempting to collect unemployment tax based upon the driver's state of residence as opposed to location from which the interstate driver is being directed and controlled. All states have somewhat similar statutory schemes addressing interstate employees – employees that perform services in more than one state. Kentucky, for example, confers unemployment tax jurisdiction on a driver's service if the service is deemed to be "localized" in Kentucky even if some service is performed both within and outside the borders of Kentucky. Service is deemed to be localized in Kentucky if all of the service is performed within Kentucky, which clearly would not be the case for an interstate driver. The Kentucky jurisdictional statute goes on to say that the driver's service is localized in Kentucky even when the service is performed within and outside of Kentucky, but the service performed outside of Kentucky is only incidental, temporary or transitory in connection with the service performed within the state. Finally, like most states, Kentucky says that regardless of where the service is performed, if the driver is directed and controlled from Kentucky, Kentucky is a proper state for unemployment tax jurisdiction.

In what may be a harbinger of aggressive unemployment tax collection tactics for other states, in at least one case Kentucky has taken the position that an interstate driver residing in Kentucky is subject to Kentucky unemployment tax, even if the driver is performing services in a number of states, including the state (other than Kentucky) from which he or she is directed and controlled (dispatched, among other things). Typically, a motor carrier will report and pay unemployment tax on all of its interstate drivers in the state from which they are based or dispatched, regardless of where the drivers live (most states also require, among other things, that some service is actually performed in the state from which drivers are directed and controlled). Most states are part of what is known as the "Interstate Compact," such that when, for example, an interstate driver living in Kentucky files an unemployment claim in Kentucky, but unemployment tax has been paid by the motor carrier in Illinois (the state from which the driver is directed and controlled), the unemployment claim will be handled in Kentucky through the Interstate Compact Office. This means that the driver's claim will be handled in the

state where he lives, but applicable benefits will be paid through the motor carrier's Illinois unemployment tax account.

While Kentucky's position that tax should be paid based upon the interstate driver's residence in Kentucky is contrary to its and other states' statutory jurisdictional schemes for interstate employees, the outcome of existing administrative appeals have yet to be decided. These types of claims are also important for motor carriers to dispute in order to avoid unemployment tax assessments that can typically reach back at least four years. If assessed in the driver's state of residence, motor carriers could claim a refund of unemployment tax paid in the state where they are located (and unemployment taxes were paid), nevertheless, refund claim statutes of limitations are typically only three years. This "gap" means that carriers could, in some instances, be required to pay unemployment tax twice – once in the state from which the driver was directed and controlled through dispatch and once in the state of residence. Additionally, unemployment tax rates can vary and assessment in the driver's state of residence could result in higher unemployment tax liability for the motor carrier.