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The Sixth Circuit upheld a trucking company's right to Section 530 relief from employment taxes based on its misclassification of workers as independent contractors because it was reasonable for the company to rely upon state administrative rulings that the workers were independent contractors when those state agencies had applied a common law test that was virtually identical to the federal common law.

Sixth Circuit Upholds Section 530 Relief for Trucking Company that Treated Drivers as Independent Contractors Based on the Common Law Factors Used in State Proceedings

By William Hays Weissman

In *Peno Trucking, Inc. v. Commissioner* (6th Cir. Oct. 3, 2008), the United States Court of Appeals for the Sixth Circuit reversed a United States Tax Court's determination and held that the company was entitled to the protections of Section 530 of the Revenue Act of 1978 despite having misclassified its drivers as independent contractors. The case is significant because it reaffirms the right to Section 530 tax relief based on a reasonable reliance upon the common law independent contractor factors, even if those factors are established by a state agency or court.

In *Peno Trucking*, the company had a contract with another company to lease tractor-trailers and to provide drivers to operate those tractor-trailers in Ohio. Under the lease agreement, the company provided drivers to operate the trucks and was responsible for their work. The company in turn contracted with each driver under an agreement that expressly stated they were independent contractors. It issued the drivers IRS Form 1099s each year consistent with its treatment of the drivers as independent contractors.

The Internal Revenue Service (IRS) reclassified the drivers as employees and issued an assessment, which the company challenged in the Tax Court. The company asserted that the drivers were properly classified, but even if they were not, the company met the requirements for Section 530 relief. The Tax Court ruled in favor of the IRS on the worker status issue, finding that the company, rather than the drivers, had a substantial investment in the tractor-trailers, the drivers' services were continuous in nature and essential to the company's business, the drivers really could not realize a profit or loss, and the company controlled the driver's responsibilities, work hours and loads hauled. On appeal, the Sixth Circuit affirmed the determination that the drivers were employees and not independent contractors.

The company had also argued that it was entitled to relief under Section 530, and on that basis was not liable for employment taxes. There are three requirements that an employer must satisfy to be able to obtain Section 530 relief. The employer must have

1. Consistently treated the workers (and similarly situated workers) as independent contractors;
2. Complied with the Form 1099 reporting requirements with respect to the compensation paid the workers for the tax years at issue; and
3. Had a reasonable basis for treating the workers as independent contractors.

The first two criteria were not at issue. The company argued that it satisfied the third criterion because the Ohio Industrial Commission (OIC) and Bureau of Workers' Compensation (BWC) ruled on two occasions that the drivers were independent contractors. The Tax Court rejected this argument, stating that, in order for a judicial precedent to be a reasonable basis, it must be evaluated using the federal common law test. The Tax Court found that there was no evidence that either the OIC or the BWC had applied the federal common law when determining that the company's drivers were independent contractors, and therefore the company's reliance upon those decisions could not meet the reasonable basis criterion.

The Sixth Circuit rejected the Tax Court's analysis. The court first noted that, if the company established a prima facie case that it met all three criteria, the burden shifted to the IRS to prove otherwise. The court found that the first two criteria of Section 530 were met because the company had always treated the truckers in question as independent contractors, and the company had always filed its tax returns in a manner consistent with this treatment.

It then rejected the Tax Court's interpretation of the reasonable basis criterion. The Sixth Circuit found that the law applied by the OIC and the BWC appeared to be virtually identical to the federal common law 20-factor test. Based on the finding that the state agencies employed a common law test virtually identical to the federal common law test, the court ruled that the determinations of the OIC and BWC were reasonable judicial precedents upon which the company could rely. The court added that "at oral argument the Commissioner could not point to another jurisdiction in the United States that uses a test for differentiating between employees and independent contractors at odds with typical common-law test. Thus, much of the Commissioner's argument stands on shaky ground." It thus concluded that the company's "reliance on the official determinations of the OIC and BWC would seem to satisfy the reasonable basis requirement."

Having determined that the company established a prima facie case, the Sixth Circuit then found that the IRS had failed to present evidence demonstrating that the company had ever treated the workers as other than independent contractors. Accordingly, because the burden of proof had shifted to the IRS upon the showing of a prima facie case, and the IRS failed to meet that burden, the Sixth Circuit held that the company was entitled to Section 530 tax relief.

The results of this case are highly favorable for taxpayers. Those states that use the common law test for state employment taxes generally are in near complete accord with the federal common law. Thus, in those states, a decision before a state administrative agency or state court that is favorable to the taxpayer on a worker's status may be used to demonstrate that such decision provides a reasonable basis for the treatment of the workers as independent contractors under an application of the law that is substantially the same as the federal common law. By recognizing the reality of the similarities in the law, taxpayers may be provided with additional grounds to support the reasonableness of their classification.

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