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KATZ, SAPPER & MILLER

TRUCK TIMES

The Financial Side of the Trucking Industry

In this issue:

Long-Awaited Tax Law Provides Benefits to Truckers

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On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act). The long-awaited and anticipated tax law extends the Bush-era tax cuts, retroactive and extension of individual and business tax breaks and credits, economic stimulus incentives, and estate and gift tax relief.

Two-year Extension of Bush-era Tax Cuts

The Act maintains the top individual tax rate of 35 percent. Absent action by Congress, the top individual rate would have reset at 39.6 percent starting in 2011. The long-term capital gain rate was scheduled to adjust to a maximum rate of 15 to 20 percent from Bush-era rates of 0 to 15 percent. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provided for a qualified dividend tax rate of 15 percent through 2010. Beginning in 2011, qualified dividends were to be taxed at ordinary rates (39.6 percent maximum). The Act extended the Bush-era long-term capital gains and the qualified dividends tax rates.

The removal of the phase-out of itemized deductions and personal exemptions for high income taxpayers and the marriage tax penalty relief has been extended through 2012. In addition, the alternative minimum tax exemption has been increased for 2011.

Tax Breaks for Businesses and Individuals

For taxpayers residing in states that do not have state income taxes, the sales and use tax itemized deduction has been extended through 2011.

Taxpayers who are 70 ½ years or older can make tax-free contributions to charities via their IRAs. These contributions are limited to $100,000 and can be counted toward minimum distribution requirements.

The exclusion of gain from the sale of certain small business stock has been extended through 2011. Seventy-five percent of the gain from stock acquired from February 17, 2009 through September 27, 2010 and 100 percent of the gain from stock acquired from September 28, 2010 through December 31, 2010 can be excluded from income.

Certain qualified leasehold improvements placed in service through December 31, 2011 can be depreciated using a 15-year life instead of the normal 39-year life. These improvements now can qualify for 100 percent bonus depreciation.

The Work Opportunity Tax Credit was set to expire on August 31, 2011. The Act extends the credit through the end of 2011. This is a credit available to employers who hire members of certain targeted groups. The 50 cent per gallon credit for the sales or use of alternative fuels or alternative fuel mixtures has been extended through 2011.

Economic Stimulus Incentives

For assets placed in service from September 9, 2010 through December 31, 2011, the first year bonus depreciation deduction has increased from 50 to 100 percent for certain qualifying assets. Generally, the assets must be new and they must have a recovery period of 20 years or less. For qualifying assets placed in service from January 1, 2010 through September 8, 2010 and in 2012, a 50 percent first-year bonus depreciation deduction will be allowed. This could make certain like kind exchanges less attractive due to the cost

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Independent Contractor Status of Owner Operators Challenged

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The independent contractor status of owner-operators in the trucking industry has long been viewed as an appropriate business model alternative to employee drivers. In the current economic downturn, owner-operators and their trucks provide flexibility to meet the changes in freight demands. Utilizing owner-operators has been seen as a method to reduce company cost of vacation, health and pension benefits. Furthermore, the utilization of owner-operators results in reduced payroll taxes that would normally be required for company drivers and administrative workload.

"The consequences of improperly classifying owner-operators can be severe."

The trucking industry has long relied on the reasonable basis provision of Section 530 that provided independent contractor relief if the driver treatment was a well documented standard within the industry. Owner-operators are a significant part of the trucking industry, making up an estimated 500,000 independent contractors. However, elimination of reasonable basis, along with the past industry practices exemption, as a safe harbor has been discussed by Congress over the last several years.

The IRS formerly used what was referred to as the "20 Factor Test" in determining independent contractor status. In an attempt to simplify, the factors have been reduced to eleven points and organized into three groups:

Behavioral Control – A review of the instructions and training given drivers will show whether there is control and procedures on how the work is completed. A business normally has the right to direct how the work is performed by drivers considered to be employees. Daily operational matters such as dispatch instructions and dictated routes could be factors considered in classification.

Financial Control – Significant investment made by a driver in equipment would be indicative of an independent contractor relationship. Likewise, the lack of expense reimbursement and the opportunity for both profit and loss are factors common with owner-operators/independent contractors. Trucking companies that offer favorable lease-to-own arrangements for owner operators could be problematic.

Relationship of the Parties – Company drivers often receive benefits such as insurance, pension and vacation. The presence of a written contract often implies an owner-operator relationship and is required by federal law for interstate owner-operators.

All factors are considered in making the classification determination; however, no single fact will make the determination and certain factors could have more influence.

The consequences of improperly classifying owner-operators can be severe. The company can be held liable retroactively for all unpaid employment taxes associated with the misclassified driver and assessed penalties for failure to file returns and pay taxes. An unintentional improper designation when a Form 1099 has been filed for the income will result in the employer owing 1.5 percent of federal withholding on the wage paid; 20 percent of the employee's FICA liability, and all the employer share of the FICA tax due. If it is determined the driver has remitted FICA tax on their own behalf, the IRS will not collect from the employer. However, any penalties and/or failure to withhold could be due.

If the improper classification was unintentional, but there was a failure to file a Form 1099 for the income, the penalties are double. Also, a 3 percent fine is assessed on the wages and the employer is liable for 40 percent of the driver's portion of the FICA as well as the employer share. If the misclassification is deemed intentional, the employer is liable for 100 percent of the driver's federal withholding, the employee's FICA, as well as the employer portion of FICA.

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Many Trucking Companies Facing Driver Shortages

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The transportation industry is faced with a problem – companies cannot find enough drivers. Although the economy has not fully recovered, transportation companies have seen increases in freight that needs to be shipped. Today, in most markets the quality of available drivers is marginal at best. Furthermore, according to CNNMoney and the Council of Supply Chain Management Professionals, the U.S. trucking industry will need to hire another 200,000 drivers by the end of 2011.

There are a number of reasons the industry is in this position. The National Transportation Institute benchmarks a multitude of factors concerning driver pay and driver supply and demand. The following are a few of the factors cited for the current driver shortfall:

- **Surgical downsizing due to the economy** – Prior to August 2009, higher quality drivers were available, which allowed companies to cut their lowest producing drivers and replace them with high producing ones.
- **Unlimited unemployment benefits** – The unemployment benefits are so good that many unemployed truck drivers are not motivated to re-enter the workforce as a truck driver.
- **Part-time jobs** – Drivers found part-time jobs that allowed them to spend more time at home with their families.
- **Many drivers are unqualified** – The transportation industry today has more arduous requirements than in previous years.
- **Lack of recruiting and retention** – Many trucking companies have not emphasized recruiting or driver retention to build and maintain their workforce.
- **Retirement, including early retirement** – The driver population is aging fast, and the economy forced many truck drivers into early retirement. Compounding the problem is that the industry is struggling to fill the pipeline with younger drivers.

In hindsight, arriving at the current predicament was like a perfect storm. The economy forced many drivers out of the work force and drove driver pay down. In the meantime, out of work truck drivers were forced to collect unemployment or pursue a new employment opportunity. In some cases these new opportunities, even if they were only part-time jobs, allowed individuals to spend more time at home. The fact is, being a truck driver can be less attractive than other jobs due to the quality of life issue. Pair this with a decrease in pay, and it is understandable why some of the best talent was lost.

In addition to these issues, the U.S. Department of Transportation's increasingly restrictive requirements have resulted in fewer qualified drivers and a loss of productivity from current drivers. Updated regulations such as the Hours-of-Service and the Comprehensive Safety Analysis (CSA 2010) are two of the main reasons for this loss in productivity, which has resulted in drivers spending less time on the road.

Finally, company cutbacks in many instances reduced, if not eliminated, recruiting departments. As a result, companies are fighting an uphill battle trying to recruit and train drivers with less available resources.

There are, however, ways in which the current situation can improve. For this to happen, driver pay will need to increase, and companies will have to emphasize and improve not only the recruiting and building of drivers, but also the retention of drivers.

It is important for a company to carefully select new drivers they believe can succeed and take the necessary steps to train them thoroughly so new hires are, and remain, qualified with today's stringent requirements. It is essential for companies to be effective at training drivers so they are productive and can continue to thrive. Having great recruiting and training departments only helps competitors because if there is not also a focus on retention management, the drivers could use the training to benefit a competitor. Hiring new talent is only the beginning.

Once a company finds the right people, it needs to find ways

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FASB Lease Exposure Draft – Potential Impact to Trucking Companies

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As discussed in a previous issue of *Truck Times* (2009 Issue 2), the Financial Accounting Standards Board (FASB) issued a discussion paper regarding leases as part of the continued convergence projects with the International Accounting Standards Board (IASB).

The objective of the project is to create common lease accounting requirements to ensure leases are recognized on the balance sheet, and to provide users of financial statements with useful and complete information about leasing transactions. In August 2010, the FASB issued an exposure draft with the comment period ending on December 15, 2010. More than 700 comment letters were received.

The proposed accounting standard update, as it currently stands, would have a dramatic impact on the presentation of trucking company financial statements. This potential change in presentation (resulting from the change in accounting for certain leases) could impact bank covenants and buy versus lease decisions.

Currently, a lessee accounts for a lease as either operating or capital. Under the exposure draft, a lessee would recognize an asset representing its right to use the leased asset and a liability for the obligation to pay rentals, essentially capitalizing all leases. The lessor would follow a performance obligation approach, in which an asset would be recorded representing the lessor's right to receive rental payments, and a liability representing its performance obligation under the lease.

Some key items in the exposure draft that would likely affect many trucking companies include:

- Substantially, all equipment leases would be recorded as capital leases. The leased equipment (right of use asset) and lease payments (liability) would be recorded on the balance sheet, which would increase leverage ratios. The income statement would be impacted as well due to replacing rent expense with depreciation (amortization of the right of use asset) and interest expense (amortization of the lease obligation), which would impact cash flow measures such as earnings before interest, taxes, depreciation and amortization (EBITDA). Additionally, interest expense under the effective yield method is higher in earlier years of a lease, in turn accelerating the recognition of overall expense. These changes could have a direct impact on bank covenant requirements.
- Accounting for independent contractor agreements could be impacted as well (dependent on the terms of the agreements). If the trucking company is deemed to have exclusive rights to the use of the independent contractor's equipment and the right to control that equipment, then the agreement may contain a lease. In the event that the agreement is determined to be a lease, the service component of the agreement would be accounted for separately from the lease obligation accounting.
- As currently proposed, existing operating leases at the date of implementation would not be excluded (i.e. no "grandfather clause"). This could require a great deal of time, effort and money by companies, depending on the number of leases, to gather the necessary information and calculate the impact.

The FASB is expected to issue the final accounting standards update by mid-2011, with implementation expected in 2012. •

Every Trucking Company Needs More Problem Solvers

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In today's increasingly complex trucking environment, it is more important than ever to ensure management teams have sharp problem-solving skills. If an evaluation of these skills has not been done recently, now may be the time.

In IBM's past three Global CEO studies, CEOs said that coping with change was their most pressing challenge. In their 2010 survey, a new primary challenge emerged – complexity. CEOs said they are operating in a world that is more volatile, uncertain and complex. Many shared that incremental changes are no longer sufficient in a world that is operating in fundamentally different ways. Four primary findings arose from this survey:

- Today's complexity is only expected to rise, and more than half of the CEOs doubt their ability to manage it.
- Creativity is the most important leadership quality, according to the CEOs.
- The most successful organizations co-create products and services with customers and integrate customers into core processes. Customer intimacy is their No. 1 priority.
- Better performers manage complexity on behalf of their organizations, customers and partners. They do so by simplifying operations and products, and increasing dexterity to change the way they work, access resources and enter markets.

One CEO in the survey stated that "Creativity means new ways of solving tough problems. Many challenges require innovative thinking." Another stated, "The management environment is rapidly becoming more complex. In these uncertain times, the need for effective and swift decision making is more important than ever."

Recently, Harvard Law School realized they do an incredibly good job of training the best analytical minds in the world, but reading and interpreting the law is not what the typical lawyer faces each day in law practice. They decided that a Problem-Solving Workshop was needed to equip lawyers with another important skill set that would include creative thinking and teamwork. They launched this unique workshop the winter term of this past year.

"CEOs said they are operating in a world that is more volatile, uncertain and complex."

With problem-solving skills being so critical in this increasingly complex world (e.g. CSA 2010, hours of service, etc.), how do trucking companies begin to train and evaluate their management team on these skills?

Katz, Sapper & Miller (KSM) asked that same question and decided it would assess its own management team since the firm places a high value on being considered problem solvers for its clients. KSM determined it would be beneficial to formally train its staff in problem solving, and needed a simple problem-solving framework to achieve this goal. KSM thoroughly researched different training methods and discovered a book written by a former McKinsey consultant, which described, in simple terms, the McKinsey problem-solving process and some of the tools that McKinsey consultants use to solve problems. A former McKinsey consultant and a leadership consultant were engaged to help KSM design a problem-solving course built around the book and its methods. The problem-solving process is simple:

- Understand the situation.
- Identify the root cause of the problem.
- Develop an effective action plan.
- Execute and modify until the problem is solved.

The author of the book explains that even though the process is simple, individuals often do not choose the solution that is the most simple and obvious. Thus, having a simple problem-solving framework and teaching staff easy problem solving tools can accomplish the following:

- Provide a framework for thinking more creatively.
- Help managers to arrive at the best solution to a problem, not a solution that may cause additional problems.

- Allow for a transfer of problem-solving skills and knowledge among staff.
- Provide staff with the confidence to make decisions quickly.
- Allow staff to be better problem solvers in their personal lives.
- Will make an organization better equipped to assist clients in solving their problems.

This framework is a good starting point, but trucking companies and their management teams have unique needs. To find the right problem-solving method, a professional familiar with the trucking industry should be consulted. •

Tax Law *(Continued from page 2)*

of these exchanges, and the fact that long-term capital gain income could be generated on the exchanged property, which will be taxed at a lower rate.

Earlier in 2010 the section 179 expensing limits were increased to $500,000 ($250,000 for certain real estate improvements) and the investment limit was increased to $2 million (for each dollar spent over $2 million the expensing limit is decreased dollar for dollar) for 2010 and 2011. The Act increases the 2012 expensing limit to $125,000, and the investment limit was increased to $500,000.

The Social Security tax has decreased by 2 percent for employees and self-employed individuals. Social security tax is paid on wages and self-employed income up to $106,800 for 2010 and 2011, resulting in a maximum tax savings of $2,136.

Estate and Gift Tax Relief

One of the many highlights of the EGTRRA in 2001 was the transition of the increased estate tax exemption coupled with the decreased estate and gift tax rate from 2002 to 2009, then ultimately the repeal of the death tax in 2010. In 2011, the estate tax was to return. The Act increased the 2011 and 2012 exemption from $1 million to $5 million and reduced the tax rate from 55 to 35 percent. In addition, the Act gives estates the option of using the EGTRRA law for 2010 or using the exemptions effective for 2011 and 2012. The Act provides for a forfeited deceased spouses estate exemption to be used by the surviving spouse. •

Independent Contractor *(Continued from page 3)*

Under certain conditions, drivers who receive Form 1099 and believe they have been wrongly classified as an independent contractor can file Form 8919, “Uncollected Social Security and Medicare Tax on Wages” with their tax returns.

Section 530 provides relief to penalties and employment taxes if the trucking company meets all three requirements of reasonable basis, substantive consistency and reporting consistency. Reasonable basis can be achieved for not treating owner-operators as employees if the business can show reliance on IRS court cases, a previous IRS audit with no change to the classification, an industry standard, or advice from a well informed professional. Substantive consistency is met if the company has treated owner-operators, and similar drivers as independent contractors. This provision is failed if the company has treated any similar drivers as employees. The reporting consistency test is passed if the trucking company has filed all required tax returns consistent with the treatment. For example, the provision is met if the driver has been classified as an owner-operator and the business has filed Form 1099 in every case.

The IRS Classification Settlement Program allows employers partially meeting the provisions of Section 530 to negotiate reduced assessments in exchange for prospective reclassification of owner-operators to employees. •

Driver Shortages *(Continued from page 4)*

to retain them. One way this can be done is to create a driver-centric culture. Every effort must be made to understand truck drivers – what motivates them, what issues are of concern to them, etc. This is a necessity not only for retaining drivers, but for recruiting new talent as well. Taking these kinds of steps lets the workforce know they are valued, which in turn makes them more likely to remain and become valuable assets to the company as their experience grows.

The rules of the game have changed and each company will have to adjust. However, if the areas of recruiting, training and retention are diligently attended to, it gives companies the best chance to succeed in any economy. •

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Here and There in the Trucking Industry

The Trucking Owners Business Roundtable was held at Katz, Sapper & Miller (KSM) on January 12, 2011. Thom Albrecht, managing director of BB&T Capital Markets was the featured speaker and discussed economic forecasts for the trucking industry. Mark Flinchum and Jason Miller of KSM also presented an Accounting and Tax Update. Our September 2010 roundtable featured Gordon Klemp, principal of The National Transportation Institute and Steve Prelipp, president of Prelipp Consulting, Inc., who discussed issues related to driver pay and driver recruiting/retention.

Katz, Sapper & Miller received Paschall Truck Lines' Finance Vendor of the Year award based on its outstanding service to the company in the areas of audit, tax preparation and business planning. KSM has also joined the Iowa Motor Truck Association and the Pennsylvania Motor Truck Association.

Tim Almack has been reappointed as an Advisor to the Indiana Motor Truck Association board of directors; and he was one of three featured speakers at TMW Systems, Inc.'s TransForum 2010 Users Conference in Dallas, Texas, which was attended by more than 1400 transportation service professionals and decision makers.

Mark Flinchum and Chris Felger presented at the Ohio Trucking Association and Ohio Association of Movers Annual Convention. They also attended the American Trucking Association convention in Phoenix, Arizona in October.

David Roush presented a webinar, "An Expert's View: Tools for Improved Carrier Profitability," hosted by TMW Systems, Inc.

KSM's Committment to the Trucking Industry:

- Alabama Trucking Association
- American Trucking Associations
- Illinois Trucking Association
- Indiana Motor Truck Association
- Iowa Motor Truck Association
- Kentucky Motor Truck Association
- Mid-West Truckers Association
- National Tank Truck Carriers
- Ohio Trucking Association
- Pennsylvania Motor Truck Association
- Truckload Carriers Association
- Tennessee Trucking Association

For more information about Katz, Sapper & Miller, please visit www.ksmcpa.com.

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