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MEMORANDUM FOR ROBERT WESTHOVEN

FROM: Jerry Holmes
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SUBJECT: 65 Questions

This memorandum is in response to your questions for the public employers' newsletter. It also clarifies an application of the continuing employment exception to the Medicare tax in a factual situation that was not covered in our memo "Employment Tax Issues for Government Entities," which appeared in the June 2000 Employment Tax Update for Government Employers.

Public Employee Question: A part-time cafeteria employee has worked for School District A without interruption since 1985. The employee is hired in 2001 by School District A in a second, summer position on a grounds crew. Neither position is covered by a state retirement plan. Do the OASDI and Medicare portions of the FICA tax apply to these two positions, or is the employee entitled to the continuing employment exception in one or both?

Answer: Both portions of the FICA tax apply to both positions. The continuing employment exception to Medicare tax provided in Code section 3121(u)(2)(C) is not available to this employee. It is only available to employees who participate in a public retirement system. Employees who are subject to FICA because they do not participate in a public retirement system must pay both portions of the FICA tax, regardless of when they were hired.

In general the Medicare portion of the FICA tax applies to employees of states and their political subdivisions, unless some exception applies. Section 3121(u)(2)(C) provides an exception from Medicare tax for continuing employment. To qualify for the exception, the employee must satisfy three conditions: (1) the employee's service would

be excluded from the term “employment” for FICA purposes if section 3121(u)(2)(A) did not apply.[1] (2) The employee was hired on or before March 31, 1986, as a bona fide employee, performing regular and substantial services. (3) The employment relationship with that employer has not been terminated after March 31, 1986. Effective for services performed after July 1, 1991, this exception is available only to employees who participate in a public retirement system.

Question 28: What is the effect on the continuing employment exemption from Medicare tax when an employee originally hired in 1985 transfers in 2001 from one employer to another within the same political subdivision?

An employee who is employed by the same political subdivision, but working a different office or division, remains eligible for the continuing employment exception.

Under section 3121(u)(2)(C) of the Code, services performed by state or local government employees hired on or before March 31, 1986, who participate in a public retirement system are exempt from Medicare taxes (if section 3121(b)(7) otherwise applies), provided that (1) the employees were performing regular and substantial services for remuneration for that employer before April 1, 1986, (2) their employment relationship with that employer was not entered into for purposes of meeting the exception under section 3121(u)(2)(C), and (3) their employment relationship with that employer has not been terminated after March 31, 1986. [Emphasis added.] This is referred to as the "continuing employment exception" to the Medicare tax.

Code section 3121(u)(2)(D) states that, for purposes of subparagraph (C):

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[1]The meaning of this condition is not self-evident. The individual’s services must be excluded from “employment” as defined in section 3121(b)(7)(F), which excludes only the services of employees participating in a public retirement system. Thus only employees participating in a public retirement system are eligible for the continuing employment exception. See Code section 3121(u)(2)(C)(i), with cross-reference to subparagraph (A) of 3121(u)(2), with cross-reference to subsection (b)(7) of section 3121. This rule is effective for services performed after July 1, 1991. It was enacted by section 11332(b) of the Omnibus Budget Reconciliation Act of 1990 (OBRA), Pub. L. 101-508, 101st. Cong., 2d Sess. (1990). This provision amended section 3121(b)(7) by adding subparagraph (F), requiring FICA coverage for public employees not participating in a retirement system. The House-Senate Conference Committee Report, H.R. Rep. No. 101-964, at 1105 (Oct. 27, 1990), makes it clear that the conference agreement extended Medicare coverage to all employees not already subject to the Medicare tax who became subject to OASDI by reason of this provision.

> (i) all agencies and instrumentalities of a State (as defined in section 218(b) of the Social Security Act) . . . shall be treated as a single employer, and
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> (ii) all agencies and instrumentalities of a political subdivision of a State (as so defined) shall be treated as a single employer and shall not be treated as described in clause (i). [Emphasis added.]

The term "political subdivision" ordinarily includes a county, city or town. Rev. Rul. 86-88, 1986-2 C.B. 172. Rev. Rul. 86-88 states that an employee hired before April 1, 1986, does not qualify for the continuing employment exception if, after March 31, 1986, the employee transfers from a political subdivision employer to a state employer. Q&A 7. Employees of a state have more latitude in their transfers under section 3121(u)(2)(D), as all agencies and instrumentalities of a state are considered to be a single employer.

Thus, an employee who qualifies for the continuing employment exception continues to qualify when transferred from one employer to another within the same political subdivision. The following points must be kept in mind.

First, the original hire date of the employee is used in evaluating the continuing employment exception, as long as there was no break in service. Thus, for an employee who transferred after April 1, 1986, from one state agency to another, the original date of hire would apply. If the employee transferred from employment with Town A to Town B, then the date of hire for this purpose would be that in Town B.

If School Districts A and B are an elementary school and a high school district which merge into a new entity, a consolidated school district, then the continuing employment exemption applies to employees of both A and B. Board of Education of Muhlenberg County v. U.S., 920 F.2d 370 (6th Cir. 1990), holds that the continuing employment exception applies to cases of merger or consolidation of school districts, as the teachers continue to work for the same employers under a new name. There was no suggestion in this case that the merging school districts had to be part of the same political subdivision (city or town): the three school districts that merged in the Muhlenberg case were not part of the same political subdivision.

Questions 3, 18 and 26 deal with rehired annuitants: An employee of a school district was covered under the state employees' retirement system. The individual retired in 1999, began receiving a pension and was subsequently rehired by the same school district as a substitute teacher, bus driver, or coach. What taxes should be withheld?

Answer: The individual would be subject to Medicare tax, as the continuing employment exception would no longer apply. This would be true in all cases.

The remaining answer to this question depends upon whether the position is covered by a an agreement under section 218 of the Social Security Act (section 218 agreement).

An individual in a position covered by a section 218 agreement providing for full coverage is subject to social security tax under the terms of the 218 agreement. The 218 agreement takes precedence over the state-retirement-system rules of section 3121(b)(7)(F), under which the individual might not have to pay social security tax. See section 3121(b)(7)(E), which excludes individuals under a 218 agreement from "employment" under section 3121(b)(7).

Thus, if a teacher who was covered under a state retirement system retired and was rehired as a bus driver, a position covered by a 218 agreement, the individual would be subject to social security tax under the terms of the 218 agreement.

Now consider the case of a physical education teacher who retired in 1998 from a full-time teaching position. He was covered by the state retirement system and is now drawing a state pension. In 2001, he was rehired as an athletic director, a position which, like a teaching position, is covered by the state retirement system. In this case, the position is not covered by a 218 agreement. Does the employer have to make contributions to the state retirement system on this individual's behalf. Does social security tax apply?

The teacher is a rehired annuitant, i.e., a former participant in state retirement system who has previously retired and who is either (1) currently receiving retirement benefits or (2) has reached normal retirement age.

The regulations provide that a rehired annuitant is deemed to be a qualified participant in the retirement system without regard to whether he or she continues to accrue a benefit or whether the distribution of benefits under the retirement system has been suspended pending cessation of services. Section 31.3121(b)(7)-2(d)(4)(ii), Employment Tax Regulations. This rule also applies if the annuitant was rehired by another school district which maintains the same retirement system as the first, for instance a second school district which participates in the same state retirement system under which the teacher is covered.

In other words, contributions do not have to be made to the state retirement system on the retired annuitant's behalf. He is also not subject to the OASDI portion of social security tax. Medicare tax would apply because the employee terminated his employment relationship after April 1, 1986, and no longer qualifies for the continuing employment exception.

Question 63: A full-time teacher has a second position, working ten hours per week for the employing school district as a bookkeeper. The school district has a 218 agreement covering all employees. Should the district withhold and pay FICA from the teacher's wages as a bookkeeper?

Answer: Yes, the wages from the second position are subject to FICA. When a worker is in a position covered by a 218 agreement, the terms of that agreement govern the application of FICA. For more detailed information on these questions, see "Employment Tax Issues for Government Entities" in the June 2000 Employment Tax Update for Government Employers.

Question 21: A town has on-call firefighters who were hired prior to 1986. They are paid annually. The town withholds OASDI tax but does not withhold Medicare. Is this tax treatment correct?

Answer: First, the firefighters do not qualify for the FICA exemption for individuals hired temporarily as emergency workers. Code section 3121(b)(7)(F)(iii). Although they are described as being "on-call" and paid yearly, they are continuously employed from year to year and paid to be available to work, even if they are not called upon to fight any fires. See Rev. Rul. 88-36, 1988-1 C.B. 343, Q10, which states that police officers who are paid to be on call for a set schedule of hours each week are performing a regular service by being available to respond to calls.

Second, if the firefighters are covered under a section 218 agreement, then the town should withhold OASDI and Medicare taxes under the terms of the agreement.

If the firefighters do not participate in a public retirement system, and they pay FICA tax for that reason, then the town should withhold both OASDI and Medicare taxes. Code sections 3121(b)(7)(F) and 3121(u)(2)(C) together impose Medicare tax on public employees who pay FICA tax because they are not covered by a public retirement system. The continuing employment exception is not available to these employees. This rule is effective for services performed after July 1, 1991. Only if the firefighters participate in a public retirement system do they qualify for the continuing employment exception to Medicare tax.

Question 54: Are emergency firefighters subject to employment taxes?

Answer: That depends on what is meant by "emergency firefighters." There is an exception to FICA tax for services performed on a temporary basis in emergencies. Section 3121(b)(7)(C)(iii). See Pub. 963 and Question 21 above. If the firefighters are

hired on a one-time basis, such as to fight a forest fire, they may be eligible for the FICA exception. In general, however, firefighters are regular employees. If the firefighters have a continuing relationship with their employer, even though they are described as “on call,” they are not temporary workers. Hence they do not qualify for the FICA tax exception. If they do not participate in a public retirement system, they are subject to OASDI and Medicare taxes.

Question 23: A town has a 218 agreement which excludes elective positions. Do elected positions have to be covered by FICA?

Answer: Yes, as of July 2, 1991, local governments are required to cover elective positions under FICA if the positions are not covered under a qualified public retirement system.

Question 29: Are there any services that may be excluded from both FICA and public retirement system coverage?

Yes, the following services are excluded unless they are covered under a section 218 agreement:

1. Services of full-time students enrolled and regularly attending classes at the school, college or university where they are working. This includes students working for a section 509(a)(3) nonprofit entity organized for the benefit of the school, college or university. Section 3121(b)(10).

2. Services of election officials and election workers paid less than a statutorily established amount in a calendar year. In 2001, the amount is $1,100.

Question 30: Are there any services that are never covered under a section 218 agreement?

Yes, the following services can never be covered under a section 218 agreement:

1. Services of an individual employed to relieve him from unemployment,

2. Services in a hospital, home, or other institution by a patient or inmate,

3. Services of an individual working on a temporary basis in case of fire, storm, snow, earthquake, flood or other emergency,

4. Services of non-resident aliens with F-1, J-1, M-1 or Q-1 visas,

5. Services performed by transportation system employees who are covered compulsorily under Section 210(k) of the Social Security Act, and

6. Services of a notary public.

Question 30: Is there an obligation to pay social security tax for employees who were previously covered under a state retirement system, but who withdrew their contributions?

Answer: An employee can withdraw his or her contributions from a state retirement plan after termination of services. The prior services would not be subject to social security.

Question 62: An employee was covered by a state retirement plan while employed. This employee resigned and withdrew his contribution from the retirement plan. The employee then went to work for another employer and was covered under social security. If this worker has the required quarters, will he be subject to the public pension offset?

Answer: No. The employee will not receive a public pension because he withdrew his contribution from the retirement plan.

Question 5 & 7: Can employees change their Forms W-4 in mid-year to increase their withholding exemptions, even though their marital status and number of dependents have not changed? For example, an employee revises his Form W-4 to increase his exemptions from three to nine or repeatedly changes his Form W-4.

Answer: No. Every employee must furnish to the employer a signed withholding exemption certificate (Form W-4) on or before the date of employment. The Form W-4 must indicate the employee's marital status and the number of withholding exemptions claimed. This number should not exceed the number to which the employee is entitled. A married employee can claim an exemption for a spouse only if the spouse does not have in effect a Form W-4 claiming his or her own exemption. Code section 3402(f)(1)(B). If the employee fails to provide a Form W-4, the employer must withhold as if the individual were single with no withholding exemptions. Section 31.3402(f)(2)-1(a), Employment Tax Regulations.

Pub. 505, Tax Withholding and Estimated Tax, provides detailed instructions for completing Form W-4. Pub. 505 and Pub. 919 provide information about determining the correct amount of income tax withholding.

Employees may amend their forms W-4 if their situations change. Some of the reasons to add an exemption would be if an employee gets married (provided the spouse does not work and claim his or her own exemption) or if a child is born or adopted. Section 31.3402(f)(2)-1(b), Employment Tax Regulations.

The purpose of completing the Form W-4 is to have the right amount of tax withheld. Sometimes this cannot be done simply by claiming an exemption for each member of a family. The employee may be entitled to additional withholding allowances, as provided in the regulations. Code section 3402(m), section 31.3402(m)-1, Employment Tax Regulations. For instance, the employee might have deductions and credits which will significantly reduce taxable income. To benefit from extra allowances, the employee must have in effect with the employer a Form W-4 claiming additional allowances.

The employee may also be entitled to fewer exemptions or need to have additional tax withheld if, for instance, the employee has additional sources of income, such as self-employment or investment income. Form W-4 is also used to authorize additional withholding. See Pub. 919.

Any unauthorized change or addition to a Form W-4 makes it invalid. This includes taking out the language by which the employee certifies that the form is correct. A Form W-4 is also invalid if, by the date an employee gives it to the employer, he or she indicates in any way that it is false. An employee who files a false Form W-4 may be subject to a $500 penalty.

An employer should not knowingly use an invalid Form W-4 to calculate withholding. The employer should tell the employee it is invalid and ask for another one. If the employee does not provide a valid one, the employer should withhold taxes as if the employee were single and claiming no withholding allowances. However, if a prior Form W-4 is in effect with respect to the employee, the employer should continue to withhold in accordance with the prior form. Sections 31.3402(f)(2)-1(e) and 31.3402(f)(5)-1(b), Employment Tax Regulations.

Question 6: Employees sometimes claim exemption from withholding on their Forms W-4. Can you explain the applicable rules?

Answer: An employer is not required to deduct and withhold income tax upon payment of wages to an employee if the employee has filed a valid certificate of exemption from withholding. An employee may claim exemption from income tax

withholding if he or she (1) had no income tax liability last year and (2) expects to have no tax liability this year. Code section 3402(n). See the Form W-4 instructions for more information.

An employee must submit a Form W-4 to the employer each year by February 15th to claim exemption from withholding. If the employee does not provide a new Form W-4, the employer must withhold tax as if the employee were single with zero withholding allowances.

The employer must send the IRS copies of Forms W-4 received during the quarter from employees claiming (1) more than 10 withholding allowances or (2) exemption from withholding when the employee's wages are usually more than $200 per week. Section 31.3402(f)(2)-1(g), Employment Tax Regulations. See also Publication 15, pp. 12 -13.

Questions 12 & 13: Is a state or local government required to withhold and pay social security taxes for its employees?

Answer: If the employees do not participate in a public retirement system, yes, the state or local government must withhold and pay OASDI and Medicare taxes (with limited exceptions). This provision applies for services performed after July 1, 1991. Code section 3121(b)(7)(F).

If the employees are in a group covered under a 218 agreement, they are subject to social security tax under the 218 agreement. Code section 3121(b)(7)(E). The rules of section 3121(b)(7)(F), discussed immediately below, do not apply. Most 218 agreements apply to both OASDI and Medicare coverage, but there are also Medicare-only agreements.

While both portions of social security tax generally apply to employees of state and local governments, there is an exception from Medicare tax for employees who participate in a public retirement system and who have been continuously employed since before March 31, 1986. See the discussion above of Code section 3121(u)(2). Employees hired (or rehired) after March 31, 1986, are subject to mandatory Medicare coverage (with limited exceptions). See Pub 963.

Question 14: A school district pays its coaches a fee for their services. Should the district report these payments on Form W-2 or Form 1099? Coaches are hired under a contract each season. The schedule of practice times, game times and locations is set by the athletic director of the school. The school provides equipment, referees, time keepers, insurance, medical coverage for the players, etc. The school

provides transportation to games and liability insurance. It issues general instructions under which the coach works.

Answer: School coaches, like teachers, are subject to sufficient control that they are typically employees under the common law. The school district has a right to control the manner and means by which coaches and athletic directors perform their functions. We know of no case or ruling in which members of the faculty of a school or college were found to be independent contractors. Potter v. Commissioner, T.C. Memo. 1994-356 (temporary, untenured college humanities professor an employee for FICA purposes); Rev. Rul. 70-308, 1970-1 C.B. 199 (part-time instructors hired by a school to teach courses for occupations in airline industry are employees for FICA purposes); Rev. Rul. 70-363, 1979-2 C.B. 207 (attorney-instructors and their substitutes conducting classes at law college are employees for FICA purposes); Rev. Rul. 57-119, 1957-1 C.B. 331 (athletic association composed of colleges and universities is employer for FICA purposes of officials it engages, trains, and supervises to officiate at intercollegiate athletic contests).

We can think of no basis for concluding that a high school coach is engaged in an independent trade or business. A coach does not have the freedom of action characteristic of an independent contractor, but must function under policies and regulations established for the school. Additional important factors are that a coach has no investment in facilities, has no opportunity for profit or loss, is an integral part of the school's trade or business, and must perform his services personally. A coach performs his services on school property, on a schedule established by the school. Schools are liable for negligent or tortious conduct of their faculty members. The fact that a coach's remuneration is termed a "fee" or "stipend" rather than salary or wages is immaterial. Coaches' wages are subject to employment taxes and should be reported on Form W-2.

Question 17: A county pays meal money allowances, including lunch and dinner, for its ballot clerks. They are not required to eat their meals on the premises and usually go to a local restaurant. Are these payments taxable?

Answer: Yes, they are taxable. Section 62(a) of the Code provides that gross income means all income from whatever source derived, including fringe benefits. There is no exclusion that applies to a fringe benefit of this type. There is no contention that the meals are provided on the business premises for the convenience of the employer. Section 119. Moreover, regular meal money does not qualify for the exclusion for de minimis fringes provided by section 1.132-6(d)(2) of the regulations. This exclusion is for meal money which meets three criteria: it is provided (1) on an occasional basis, (b) because overtime work necessitates the extension of the employee's normal work schedule, and (3) to enable the employee to work overtime.

The meal money in this case is provided on a routine basis and is not excludible from income.

Question 24: A school district has a 218 agreement which covers employees who are not teachers. School board members for this district meet 10 times a year and are paid a fee of $25 per meeting. Are these individuals employees, and, if so, are their fees subject to withholding, OASDI and Medicare taxes?

Officers, employees and elected officials of states and their political subdivisions and instrumentalities are employees for purposes of income tax withholding. Code section 3401(c). Are school board members public officials?

The Code does not define the term "public official," but section 1.1402(c)-2(b) of the Income Tax Regulations gives the following examples: the president, the vice president, a governor, a mayor, the secretary of state, a member of Congress, a state representative, a county commissioner, a judge, a justice of the peace, a county or city attorney, a marshal, a sheriff, a constable, a registrar of deeds, or a notary public.

Under federal law (Supreme Court cases), an office is a public station conferred by the appointment of a government. The term embraces the idea of tenure, duration, emolument and duties fixed by law. Where an office is created, the law usually fixes its incidents, including its term, its duties, and its compensation. Metcalf & Eddy v.Mitchel, 269 U.S. 514, 520 (1926). Officers and employees are agents of a state or political subdivision to administer its laws. The independent contractor has liberty of action which excludes control or the right to control characteristic of the employer-employee relationship. Id. at 521. An official operates with a certain amount of independence under the law, but the law also usually specifies a chain of command, including provision for an official's removal. A public official usually takes an oath of office. An elected official is responsible to the electorate.

It is necessary to consult the statutes or ordinances establishing a position to determine whether the position is a public office. In the case of school boards, consultation of state statutes, and their annotations, is likely to provide ample evidence that school board members are public officials.

For instance, we consulted the Annotated Code of Maryland (2000, Matthew Bender) and found that county school boards are created by statute as bodies politic and corporate. Section 3.104. A county board of education is an agent of the State of Maryland entitled to Eleventh Amendment immunity. Jones v. Frederick County B. of Ed., 689 F. Supp. 535 (D. Md. 1988). Some county board members are appointed by the Governor and some are elected. Appointed members may be removed for cause by the State Superintendent of Education, with the approval of the Governor. Section 3-108(d). Elected members may be removed for cause by the State Board of

Education, with approval of the Governor. Section 3-1002(i). The duties and responsibilities of county boards are established by statute. Although educational matters affecting counties are under the control of the county boards of education, the county boards' authority is subject to statutes enacted by the legislature and to the supervening authority of the State Board of Education. In re Patrick Y, 358 Md. 50 (2000).

These statutory provisions and cases make it clear that in Maryland a school board member is subject to a degree of control likely to make him or her a public official whose compensation is subject to income tax withholding. This situation is likely to prevail throughout the nation. Boards of education, water boards, and other boards and commissions are created by state statute. Consultation of these statutes is likely to show that these positions are defined as public officials of the states or their political subdivisions or instrumentalities.

Are school board members employees for FICA purposes?

The common-law rules apply to determine whether an individual is an employee for FICA purposes. Section 3121(d)(2). In the case of public officials, the statutory provisions which establish their status as officials are also relevant to the determination of whether they are common-law employees. These provisions provide facts tending to show that officials' performance of their duties under the law is controlled by state statute, the authority of superior officials and the electorate.

Are school board members whose compensation is called "fees" properly treated as fee-based public officials?

No. Their compensation is wages subject to FICA tax. A fee-based public official is one who receives compensation in the form of fees directly from the public with whom he does business, for instance, a notary public. Rev. Rul. 74-608, 1974-2 C.B. 275. It does not matter what an official's compensation is called or how often it is paid. If the individual is an employee and receives compensation from a public employer rather than directly from members of the public, his or her compensation is subject to FICA tax.

Question 11(A): Are liquidated and punitive damages subject to FICA taxes?

The term "liquidated damages" means damages whose amount has been ascertained, either in a judgment or in an agreement. Typically, when a specific sum has been expressly agreed to by two parties as the amount of damages to be recovered in case of breach of an agreement, the sum is referred to as "liquidated damages."

It is necessary to look at the origin of the claim to determine whether employment taxes apply. Generally, FICA taxes apply to a dismissal payment. Rev. Rul. 71-408, 1971-2 C.B. 340. (See the cases listed below.) Be aware, however, that in Rev. Rul. 58-301, 1958-1 C.B. 23, the Service ruled that liquidated damages for termination of a 5-year employment contract were not wages for FICA purposes. The Service limits the application of this ruling to cases in which there is a buy-out of a contract of specific duration.

Punitive damages are awarded to punish or make an example of a defendant on account of outrageous conduct. Punitive damages are awarded in addition to compensatory damages for actual monetary losses. Because of the nature of punitive damages, they will not be the equivalent of wages on account of employment and consequently are not subject to FICA taxes.

You should be aware that Congress recently amended the treatment of punitive damages in section 104, dealing with compensation for injuries or sickness. Section 104(a)(2) now excludes from income only "damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness." Therefore, punitive damages, even in connection with personal injuries, are not excludible from income. New subsection 104(c) provides a narrow exception to the rule of inclusion for punitive damages in a wrongful death action where state law provides the only damages that may be awarded are punitive damages. These rules apply generally to amounts received after August 20, 1996.

(B) If liquidated damages are not subject to FICA taxes, is an employer required to provide a Form 1099 to an individual who receives a legal settlement?

In general, yes, a payor of damages, or its insurer, is required by Code section 6041 to report on Form 1099 when it makes payments of $600 or more, as a result of a judgment or a settlement. It is generally agreed that no information reporting is required for payments which are not subject to income tax. Thus there would be no reporting requirement for a payment of damages exclusively for physical injuries (with the exception of punitive damages, which are includible in income). Section 104(a)(2).

(C) What if the legal settlement is related to termination of an employee?

Settlements of suits in cases of employee termination arise from a variety of causes of action. The settlement could be for a breach of contract, a tort, or a violation of any one of a number of federal or state statutes such as the Age Discrimination in Employment Act or the Americans With Disabilities Act. All the facts must be considered, for instance the complaint, the settlement document, a court's opinion, etc., to determine what the award is for. There is no simple answer to this question.

We will focus upon damages received to compensate for economic loss, for example lost wages, business income, and benefits. These amounts are includible in gross income unless a personal physical injury caused the loss.

In general, severance payments are wages for employment and are subject to FICA taxes. This position is supported by no fewer than six court decisions dealing with payments made in the course of the layoffs and downsizing of the 1980s and 90s. Two of these decisions have been affirmed by the Second and Federal Circuits. Associated Electric Cooperative, Inc. v. U.S., 42 Fed. Cl. 867 (1999), aff'd 226 F.3d 1322 (Fed. Cir. 2000) (plaintiff was required to sign a Release and Covenant Not to Sue in exchange for the payment); Abrahamsen v. U.S., 44 Fed. Cl. 260 (1999); Abbott v. U.S., 76 F. Supp. 2d 236 (N.D.N.Y. 1999), aff'd 231 F.3d 889 (2d Cir. 2000). Indications that the settlement amounts were wages for employment were that the payments arose in connection with the employment relationship and that the amounts were based on salary and years of service.

Wages are generally subject to FICA tax when they are actually or constructively paid. Employment Tax Regulation section 31.3121(a)-2(a). Severance payments are subject to FICA tax in the year in which they are paid. The FICA tax rate and wage base are those in effect in the year of payment. FUTA tax and income tax withholding also apply. Sections 3306(b), 3401(a). The Supreme Court recently affirmed the Service's position that FICA tax applies for the year of payment, not the year in which the services were, or were not, performed. U.S. v. Cleveland Indians, 121 S.Ct. 1433; 149 L. Ed.2d 401 (2001); rev'g 215 F. 3d 1325 (6th Cir. 2000).

Note that the Service has recently issued an MSSP: Audit Guide for Lawsuit Awards and Settlements (January 1, 2001), Training 3123-009(11-00), TPDS No. 86391G. It provides a lot of interesting information on this topic.

Question 22: A town official pursues a masters degree in public administration. The town pays the cost of the tuition for the courses and treats these payments as a taxable fringe benefit. The courses are job-related for the most part. Is the town treating this benefit correctly?

Answer: When an employer pays an employee's tuition, the available exclusion would be under section 132(a)(3) as a working condition fringe. A working condition fringe is any property or services provided to an employee to the extent that, if the employee paid for them, the payment would be allowable as a deduction by the employee under section 162 or 167. Section 162 provides for the deduction of business expenses; section 167 provides for the deduction of depreciation.

The payments are excludible from income as a working condition fringe if they meet the requirements of section 162 and its regulations. Educational expenses are

deductible if they maintain or improve skills required by the individual in his employment or if they meet the express requirements of the employer. The expenses are deductible if the educational requirements are imposed as a condition to retention of employment, status, or pay level, and also if new requirements are imposed after the employee is hired. Section 1.162-5(c), Income Tax Regulations.

The town official resembles the taxpayer in Blair v. CIR, T.C. Memo. 1980-488, who was employed as a personnel manager, taking courses toward a master's degree in business administration. She was entitled to deduct her tuition expenses for relevant courses because they improved her job skills and did not qualify her for a new trade or business. In this case there were no minimum qualifications for the job. No deduction was allowed for courses which did not pertain to her trade or business.

Educational expenses are not deductible if the courses are required to satisfy the minimum educational requirements to qualify for employment. For instance, if a bachelor's degree is a minimum requirement for a teacher, none of the costs of a bachelor's degree would be deductible, even if an individual was hired provisionally as a teacher, with the understanding that he would complete his bachelor's degree. Section 1.162-5(b)(2), Income Tax Regulations.

Educational expenses are not deductible if they qualify the individual for a new trade or business. Thus, if an employer requires an employee to pursue a law degree in order to continue her current non-legal employment, the expenditures of attending law school are not deductible because pursuit of a law degree always qualifies an individual who is not an attorney for a new trade or business. Section 1.165-2(b)(3), Income Tax Regulations.

You have asked about expenses being paid directly. If the employee is reimbursed for expenditures, the reimbursement arrangement must be an accountable plan within the meaning of section 62(c) and regulations. This means the employees must submit documentation of their business expenses. The plan must require that the employee return any excess reimbursement to the employer.

Code section 127 provides another exclusion for an educational assistance program under a separate written plan for employees. This provision allows an individual an exclusion of up to $5,250 in a calendar year. For tax years beginning before 2002, it does not apply to graduate level courses leading to a law, business, medical, or other advanced academic or professional degree. The Economic Growth and Tax Relief Reconciliation Act of 2001 made this provision permanent and extended the exclusion to graduate level courses after December 21, 2001.

Question 25: A town has a public safety director who is a retired police chief. He carries a firearm and has arrest powers. He drives a regular unmarked vehicle and

commutes in this vehicle from home to the office. Is he entitled to exclude the value of the use of the car from his income?

Answer: As a general rule, fringe benefits such as the use of a car are includible in income. We do not have enough facts to answer this question, but the law is as follows.

Section 132(a)(3) of the Code allows an exclusion for a working condition fringe. A working condition fringe is any property or services provided to an employee by an employer to the extent that, if the employee paid for the property or services, the payment would be allowable as a deduction under section 162 or 167. Section 132(d). In this context, the payment would have to be a business expense.

The value of a "qualified nonpersonal use vehicle" can be excluded from income as a working condition fringe if the use of the vehicle conforms to the requirements of paragraphs (k)(3) through (7) of section 1.274-5T of the regulations. Section 1.132-5T(h), Income Tax Regulations. An employee does not have to substantiate the business use of a nonpersonal use vehicle in order to exclude its value from income.[2]

A qualified nonpersonal use vehicle means any vehicle which, by reason of its nature, is not likely to be used more than a minimal amount for personal purposes. Section 274(i). Normally this is something like a fire engine, a clearly marked police or fire vehicle, a flatbed truck, school bus, ambulance, etc.

There are only limited circumstances under which an unmarked police car qualifies as a nonpersonal use vehicle. First, the driver must be a "law enforcement officer." A law enforcement officer must satisfy all of the following requirements. He or she must be a full-time employee of a governmental unit that is responsible for preventing or investigating crimes involving injury to persons or property (including catching or detaining persons for these crimes). The officer must be authorized by law to carry firearms, execute search warrants, and to make arrests. The officer must regularly carry firearms, except when it is not possible to do so because of the requirements of undercover work.

Second, any personal use of the vehicle must be authorized by the government agency or department that owns or leases the vehicle and employs the officer, and,

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[2]Section 274(d) of the Code provides, in part, that a deduction incurred with respect to "listed property" (as defined in section 280F(d)(4)) will be disallowed unless substantiated by adequate records or sufficient corroborative evidence. Listed property generally includes any passenger automobile or any other property used as a means of transportation. Section 274(d) does not apply to a qualified nonpersonal use vehicle as defined in section 274(i).

third, the use must be incident to law-enforcement functions, such as being able to report directly from home to a stakeout or surveillance site, or to an emergency situation. Use of an unmarked vehicle for vacation or recreation trips cannot qualify as an authorized use. Section 1.274-5T(k)(6), Income Tax Regulations.

It is not clear whether a public safety director is employed by an agency responsible for preventing or investigating crimes involving injury to persons or property. The individual appears to have some of the powers of a law enforcement officer, except that the authority to execute search warrants is not mentioned. A law enforcement officer must have all of the powers listed above.

It is not clear from the facts whether the individual's use of the vehicle is authorized by the governmental agency which employs him or whether the use is incident to law-enforcement functions. If the individual is allowed to use the vehicle as a courtesy and for commuting purposes, it does not qualify as a nonpersonal use vehicle, and the commuting value is income subject to FICA and income tax withholding.

Question 56: For purposes of defining a qualified nonpersonal use vehicle, what qualifies as a clearly marked police or fire vehicle?

Answer: A police or fire vehicle is clearly marked if it has insignia or words which make it clear that it is a police or fire vehicle. A marking on a license plate is not a clear marking for this purpose.

According to the regulations, the exclusion for a clearly marked police or fire vehicle applies only to a vehicle that is required to be used for commuting by a police officer or fire fighter who, when not on a regular shift, is on call at all times. Other than commuting, personal use of the vehicle, outside the limit of the police officer's arrest powers or the fire fighter's obligation to respond to an emergency, must be prohibited by the governmental unit. Section 1.274-5T(k)(3), Income Tax Regulations.

Question 53: A town provides cars which its officials and other employees use during the workday for business purposes. These employees also use the cars for commuting to and from work. Is the use of these vehicles for commuting taxable income to the employees?

Generally, yes, the value of noncash fringe benefits is taxable income to the recipient. Code section 61(a). Thus the commuting value of a vehicle owned or leased by a public entity usually represents taxable income to the employee.

One exception is for the qualified nonpersonal use vehicle, described above. Thus, for example, when a law enforcement officer drives a clearly marked police car to his or her residence when off duty and otherwise satisfies the requirements described above, the commuting value of that vehicle is not income to the employee.

There are several ways to value the commuting use of a car for income and FICA tax purposes: the cents-per-mile rule, the lease value rule, and the commuting rule. Under the cents-per-mile rule, the value of the use of a car is the standard mileage rate (for 2001 34.5 cents per mile) multiplied by the number of personal miles driven. Under the lease value rule, the value of the use of the car is the annual lease value (in the regulations) less the amount of use which would be a working condition fringe to the employee. See section 1.61-21(d)(2), Income Tax Regulations, which also discusses this valuation method in detail. To qualify as a working condition fringe, the business use must be deductible as a business expense by the employee. This means that the employee must keep a log to account for the business miles driven. More information about these methods can be found in Publication 15-B, Employer's Tax Guide to Fringe Benefits.

Under limited circumstances, the "commuting rule" can be used to determine the commuting value of a car. Under this rule, the employer determines the commuting value by multiplying each one-way commute (from home to work or from work to home) by $1.50. If more than one employee commutes in the vehicle, this value applies to each employee. To use this rule, the employer must meet all the following requirements.

1) The employer owns or leases the vehicle and provides it to one or more employees for business use.

2) For bona fide noncompensatory business reasons, the employee is **required** to commute in the vehicle. The employer is treated as meeting this requirement if the vehicle is generally used each workday to carry at least three employees to and from work in an employer-sponsored commuting pool.

3) The employer establishes a written policy under which the employee is not allowed to use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home).

4) The employee does not use the vehicle for personal purposes, other than commuting and de minimis personal use.

5) If this vehicle is an automobile, the employee who must use it for commuting is not a control employee. An elected official is always a control employee. (For tax year

2001, a control employee of a government employer is one whose compensation is $155,000 or more for the year.)

The term “bona fide noncompensatory business reason” means that the employee must be required to commute in the vehicle for the benefit of the employer, not for the benefit of the employee. This would be the case if the employee was driving a van in an employer-sponsored carpool. Another example would be if a car, though unmarked, was outfitted with communications or other equipment the employee would need if on call 24 hours a day. Other possibilities might be unavailability of parking at the workplace. Also, an employee in the field who would otherwise have to return to the workplace before going home might be able to work longer if allowed to commute in an employer-provided vehicle. It is not enough for the employer to simply state that it requires employees to commute in employer-owned vehicles.

Question 38: Can an appointed executive or official have a portion of his salary paid to him as reimbursement for mileage, phone calls, etc., and the balance as salary subject to FICA and withholding?

This depends upon what is meant by having “a portion of his salary paid as reimbursement.” If this is simply a portion of his compensation that is deemed to be for expenses, without evidence that this money reimburses expenses actually paid, the answer is no.

To be excluded from wages, reimbursements must be for actual documented expenses under an accountable plan, i.e., a reimbursement or other expense allowance arrangement set up by the employer. Code section 62(c) and section 1.62-2. Income Tax Regulations.

To qualify as a reimbursement or other expense allowance arrangement, the arrangement must require (1) that the employee substantiate all expenses to the employer. The arrangement must also require (2) that the employee return any amount in excess of substantiated expenses. An expense should be substantiated within 60 days after it is paid. If the individual receives an advance, any money not accounted for must be returned within 120 days. See section 1.62-2(g) of the Income Tax Regulations, defining a “reasonable period” for purpose of this section.

To substantiate the expense, the employee must document the amount, time and place of travel, the business purpose, and the business relationship to the taxpayer of the people involved if the expense is for entertainment. Miscellaneous expenses must also be documented. Section 1.274-5(b), Income Tax Regs. In other words, the substantiation requirement involves furnishing the employer a detailed breakdown of expenses, backed up by receipts. The employee must be required to document

business expenses, must be required to return any portion of an advance that is not used, and must comply with these requirements.

The government recently won a case in which the taxpayer paid its employees a so-called "per diem," which bore no relationship to actual expenses. The court held that the payments were wages subject to income and FICA taxes. To avoid classification of the payments as wages, the employer was required to set up an accountable plan as defined in Code section 62(c). Worldwide Labor Support of Mississippi v. U.S., 87 A.F.T.R. 2d ¶2001-997 (S.D Miss 2001),

Question 31: A town is seeking clarification of IRS rules regarding reimbursement of employees for use of their vehicles in the employer's business.

1. An employee is paid $l0 per day, in addition to his regular compensation, to pick up and deliver mail between four schools and a central office.

2. An employee is paid $8.50 per trip, in addition to his regular compensation, to deliver meals from two satellite kitchens to two receiving schools.

3. An employee is paid $26 per hour for using his truck to plow snow during off hours.

Answer: The employees in #1 and #2 are using their own vehicles for business travel. Under these facts, the payments are additional compensation subject to income and employment taxes.

The employees would be able to exclude mileage reimbursements from income and employment taxes only if reimbursements were made under an accountable plan as defined in Code section 62(c) and regulations. Employees must be required to keep track of actual mileage and submit documentation to their employer showing date traveled, mileage, and business purpose. The employer can reimburse the employee using the standard federal mileage rate of up to 34.5 cents per mile for calendar year 2001. If the employee receives more than the standard rate, the excess is taxable and must be reported on the employee's W-2 subject to applicable income and FICA taxes.

These requirements, as discussed above, are found in Code section 62(c) and section 1.62-2, Income Tax Regulations, defining reimbursements and other expense allowance arrangements. The Service has recently won several cases on the issue of "reimbursement" arrangements which did not satisfy the rules for accountable plans. Trans-Box Systems v. U.S., 86 A.F.T.R. 2d (RIA) 5015 (9th Cir. 2000), aff'g 84 A.F.T.R. 2d (RIA) 6479 (N.D. Cal. 1998); Shotgun Delivery, Inc. v. U.S., 85 F. Supp. 2d 962 (N.D. Ca, 2000); Escobar v. Commissioner, T.C. Memo. 2000-176 (rejecting the theory that truck rental was a separate self-employment activity) .

If plowing snow is simply an extension of employee #3's regular services, the $26 per hour would be wages. Payment for the use of the truck would have to be under an accountable plan before it could be excluded from FICA wages and taxable income. However, it is possible that this worker is working in two capacities, employee and independent contractor. For the individual to qualify as working in two capacities, both the types of work and the manner of payment must be separate and distinct. The IRS will make this determination if the employer or the employee requests it by filing Form SS-8.

Question 33: Are clerks of the works always employees?

An individual is an employee if, under the common law rules, the relationship between the individual and the person for whom he or she performs services is the legal relationship of employee and employer. Code section 3121(d)(2). Generally this relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished but also as to the details and means by which the result is accomplished. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so. Section 31.3121(d)-1(c), Employment Tax Regulations.

Revenue Ruling 57-145, 1957-1 C.B. 332, dealt with clerks of the works, in a situation where there was sufficient right to control for them to be classified as employees. A corporation contracted with a construction company to construct a building in accordance with plans prepared by a firm of architects. The corporation also required the architects to visit the project to check the progress from time to time. However, in order to have constant supervision of the project, the corporation engaged several individuals known in the building trade as clerks of the works. These individuals were responsible to the corporation to assure that the construction work and materials used were of appropriate quality. The clerks made their reports directly to the corporation, which had the right to dismiss them. They had no responsibility to the architectural firm. At the request of the corporation, the architectural firm paid the clerks from its own funds and was reimbursed by the corporation for the amounts advanced. The clerks of the works were employees of the corporation for purposes of FICA. The architectural firm controlled the payment of wages and thus was responsible for the withholding of income and FICA tax. Code section 3401(d)(1).

We cannot say, however, that construction supervisors, by whatever name, are always employees. Today construction projects are more complex than in 1957, the year of the revenue ruling. Construction supervision is now a highly skilled specialty, and there are individuals and corporations that do nothing but manage construction projects and serve as expert witnesses in contract disputes. Consequently, we must always consider the entire relationship of the parties to determine whether the

construction manager is engaged in an independent trade or business or serving as an employee. In other words, apply the common law rule.

Question 34: An adult education teacher is a school district employee. In addition to her teaching job, she performs services of editing and layout for a school district newsletter. Is the compensation for the editing and layout work properly reported on her Form W-2 as wages for employment, or is she an independent contractor?

We do not have enough facts to answer this question. To determine if the teacher is an employee or independent contractor in the layout and editing job, the school district would need to look at the common-law rules, discussed in detail in Publication l5-A.

If the school district can control what will be done and how it will be done, the worker is an employee. This is so even when the employee has a certain amount of freedom of action. What matters is that the employer have the right to control the details of how the services are performed. Generally the determination involves questions of whether the service recipient has behavioral control and economic control, and of the relationship between the parties, including any written contract.

Concerning behavioral control, does the individual do her editing work on school premises, under supervision, or does she work at home on her own computer? Who has final say about the appearance and content of the newsletter? If the individual carries on an editing business and holds herself out to the public as an editor, this is a factor favoring independent contractor status.

Does the service recipient have economic control? Does the individual have a genuine possibility of profit or loss in the editing activity, or does she essentially receive a salary? Is the position covered by the teachers' retirement system? Does the individual receive any employee benefits in the editing job?

When analyzing the relationship of the parties, one of the main questions is whether there is a written contract stating how the parties view their relationship. The characterization given to the position in a contract is not determinative, if that characterization does square with reality, but in close cases it can be an important factor.

The Service recognizes that an individual can work for one entity in a dual capacity. In Rev. Rul. 58-505, 1958-2 C.B., 728, the officers of an insurance company performed administrative duties for the company and also sold insurance policies under a standard independent contractor agreement. The Service held that they worked in two distinct capacities, employee and independent contractor. The ruling states that, if

the two services are “interrelated,” the officers do not act in two separate capacities. If, however, the services in the two capacities are separate and distinct, then the status of each type of service must be considered separately. This means that there is no interrelation either as to duties or remuneration in the two capacities. In this case, the two types of work are sufficiently different that it is possible, thought not certain, that the employee is working in two capacities.

Question 41: A municipality reimburses its retirees for the cost of Medicare B premiums. Is this a taxable fringe benefit?

If the reimbursement is properly handled, it can be tax-exempt. Section 106 of the Code excludes from gross income employer-provided insurance coverage under an accident or health plan. Retirees are treated like employees for this purpose. Rev. Rul. 82-196, 1982-2 C.B. 53; Rev. Rul. 75-539, 1975-2 C.B. 45; Rev. Rul. 62-199, 1962-2 C.B. 38.

Reimbursement for the cost of Medicare B premiums can be excluded from a retiree’s income. The reimbursements have to be handled so as to ensure that they are for actual premiums paid. Rev. Rul. 61-146, 1961-1 C.B. 25, gives examples of acceptable methods of reimbursement. The employer can reimburse the employee after receiving proof of prior payment of the premiums by the employee. It can also issue the employee a check payable to Medicare. The Medicare B premium reimbursements in this case would not be a taxable fringe benefit.

Question 48: A school district has no health insurance plan. It gives employees cash from accounts payable to pay for their own health insurance. Is this benefit taxable and subject to FICA?

Yes, cash given to employees in lieu of health insurance is taxable and should be reported as income and FICA wages on Form W-2. If an employer issues a check to an employee to pay for health insurance without requiring proof of payment of premiums, the amount is a taxable fringe benefit. Rev. Rul. 57-33, 1957-1 C.B. 303 (holding that payments made directly by an employer to employees, pursuant to a union contract, for the purpose of enabling the employees to purchase health insurance were wages for FICA purposes).

Question 36: A town is required to pay retroactive pay increases. Please describe the applicable withholding requirements.

This type of payment is considered supplemental wages. Supplemental wages are compensation paid in addition to the employee’s regular wages, for example

bonuses, commissions, overtime pay, awards, prizes, back pay, taxable fringe benefits and expense allowance payments paid under a nonaccountable plan. Supplemental wages can be paid for the same or a different period, or without regard to a particular period.

If an employer pays supplemental wages with regular wages but does not specify the amount of each, the employer must withhold income tax as if the total were a single payment for a regular payroll period.

If the employer pays supplemental wages separately (or combines them in a single payment and specifies the amount of each), the income tax withholding method depends partly on whether income tax was withheld from regular wages:

1l) If income tax was withheld from an employee's regular wages, the employer can use one of two methods for the supplemental wages:

a) Withhold a flat 28% (without regard to exemptions or regular payment of wages).

b) Add the supplemental and regular wages for the most recent payroll period. Then figure the income tax withholding as if the total were a single payment. Subtract the tax already withheld from the regular wages. Withhold the remaining tax from the supplemental wages.

2) If the employer does not withhold income tax from the employee's regular wages, use method b above. (This would occur, for example, when the value of the employee's withholding allowances claimed on Form W-4 is more than the employee's wages.) See section 31.3402(g)-1(b) of the Employment Tax Regulations for more information on this method.

Supplemental wages are subject to FICA taxes, regardless of the method used to withhold income tax. See Publication l5, Page 11.

Question 42: A teacher who is not of retirement age retires from service due to a permanent disability. She was a member of the state teachers' retirement system and begins receiving annuity payments from the system. Later she returns to work for the same school district as a part-time tutor. The school district has no 218 agreement, and the position is not covered by a state retirement plan. Is she subject to OASDI or Medicare taxes?

It is our opinion that the teacher would not be subject to OASDI tax, as she would be regarded as a rehired annuitant. She was a qualified participant in the retirement system, and she is "in pay status" i.e., currently receiving retirement benefits. Consequently, she is deemed to be a qualified participant in the retirement system

without regard to whether she continues to accrue a benefit. Section 31.3121(b)(7)-2(d)(4)(ii), Employment Tax Regulations. The teacher's remuneration as a part-time tutor would be subject to the Medicare tax if she was rehired after April 1, 1986.

Question 43: A school district hired a part-time special education director, a rehired annuitant who previously worked for another school district. She is currently paying the cost of her health insurance, which is being deducted from her state retirement check. She qualifies to obtain health insurance at the new school district. She provides documentation of her payment of the insurance premium that is being deducted from her state retirement check. If the school district reimburses her the full amount of this health insurance cost, is the reimbursement taxable?

No, the reimbursement is not taxable once the employee establishes proof of insurance and payment of the premiums. Rev. Rul. 61-146, 1961-2 C.B. 146, describes methods by which an employer can pay its employees' health insurance premiums, in addition to paying them directly to the insurance company. The employer can reimburse the employee, upon proof of prior payment of the premiums by the employee. The employer can issue a check to the employee payable to the employee's health insurance company, the employee being obligated to turn the check over to the insurance company. The employer can also issue a check made payable jointly to the insurance company and the employee.

Question 51: A fire chief uses his own pickup truck for work. He accounts for the business use of his truck and is reimbursed for his mileage. He sometimes travels to and from the fire station outside of his regular work schedule. Is this considered commuting and would reimbursement be taxable?

This travel is commuting and it's a personal expense. It does not matter if the fire chief is commuting outside of his regular work schedule. Any reimbursement would be taxable to the employee.

In O'Hare v. Commissioner, 54 T.C. 874 (1970), the taxpayer, a physician, was not entitled to deduct the costs of traveling between his home and a hospital, in connection with extra hospital duty. In Potenga v. Commissioner, T.C. Memo 1976-151, the Tax Court held: "The fact that petitioner made more than one trip per day between her home and place of employment does not change the nature of the trips. When a taxpayer travels between his place of employment and his home, the expenses incurred are still personal commuting expenses regardless of the number of trips made each day." The court went on to say: "Although commuting expenses are incurred in order to reach one's place of employment, they are treated as non-business expenses since their amount depends upon the place where one chooses to reside—a choice

which results from personal and family considerations. This reasoning applies equally to the expenses of commuting for regular duty or for extra days."

Question 55: A town has a sheltered workshop where two disabled employees do cleaning chores. It has also hired two people who use wheelchairs to wipe tables one hour each day for $5.15 per hour. Are these amounts reportable as income and subject to FICA tax?

All income is taxable unless it is excluded from taxation by some specific Code provision. Section 61(a). No exclusion appears to apply to these payments. Whether the workers' earnings are subject to FICA tax depends upon whether they are common-law employees, receiving remuneration for employment.

The Service's position on the application of FICA tax to the earnings of workers in sheltered workshops is set forth in Rev. Rul. 65-165, 1965-1 C.B. 446, dealing, in part, with the following two fact patterns.[3]

Fact Pattern 1: Individuals in training. The individuals were given orientation and training for 16 weeks in a sheltered workshop operated by a 501(c)(3) organization. The program was designed to prepare the individuals to work in private industry, but in fact few were able to do so. They received an allowance, but the purpose of this phase was training. These workers were not employees. The facts were that, at this stage, no employment relation was intended.

Fact Pattern 2: Regular workshop workers. An individual who completed training could continue to work in the workshop temporarily, while awaiting placement in private industry, or permanently, if he or she was unable to find a job. The organization provided working conditions and pay scales comparable to private industry in the sense that it paid a sub-minimum wage, compensating the workers on a pro-rated basis, relative to the commercial value of their work. Workers got some benefits, such as vacations and bonuses. They could be discharged if their work was not satisfactory. Here an employment relationship was intended. These workers were employees.

The facts presented are insufficient to determine whether the workers in question are subject to control sufficient for them to be common law employees. We think it is implied that the individuals are common-law employees. They do not appear to be in a training program; they are regularly employed, and those cleaning tables are paid a minimum wage. If an employment relationship is intended, the wages are subject to FICA tax.

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[3]The Service's position is still expressed in Rev. Rul. 65-165 and not in private letter rulings.

Question 57: Is payment received for jury duty subject to income tax? What if jurors are paid for mileage from home to the courthouse?

Amounts received for jury duty are includible in gross income. Section 1.61-2(a)(1), Income Tax Regulations. Reimbursement for travel to and from the courthouse is for commuting expenses and is also includible in gross income.

There is an exception to this rule: If an employee must surrender the jury duty pay to her employer in order to receive her normal compensation, then the amount of jury duty pay may be claimed as an above-the-line deduction in determining adjusted gross income. Code Section 62(a)(13). In this situation, the deduction for jury duty pay should be included in the total on Line 32 of Form 1040 (tax year 2000).

Question 61: An employee of a town was laid off. During the period when he was receiving severance pay, he died. The remaining severance pay is paid to his widow (the beneficiary) before the end of the calendar year when the employee died. How is the payment of the severance pay treated for purposes of income tax, FICA tax and information reporting?

Severance pay is typically wages subject to FICA tax because the employee fully earned the right to the severance pay before death. Any payment made to a beneficiary or the estate of a former employee after the end of the calendar year when the employee died is exempt from FICA, however. Code section 3121(a)(14).

Payments made to a beneficiary or the decedent's estate before the close of the taxable year in which the decedent dies are subject to FICA taxes. For income tax purposes, however, these amounts are taxable to the beneficiary or the estate. They should be reported to the beneficiary or the estate on Form 1099-MISC.

To ensure that the deceased employee receives proper social security and Medicare credit, severance pay earned by the deceased employee before his death should be reported on Form W-2 as social security wages and Medicare wages, on the decreased employee's final Form W-2. However, only the income paid to the decedent should appear as "Wages, tips, other compensation." Rev. Rul. 86-109, 1986-2 C.B. 196.

Question #52: A public agency obtains financing for low-income or first-time homebuyers to assist them in purchasing homes. The agency retains the services of an attorney to conduct closings on the properties. The agency issues one check to the attorney to be deposited in escrow. The amount of the check includes the proceeds of the loans as well as the closing fees for multiple properties. The closing costs include

legal fees and other settlement expenses. The agency must issue a Form 1099 to the attorney. What amount should it report? The gross amount, the amount of the closing costs, or only the amount of the legal fees?

In the facts presented, the agency hired the attorney and is obligated to pay the legal fees. It is paying its own legal fees, not those of the homebuyers. Such fees are reportable to the attorney under Code section 6041. That section requires information reporting by persons engaged in a trade or business and making payment to another person in the course of such trade or business of fixed or determinable income of $600 or more. The legal fees paid to the attorney represent fixed or determinable income to him. If the fees total $600 or more, they should be reported to the attorney on a Form 1099-MISC as nonemployee compensation in Box 7.

The amount of the legal fees in this situation should be known to the agency. However, if they are not, then no part of the amount paid to the attorney is reportable under Code section 6041. Instead, the entire amount paid to the attorney is reportable under section 6045(f), which requires information reporting by any person engaged in a trade or business with respect to payments made to an attorney in connection with legal services. This requirement applies to the gross proceeds paid to the attorney, not just the amount that is fixed or determinable income to the attorney. The gross proceeds reportable under this section are included on Form 1099-MISC, Box 14. Section 6045(f) applies to payments made after December 31, 1997.

The gross amount paid to the attorney need not be reported under section 6045(f) if any portion of that payment is reportable to the attorney under section 6041 (or would be reportable if not for the dollar amount involved) or 6051 (payments to employees). Thus, if the agency must report the legal fees paid to the attorney under section 6041, or would be required to report were it not for the fact that the amount is under $600, it does not have the obligation to report the gross proceeds paid under section 6045(f).

Finally, the exception for reporting payments to a corporation does not apply. Reporting is required for payments to an attorney or law firm that is a corporation.

If you have any questions, please contact Elizabeth Edwards of this office at (202) 622-6040.