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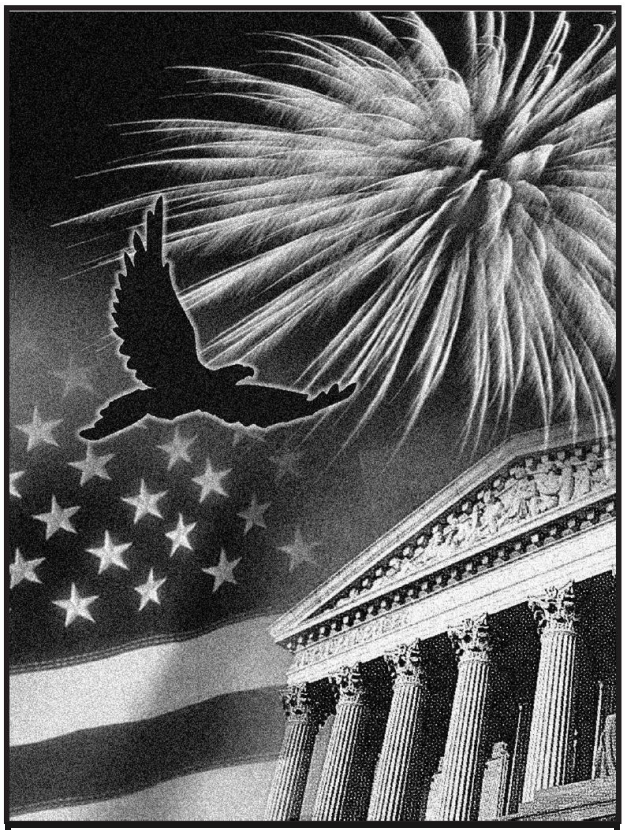
Volume 1 of 6



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Introduction

The Federal-State Reference Guide provides state and local government employers a comprehensive reference source on Social Security and Medicare coverage and federal tax withholding issues. The guide was first published

by the Internal Revenue Service (IRS) in 1995 with assistance from the State of Colorado and is a cooperative effort of the Social Security Administration (SSA), the IRS and the National Conference of State Social

Security Administrators (NCSSSA). Topics addressed in this publication include determination of worker status, public retirement systems (FICA replacement plans), Social Security and Medicare coverage and benefits, agreements under Section 218 of the Social Security Act (Section 218 Agreements), employment tax laws and other tax issues. The tax information generally applies to federal agencies, with some exceptions; for example, the discussion of employment that is subject to Social Security and Medicare taxes, including the Section 218 Agreement information, and the discussion of relief under Section 530 of the Revenue Act of 1978 (Section 530 relief) doesn't apply to federal agencies.

All IRS forms and publications mentioned in this publication can be ordered without charge from the IRS at 800-829-3676, or can be downloaded at www.irs.gov/forms. Governmental taxpayers may get assistance

with general or account-related questions by calling Customer Account Services at 877-829-5500, Monday through Friday.

This publication also includes information for Indian tribal governments. Federal tax law establishes the role of Indian tribal governments as employers. Tribal governments are required to follow substantially the same procedures as other employers. Tribes are not eligible for Section 218 Agreements; however, tribes may apply to SSA to have wages paid to tribal council members covered by an agreement under section 218A of the Social Security Act (Section 218A Agreement). Other special statutory provisions apply to tribal governments. For more information about Indian tribal governments, visit IRS.gov/tribes. Publication 4268, Employment Tax for Indian Tribal Governments, addresses employment tax issues for tribal governments.

Frequently asked questions appear at the end of each chapter of this publication. After each answer, the primary contact for the topic is indicated - IRS, SSA or STATE.

The Federal-State Reference Guide is for informational and reference purposes only. This content cannot be used or cited as authority for assuming, or attempting to sustain, a technical position on employment tax, Social Security benefits or other legal issues. Valid citations of authority for technical matters are:

- The Internal Revenue Code (IRC);
- Certain statutory tax provisions affecting the IRC that are not actually part of the IRC (off-IRC provisions, such as Section 530 of the Revenue Act of 1978) and the Social Security Act (Act); and
- Regulations, other published administrative guidance (such as rulings) and case law related to these laws.

Chapter 1

Social Security and Government Employers

Federal tax requirements generally apply to public employers in the same way that they do to private employers. However, there are some differences arising from the unique history of laws governing Social Security and Medicare coverage for state and local government employees. Special provisions apply to the application of these taxes as well as certain withholding requirements.

Historical Overview

Social Security taxes were first collected in 1937. The funding mechanism for the Social Security program was officially established in the Internal Revenue Code (IRC) as the Federal Insurance Contributions Act (FICA). Under the original Social Security Act of 1935, state and local government employees were

excluded from Social Security coverage because of unresolved legal questions about the federal government's authority to impose taxes on state and local governments and their employees.

Beginning in 1951, states could enter into voluntary agreements with the federal government to provide Social Security coverage to public employees. These arrangements are called "Section 218 Agreements" because they are authorized by Section 218 of the Social Security Act. Originally, government entities filed with the SSA, but since 1987, the IRS has been responsible for collecting these taxes from governmental employers. All 50 states, Puerto Rico, the Virgin Islands and approximately 60 interstate instrumentalities have Section 218 Agreements with SSA, providing varying degrees of coverage for employees in the state.

Social Security coverage of government employees varies greatly from state to state. In 22 states, at least 90% of state and local government employees work in positions covered by Social Security. By contrast, in Alaska, California, Colorado, Louisiana, Massachusetts, Ohio, Nevada and Texas, less than half of state and local government employees are covered. As of 2014, 28.1% of the state and local government workforce, or 6.4 million state and local government employees were not covered by Social Security.

The largest portion of uncovered government employees work at the local level. Most uncovered local government public employees are police officers, firefighters and teachers.

The following chart includes the major historical developments since state and local employees first became eligible for Social Security coverage in 1951.

Key Dates

January 1, 1951	Beginning this date, states could voluntarily elect Social Security coverage for public employees not covered under a public retirement system (FICA replacement plan) by entering into a Section 218 Agreement with SSA. Prior to this date, there was no mandatory Social Security coverage.
January 1, 1955	Beginning this date, states could extend Social Security coverage to employees (other than police officers and firefighters) covered under a public retirement system.
July 1, 1966	Beginning this date, employees covered for Social Security under a Section 218 Agreement are automatically covered for Medicare.

April 20, 1983	Beginning this date, coverage under a Section 218 Agreement cannot be terminated unless the governmental entity is legally dissolved.
April 1, 1986	State and local government employees hired on or after this date, not already covered, are mandatorily covered for Medicare, unless the position is specifically excluded by law. For state and local government employees hired before April 1, 1986, Medicare coverage may be elected under a Section 218 Agreement.
January 1, 1987	Beginning this date, State Social Security Administrators are no longer responsible for collecting Social Security contributions from public employers or for verifying

	and depositing the taxes owed by public employers. After 1986, public employers pay FICA taxes directly to the IRS in the same manner as do private employers.
July 2, 1991	Beginning this date, state and local government employees became subject to mandatory Social Security and Medicare coverage, unless they are (1) members of a qualifying public retirement system, or (2) covered under a Section 218 Agreement.
August 15, 1994	The Social Security Independence and Program Improvements Act of 1994 established the SSA as an independent agency, effective March 31, 1995. This Act also increased the FICA exclusion amount for election workers from

	$100 to any amount less than the threshold amount mandated by law in a calendar year. (To verify the current year amount, see the SSA website.) States were authorized to amend their Section 218 Agreements to increase the FICA exclusion amount for election workers to the statutorily mandated threshold. This Act also amended Section 218 to allow all states the option to extend Social Security and Medicare coverage to police officers and firefighters who participate in a public retirement system. (Under previous law, only 23 states were authorized to do so.)
October 21, 1998	Public Law 105-277 provided a 3-month period for states to modify their Section 218 Agreements to

	exclude from coverage services performed by students. This provision was effective July 1, 2000, for states that exercised the option to take this exclusion.
March 2, 2004	Public Law 108-203 requires public employers to furnish Form SSA-1945 to public employees hired after December 31, 2004, informing them that they are earning retirement benefits not covered by Social Security; also closed the Government Pension Offset (GPO) loophole, effective April 1, 2004.

Key Public Employer Responsibilities

The following are the major responsibilities that apply to all public employers, regardless of their Social Security coverage and public retirement system:

- Properly classify workers as either independent contractors or employees.
- Solicit and collect valid taxpayer identification numbers from all employees and payees.
- Determine which employees are exempt from Social Security and/or Medicare taxes.
- Withhold, report and pay appropriate Social Security and Medicare taxes, or Medicare-only taxes, for each employee.
- Obtain clarifications of laws, regulations and other appropriate information from State Social Security Administrators, IRS and SSA.

Considerations for Social Security Coverage (Section 218 and Mandatory)

Social Security coverage can vary widely within a state or even a local area. Do not

make an assumption about Section 218 Agreement coverage for an entity and whether it complies with all applicable laws merely because of the status of a similar entity, either in the same or a different state. For Section 218 Agreement coverage questions, contact your State Social Security Administrator (see www.NCSSSA.org). Related information can also be found at SSA State and Local Government Employers.

In general, to determine the correct coverage for a group of employees, a government employer must address the following questions:

If employees **are** covered by a Section 218 Agreement:

1. When did the state enter into a Section 218 Agreement to elect Social Security coverage for a particular political subdivision?

2. What optional exclusions and what coverage groups were listed in that Agreement or later modification?

3. Does the political subdivision have more than one modification?

4. Did the state or political subdivision terminate voluntary Social Security coverage in its entirety or for any coverage groups before April 20, 1983?

5. Has the state elected to provide Medicare-only coverage for a particular entity?

If employees **are not** covered by a Section 218 Agreement:

1. Does the state or political subdivision have any employees who were hired prior to April 1, 1986, and who are exempt from mandatory Medicare?

2. Does the state or political subdivision have a public retirement system?* If so, employees who are qualified participants in the public retirement system are not subject to mandatory Social Security coverage that began July 2, 1991.

*Throughout this publication, the term "public retirement system" (also known as FICA replacement plan) refers to a retirement system administered by a state, political subdivision or instrumentality thereof that meets the requirements of IRC Section 3121(b)(7)(F). See Revenue Procedure 91-40. For Section 218 purposes, it is irrelevant whether the retirement system meets the minimum benefit standards for a qualified plan under the Employee Retirement Income Security Act (ERISA). See Chapter 6.

Note: In some situations, legal challenges occur that are resolved in the federal courts. It's even possible that, while cases are

pending, the application of the laws can vary and be applied by the IRS and SSA solely in one state (if a case has been heard and decided in a federal district court) or in states only in one federal circuit (if a case has been heard and decided at the federal circuit court level). It's important in these situations to be aware of which federal district or circuit court has jurisdiction over federal laws that apply to each state. To locate a map and contact information for federal courts, see www.uscourts.gov/court_locator.

Steps to Determine Social Security and Medicare Coverage of State and Local Government Employees

State and local government employees may be covered for Social Security and Medicare under either a Section 218 Agreement, which applies to anyone holding the affected position, or under mandatory coverage, which is based on the individual employee's situation.

If the position is covered under a Section 218 Agreement, any employee occupying that position is covered. This is the first coverage consideration for a governmental employer. If, however, the position is not covered under a Section 218 Agreement, then the employer must determine whether mandatory FICA coverage applies. To do this, the employer must first determine whether the employee is deemed to be a member of a public retirement system (FICA replacement plan). This is a critical consideration in determining whether and how a Section 218 Agreement or mandatory FICA coverage applies to an employee.

The following steps outline how a public employer should determine whether Social Security and Medicare coverage or Medicare-only coverage applies to an employee.

Step 1: Determine whether the employee's position is covered by a Section 218 Agreement (Chapter 5, Social Security and Medicare Coverage).* If yes, the employee is covered for Social Security and Medicare under the Agreement, unless an exclusion applies for that position. If no, proceed to the next step.

Step 2: If the employee's position is not covered under a Section 218 Agreement, determine whether the employee is a member of a public retirement system (Chapter 6, Social Security and Public Retirement Systems). If no, the employee is subject to mandatory Social Security and Medicare, unless an exclusion applies. If yes (the employee is a member of a public retirement system), the employee is

exempt from mandatory Social Security. Medicare is mandatory for public employees hired or rehired after March 31, 1986, regardless of membership in a public retirement system. Proceed to the next step to determine Medicare coverage for any employee hired before April 1, 1986.

Step 3: Determine whether a Section 218 Agreement provides Medicare only coverage for employees hired before April 1, 1986. If yes, the employee is covered for Medicare only. If no, proceed to the next step.

Step 4: Determine whether the Medicare continuing employment exception applies to the employee (Chapter 5). If yes, the employee is exempt from mandatory Medicare. If no, the employee is subject to mandatory

Medicare, unless an exclusion applies.

* State enabling legislation can have an effect on positions and entities covered by the particular state's Section 218 Agreement. Consult the appropriate state's enabling legislation to determine which positions are eligible for coverage under that state's Section 218 Agreement. For a list of state enabling statutes, see the Appendix of this publication.

The following flowchart illustrates these steps:

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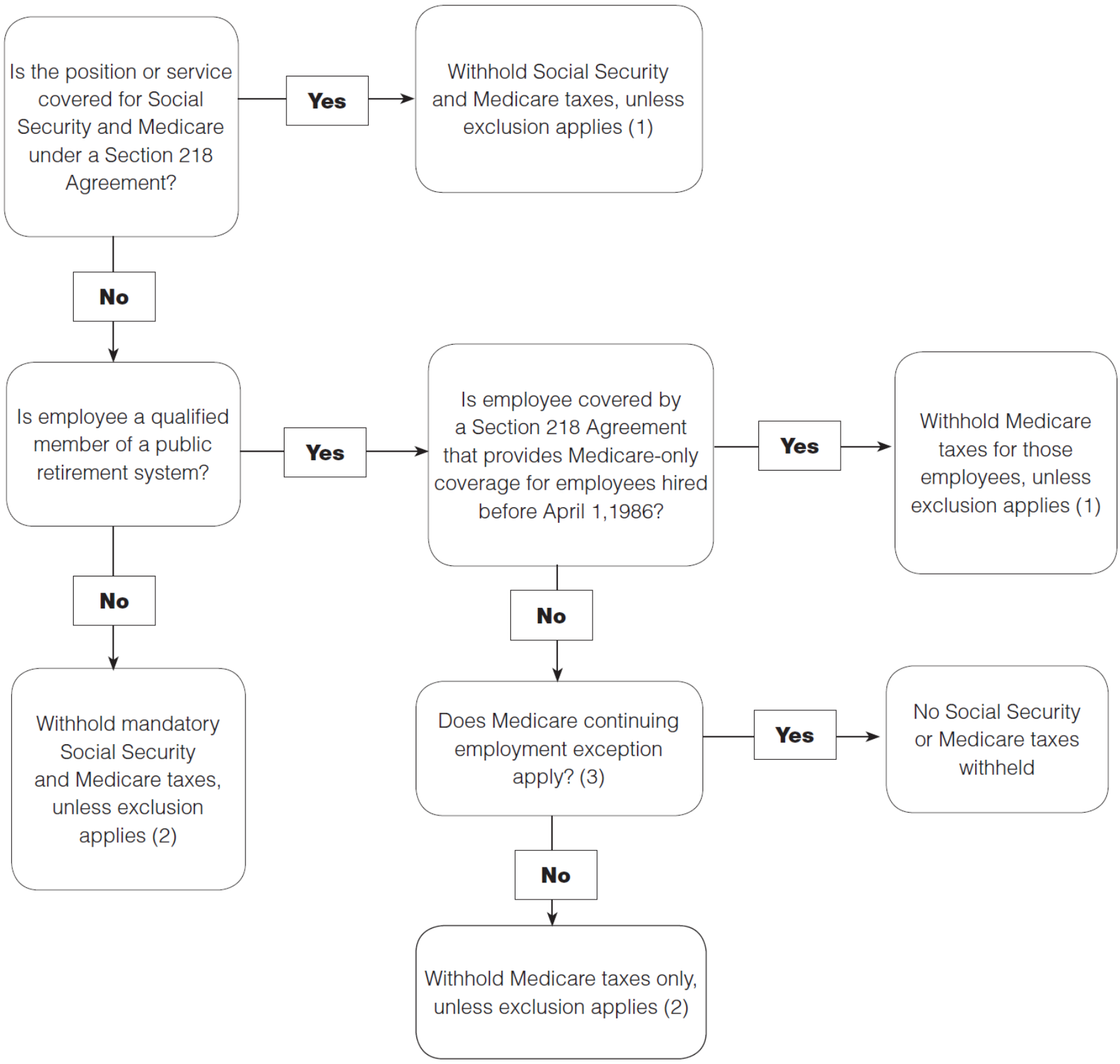
SOCIAL SECURITY AND MEDICARE COVERAGE OF STATE AND LOCAL GOVERNMENT EMPLOYEES

This chart is a guide only and is not a substitute for discussing complex Section 218 Agreement coverage situations with your State Social Security Administrator or FICA taxation issues with your IRS agent.



1) Section 218 required and optional exclusions (see Chapter 5)

2) Exclusions from mandatory Social Security and Medicare (see Chapter 5)

3) Medicare continuing employment exception (see Chapter 5)

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SSA, IRS, State Social Security Administrators and Public Employer Social Security and Medicare Tax Responsibilities

The Social Security Administration (SSA) is responsible for administering the Social Security Act, including the interpretation of individual Section 218 Agreements. SSA also administers benefits and maintains individual earnings records. See Chapter 7, Social Security Administration.

The Internal Revenue Service (IRS) is responsible for administering the Internal Revenue Code, which includes the

Federal Insurance Contributions Act (FICA), advising employers of their responsibilities, collecting taxes and working with SSA and State Social Security Administrators on Social Security coverage and related tax issues. See Chapter 8**,** Internal Revenue Service.

The State Social Security Administrator (SSSA) is the designated official legally appointed to act for the state in negotiations with the SSA. This official acts for the state with respect to the initial Section 218 Agreement and modifications, the performance of the state's responsibilities under the agreement, and in all state dealings on the administration of the agreement. Each state's Section 218 Agreement and Social Security Regulation 404.1204 provide a legal obligation for each state to designate an official. In many states the actual day-to-day responsibilities are delegated to the staff of the designated state official. See Chapter 9, State Social Security Administrators.

Public employers are responsible for:

- Properly classifying workers as either independent contractors or employees
- Soliciting and collecting valid taxpayer identification numbers from all employees and payees

- Determining which employees are exempt from Social Security and/or Medicare taxes
- Withholding, reporting and paying appropriate Social Security and Medicare taxes, or Medicare-only taxes for each employee
- Obtaining clarifications of laws, regulations and other information from State Social Security Administrators, IRS and SSA

Where to Direct Questions

The IRS, SSA and State Social Security Administrator have different responsibilities and areas of authority in dealing with issues on Social Security coverage, taxation and reporting.

The following indicates the primary point of contact for many common questions.

Topics for the IRS:

- Federal income tax
- Worker classification (employee or independent contractor)
- Collection of Social Security and/or Medicare tax
- Completion and filing of Forms W-2, W-3, 1099 and 1096
- Employment tax returns (Forms 941, 944)
- Definition of public retirement system (FICA replacement plan)
- Whether an employee is covered by mandatory Social Security
- Whether certain payments are subject to Social Security and/or Medicare tax
- Questions about employer identification numbers

Topics for the SSA:

- Social Security benefits
- Section 218 coverage
- Individual earnings records and quarters of coverage
- Verification of Section 218 terms
- Form W-2 records
- Problems with Social Security number

Topics for the SSSA:

- Existence and/or terms of a Section 218 Agreement
- Modifications to the Section 218 Agreement
- Treatment of a specific position under a Section 218 Agreement
- Other issues involving interpretation of state law

1. Frequently Asked Questions

What is a Section 218 Agreement?

A Section 218 Agreement is a written, voluntary agreement between one of the 50 states (or Puerto

Rico, the Virgin Islands or an interstate instrumentality) and the SSA under Section 218 of the Social Security Act. This agreement provides Social Security and Medicare, or Medicare-only coverage for designated groups of state and local government employees. The term refers to the original agreement and all subsequent modifications. These agreements can cover services of employees who are covered by a public retirement system as well as those who are not. To determine whether your entity is covered under a Section 218 Agreement, or can execute one, contact your State Social Security Administrator. See the list of State Administrators at NCSSSA.org. [SSA/STATE]

2. How may a Section 218 Agreement affect employees who are qualifying members of a public retirement system?

An agreement may provide Social Security and Medicare coverage for employees already covered by a public retirement system (or FICA replacement plan). This may include:

a. Employees covered by a public retirement system who elect coverage under a referendum. The Social Security and Medicare coverage applies in addition to retirement system coverage.

b. Employees performing services that are excluded from mandatory Social Security coverage provisions, but are only optionally excluded under Section 218 Agreements, such as student services, and services of election workers who earn less than the threshold amount.

c. Election workers in some state Section 218 Agreements that establish a dollar threshold for FICA coverage that's lower than the federal statutory requirement.

d. Employees hired before April 1, 1986, who meet the continuing employment Medicare exception. [STATE]

3. Why might a Section 218 Agreement be modified?

Modifications to Section 218 Agreements are necessary to include additional coverage groups, to cover additional services in a group already covered (services previously optionally excluded), to cover ineligibles, to cover employees changing to the "Yes" group in a divided retirement system, to cover previously terminated groups, or to identify political subdivisions joining a covered public retirement system. See Chapter 5. [STATE]

4. **I was told by the State Social Security Administrator that my town is covered for Social Security under the state's Section 218 Agreement and the coverage cannot be terminated. Is this true?**

Yes. By law after April 20, 1983, coverage under a Section 218 Agreement cannot be terminated. Beginning July 2, 1991, any state and local government employees not covered for Social Security under a Section 218 Agreement who are not qualified members of a public retirement system (FICA replacement plan), are covered under **mandatory** Social Security. [STATE/SSA]

5. **Are Indian tribal government employers eligible to enter into Section 218 Agreements?**

No, Indian tribal governments are not considered states or subdivisions of states for Section 218 purposes. See IRC Section 7871. However, the Tribal Social Security Fairness

Act of 2018 (PDF) provides information about Indian tribes wishing to offer Social Security coverage to tribal council members per Section 218A of the Social Security Act. For more information about Social Security coverage, Medicare and tribal governments, see the IRS Indian Tribal Governments website. [IRS]

6. I have a question about Social Security and Medicare coverage requirements for employees of my city. Whom do I contact?

The State Social Security Administrator should always be your first contact on any questions about coverage under Social Security or Medicare. Consult SSA if you need additional assistance on coverage. Direct questions about whether specific services are subject to mandatory Social Security and Medicare taxes to the IRS. [STATE]

7. What is the responsibility of State Social Security Administrators for non-Section 218 entities?

Under Section 218 of the Act, the primary legal responsibility State Social Security Administrators have is for Section 218 entities. However, the Administrator's responsibilities to entities not covered under the state's Section 218 Agreement (non-Section 218 entities) vary from state to state. Some State Administrators may not interact with non-Section 218 entities, while in other states the State Administrator may perform monitoring, quasi-regulatory and enforcement functions for them. If a non-Section 218 entity needs information about coverage under an agreement, contact the State Social Security Administrator. [STATE]

8. If an entity has a Section 218 Agreement in effect, and joins the state's public employee retirement

system, does Section 218 Agreement coverage continue?

After April 20, 1983, a Section 218 Agreement cannot be terminated for any reason as long as that entity exists. The addition of a retirement system does not affect employee coverage under the Section 218 Agreement. [SSA]

Chapter 2

Government Entities and Federal Taxes

The Bureau of the Census collected data showing that there were approximately 89,000 units of local government in the United States in 2012. These units of government employ more than 20% of the American workforce.

This chapter discusses the legal basis for different types of government entities and the specific tax questions that arise in connection with them. Many tax laws apply differently to government entities than to other organizations and individuals.

The income of certain government entities, including states, political subdivisions of states, or integral parts of states or political subdivisions, is generally exempt from tax. The income of other government entities, such as instrumentalities, might be excludable from gross income under IRC

Section 115 if that income is derived from the exercise of an essential governmental function and accrues to a state or political subdivision of a state.

Certain government entities, such as colleges or universities, that are agencies or instrumentalities of a state or political subdivision of a state, are subject to the tax on unrelated business income under IRC Section 511. For more information, see Publication 598, Tax on Unrelated Business Income of Exempt Organizations.

State Government

States are recognized as entities by the U.S. Constitution. However, different definitions of a state apply for different legal purposes. Federal employment taxes generally apply to all 50 states, the District of Columbia and all U.S. Territories. For purposes of a Section 218 Agreement, a state may refer to any of the 50 states, Puerto Rico, the Virgin Islands and interstate instrumentalities. For this

purpose, the definition of a state does not include the District of Columbia, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands or Indian tribal governments.

Authority

The states have primary responsibility for many aspects of government. The 10th Amendment to the U.S. Constitution reserves to the states, or to the people, all powers not delegated to the federal government nor prohibited by the Constitution. Some services for which the state has primary responsibility include:

- Protection of lives and property by maintenance of a police force
- Regulation and improvement of transportation and roads within the state
- Regulation of business within the state

- Education and maintenance of schools within the state
- Condemnation of property through eminent domain within the state

In many cases, the federal and state governments share responsibility, with the federal government providing most of the funding and the state distributing the services. Some common services involving shared responsibility include:

- Health care
- Public assistance for persons in need
- Protection of natural resources
- Improvement in living and working conditions

Local Government and Political Subdivisions

Local governments are generally political subdivisions of states. They differ from state

and federal governments in that their authority is not based directly on a constitution. Each state constitution governs the procedure for the establishment of local governments. In most cases, the state legislature must approve the creation or incorporation of a local government. The local government then receives a charter defining its organization, authority and responsibilities, including the means for electing governing officials.

Local government units bear a variety of names, such as city, county, township, village, parish, borough or district. The legal significance of these terms may vary from state to state.

Authority

The authority of local governments varies greatly among the states and individual jurisdictions. Generally, a local government has the authority to:

- Impose taxes
- Try people accused of breaking local laws or ordinances
- Administer local programs within its boundaries

In addition to funding provided by local taxes, fees and other sources, local governments receive financial aid from state and federal governments in providing these services according to need.

Some of the services that local governments take primary responsibility for providing include:

- Conducting and coordinating elections
- Maintaining public safety
- Building and repairing local roads and streets
- Providing police and fire protection
- Collecting garbage and recycling

- Ensuring the safety of drinking water
- Maintaining courts, courthouses and jails
- Collecting state and local government taxes
- Keeping official records, such as for marriage, birth and death

Instrumentalities

An instrumentality is an organization separate from, but affiliated with, a state or local government. It may or may not be created by or pursuant to state statute, but it is operated for public purposes. Generally, an instrumentality performs governmental functions, but does not have the full powers of a government, such as police authority, taxation and eminent domain (sovereign powers). Direct questions on the legal status of an instrumentality, for federal tax or Social Security and Medicare purposes, to the IRS. Address questions on a specific Section 218

Agreement to the State Social Security Administrator or the SSA (see Chapter 7).

A wholly-owned instrumentality of one or more states or political subdivisions is treated as a state or local government employer for purposes of the mandatory Social Security and Medicare provisions of IRC Section 3121(b)(7)(F).

Interstate Instrumentalities

An interstate instrumentality is an independent legal entity organized by two or more states to carry on governmental functions. Examples include a regional planning authority, transportation system or water district. For purposes of Section 218 Agreements, an interstate instrumentality is treated as a state.

A referendum (vote) for Social Security and/or Medicare coverage must be held prior to the execution of a Section 218 Agreement for interstate instrumentality employees in

positions under a retirement system. All interstate instrumentalities are authorized to hold a referendum using either a majority vote or a divided system retirement process. (see Chapter 5 for referendum procedures). Employees of an interstate instrumentality who are not covered for Social Security under a Section 218 Agreement, but who are qualified participants in a public retirement system, are not covered for Social Security even if the employer incorrectly continues to withhold and report Social Security taxes.

Characteristics of Instrumentalities

In Revenue Ruling 57-128, 1957-1 C.B. 311, the IRS addressed the question of whether an organization is a wholly-owned instrumentality of one or more states or political subdivisions. This revenue ruling established the following factors as relevant to a determination of whether the entity is an instrumentality of a government:

- Whether it is used for a governmental purpose and performs a governmental function
- Whether performance of its function is on behalf of one or more states or political subdivisions
- Whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner
- Whether control and supervision of the organization is vested in public authority or authorities
- The degree of financial autonomy and the source of operating expenses
- Whether express or implied statutory or other authority is necessary for its creation and/or use of the instrumentality, and whether that authority exists

Schools, hospitals and libraries, as well as associations formed for public purposes, such as soil and water conservation districts, may be instrumentalities of government, depending on the facts and circumstances. State sponsorship of an organization, state regulation of its activities, the participation of its employees in a public retirement system, and operation with public funds are among the factors to be considered in determining whether an organization is an instrumentality. If an organization is essentially under private ownership and control, it is not an instrumentality of government.

Associations formed for conservation, protection and promotion, although carrying out a public purpose, may not rise to the level of state instrumentalities. The following associations may or may not be state instrumentalities:

- Soil and water conservation districts
- Fire associations that protect forestland

- Associations that promote a state or municipality

To determine the status of an entity, it is essential to review the documents that establish statutory authority. The following cases elaborate on the principles established in Revenue Ruling 57-128.

Soil and Water Conservation Districts - Entities whose revenues are principally generated from fees collected from land owners within the district may or may not be instrumentalities of government, depending upon application of the factors listed above, including whether the district is under public or private control.

Example: A soil conservation district in Minnesota was established to carry out a state conservation program. The Soil Conservation Service of the U.S. Department of Agriculture furnished the district with technical and clerical personnel. The disbursements made by the district were

made from fees collected from members (occupiers of the land within the district) for services rendered, from funds allocated by the U.S. Department of Agriculture and from state appropriations. The soil conservation district was created by statute as a political subdivision of the state and was under the control of a board of supervisors elected or appointed in accordance with state law. The soil conservation district is a political subdivision of the state. [Revenue Ruling 57-120, 1957-1 C.B. 310]

Example: A Connecticut soil and water conservation district was formed as a private nonstock corporation by private individuals. The state had authority to assist private individuals in forming conservation districts but did not have the power to operate them. The private individuals had complete control over the corporate operations, revenue and expenditures. Therefore, the soil and water conservation district is not a wholly-owned

instrumentality of the state. [Revenue Ruling 69-453, 1969-2 C.B. 182]

Fire Associations - Fire associations may or may not be instrumentalities of government, depending on whether they are under public or private control.

Example: A fire association was organized under an Oregon state law that required all forest land in the state to be adequately protected from the dangers of fire. While the fire association was organized as a result of an Oregon law, it was organized and operated for the mutual benefit of its members and was not an instrumentality of the state. Furthermore, except for the work it performed on a cost basis for the state and federal government, the association derived most of its support from assessments imposed on its members. [Revenue Ruling 70-483, 1970-2 C.B. 201]

Example: Under the laws of the state of Pennsylvania, townships have the authority to purchase fire engines and fire apparatus out of general township funds for use of the township and to appropriate money to fire companies located in the township to secure fire protection. These volunteer fire companies are instrumentalities under Pennsylvania state law, and the members of volunteer fire departments are employees of the political subdivision. [Revenue Ruling 70-484, 1970-2 C.B. 202]

Associations that Promote a State or Municipality - State sponsorship of promotional activities is not sufficient to raise an association to instrumentality status.

Example: A municipal league comprised of qualified officials of member cities or villages, but with no control and supervision vested in a public authority, is not a state instrumentality. The league's activities consisted of publishing a monthly magazine

featuring articles on governmental matters, conducting conferences, and sponsoring and participating in municipal law institutes and seminars. The state had no statute for the incorporation of a league of this nature as an instrumentality. [Revenue Ruling 65-26, 1965-1 C.B. 444]

Note: Some state statutes specifically create certain associations as instrumentalities. A review of the establishing legislation is required to make a status determination.

Indian Tribal Governments

The legal relationship between the United States and Indian tribal governments is set forth in the Constitution, treaties, statutes and court decisions. Congress may limit the authority of Indian tribal governments, but within those limits, the tribal governments retain attributes of sovereignty over both their members and their territory. Generally, Indian tribal governments provide

government services, such as transportation, education and medical care to its members.

Authority

Tribal governmental power includes the authority to:

- Choose the form of tribal government
- Determine tribal membership
- Regulate tribal and individual property
- Levy taxes
- Establish courts
- Maintain law and order

Employment Taxes

Generally, Indian tribal governments should follow general rules that apply to nongovernmental entities for employment tax. Publication 15 (Circular E), Employer's Tax Guide, and Publication 15-A, Employer's Supplemental Tax Guide, provide the basic rules for employers. There are, however,

some special employment tax rules that apply to Indian tribal governments:

- An exception applies to the definition of "employment" for FUTA purposes for services performed in the employ of an Indian tribe (IRC Section 3306(c)(7)). An Indian tribe may elect to make contributions to the state unemployment fund as if services by its employees were employment under FUTA, or it may make payments in lieu of the contributions to reimburse the state for benefits paid former employees of the tribe. An Indian tribe may make separate elections for any subdivision, subsidiary or business enterprise wholly owned by it. If an Indian tribe fails to make either form of payment within 90 days of receiving a notice of delinquency, or if it fails to post a required payment bond, then service for the tribe is not excepted from "employment" until the failure has been corrected (IRC

Section 3309(d)). For this purpose, the term “Indian tribe” has the meaning given in 25 USC Section 450b(e) (Section 4(e) of the Indian Self-Determination and Education Assistance Act), and includes any subdivision, subsidiary or business enterprise wholly-owned by an Indian tribe (IRC Section 3306(u)).

Amounts paid to members of Indian tribal councils for services performed as council members are generally not wages for purposes of FICA and income tax withholding, although these amounts are includible in gross income. (Revenue Ruling 59-354). The Tribal Social Security Fairness Act of 2018 authorizes SSA to enter into voluntary agreements with Indian tribes to provide individual tribal council members with Social Security coverage. Visit SSA.gov for more information.

- Certain income derived by Indians from the exercise of their recognized tribal fishing rights is exempt from federal income and employment taxes (IRC Section 7873). Wages paid to a member of a tribe employed by another member of the same tribe, or by a qualified Indian entity, for services performed in a fishing rights-related activity of the employee's tribe, are exempt not only from federal income tax, but also from both the employer's and the employee's share of the Social Security and Medicare tax (Notice 89-34, 1989-1 C.B. 674).

Information addressing Indian tribal governments and employment tax issues can be found in Publication 4268, Employment Tax for Indian Tribal Governments.

Frequently Asked Questions

1. How is the tax treatment of governments different from that of other entities?

The income of certain government entities, including states, political subdivisions of states, or integral parts of states or political subdivisions, is generally not taxable. The income of other government entities, such as instrumentalities, might be excludable from gross income under IRC Section 115 if that income is derived from the exercise of an essential governmental function and accrues to a state or political subdivision of a state. Colleges and universities that are agencies or instrumentalities of any government, or any political subdivision of government, or that are owned or operated by a government or political subdivision of a government, are subject to tax on unrelated business income. [IRS]

2. Can the IRS issue a letter indicating that our entity is a tax-exempt government?

For a government entity to receive an official determination of its status as a political subdivision, instrumentality of government, or whether its income is excludable from gross income under IRC Section 115, it must obtain a private letter ruling (PLR) by following the procedures in Rev. Proc. 2020-1 (updated annually). There is a fee to receive a PLR. [IRS]

As a service to government entities, IRS can issue a "governmental information letter" free of charge. This letter describes government entity exemption from federal income tax and cites the IRC sections on deductible contributions and income exclusion. Most organizations and individuals will accept the governmental information letter as the substantiation required for these purposes.

Contact IRS Customer Account Services at 877-829-5500. [IRS]

Chapter 3

Wage Reporting and Employment Taxes

A government entity that has employees needs to be familiar with the basic responsibilities and requirements that apply to all employers, as well as some provisions that are unique to governments. This chapter briefly covers the main types of compensation that are included in employee wages and the requirements for tax withholding and payments. Tax requirements for employers are discussed in Publication 15, (Circular E), Employer's Tax Guide. This chapter highlights some key requirements for employers and matters of special interest to governmental employers.

All governmental entities that employ workers are subject to federal employment taxes on wages, except where the law provides specific

exceptions. The Internal Revenue Code defines wages subject to income tax withholding under Section 3401 and defines wages for Social Security and Medicare tax purposes under Section 3121. As discussed in Chapter 2, a broad exception exempts government employment from federal unemployment tax (FUTA).

Social Security and Medicare taxes, also referred to as FICA taxes, consist of Old-Age, Survivors and Disability Insurance (OASDI, or Social Security) and Hospital Insurance (Medicare) taxes. IRC Section 3101 imposes taxes on the employee, and Section 3111 imposes taxes on the employer. State or local entities covered by Social Security and Medicare must withhold and pay over the employee share of the taxes and must pay the employer share. Under Section 3402, employers are also generally required to withhold income tax from wages.

In general, all compensation provided to an employee is included in taxable wages unless an exception is provided by law. An exception may apply for FICA taxes, or federal income tax withholding, or both. The following discussion addresses the treatment of certain forms of compensation, focusing on some that are of interest to government employers.

Social Security and Medicare Wages

IRC Section 3121(a) provides that wages include all remuneration for employment, whether paid in cash or in some other form, unless specifically excluded by statute. Examples of wages for Social Security and Medicare purposes include salaries, fees, stipends, bonuses, prizes, awards and commissions. It is immaterial whether the payments are based on the hour, week, month, year, piecework, percentage of revenue or other system.

An important exception is provided by IRC Section 3121(b)(7)(F), which excludes services performed by state and local government employees from Social Security tax if the employee's services are not covered under a Section 218 Agreement (voluntary Social Security coverage) and if the employee is a qualifying member of a public retirement system (FICA replacement plan) as described in Treas. Reg. Section 31.3121(b)(7)-2. Chapters 5 and 6 discuss the application of the tax to governmental employees.

The Social Security Administration establishes the maximum amount of wages subject to the Social Security tax each year. This amount is updated annually and is $137,700 in 2020. Since 1994, there has been no wage base limit for Medicare tax.

Social Security, Medicare and Additional Medicare Tax Rates and Limits

Social Security and Medicare Tax					
	2016	**2017**	**2018**	**2019**	**2020**
Social Security Tax (OASDI) Information					
Employee Rate	6.20%	6.20%	6.20%	6.20%	6.20%
Employer Rate	6.20%	6.20%	6.20%	6.20%	6.20%
Maximum Wages Subject to Tax	$118,500	$127,200	$128,400	$132,900	$137,700
Medicare Tax Information					
Employee Rate	1.45%	1.45%	1.45%	1.45%	1.45%
Employer Rate	1.45%	1.45%	1.45%	1.45%	1.45%
Maximum Wages Subject to Tax	No maximum (applies to all wages)				
Additional Medicare Tax Information					
Employee Rate	0.9%	0.9%	0.9%	0.9%	0.9%
Employer Rate	N/A	N/A	N/A	N/A	N/A
Withholding Threshold	Wages that exceed $200,000 in a calendar year				

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Additional Medicare Tax

As of 2013, a 0.9% Additional Medicare Tax applies to Medicare wages over a threshold amount based on the taxpayer's filing status. However, an employer must withhold Additional Medicare Tax from wages in excess of $200,000 it pays to an employee in a calendar year, without regard to the employee's filing status or wages paid by another employer.

Unlike Social Security and basic Medicare taxes, there is no employer match for Additional Medicare Tax.

An employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of $200,000 to an employee and continue withholding it until the end of the calendar year.

For more information on Additional Medicare Tax, see Questions and Answers for the Additional Medicare Tax.

Chapter 5 also discusses in detail the application of Social Security and Medicare to the compensation of governmental employees.

Other Forms of Cash Compensation

In addition to salary or wages, employees may receive cash in other ways. Some common forms of cash compensation include:

Sick Pay

Sick pay is an amount paid to an employee because of inability to work due to sickness or injury. Sick pay is generally subject to Social Security and Medicare taxes the same as other remuneration paid to the employee, regardless of whether the employer or a third party pays the sick pay. Sick pay paid by an employer is also subject to income tax withholding. The employer withholds income tax from sick pay based on the employee's Form W-4, Employee's Withholding Certificate.

Sick pay is sometimes paid by a third party, such as an insurance company or employee trust. The rules on third-party withholding, paying and reporting Social Security and Medicare taxes differ, depending upon whether:

- The third party is acting as an agent of the employer or an independent insurer, and
- The terms of an agreement between the employer and agent or insurer.

If the third party paying sick pay is an agent of the employer, the third party is generally required to withhold income tax from the sick pay. If the third-party payer is not an agent of the employer, the third-party payer is not required to withhold income tax, unless the employee requests that income tax be withheld by completing and giving the third party a Form W-4S, Request for Federal Income Tax Withholding From Sick Pay.

See Publication 15-A, Employer's Supplemental Tax Guide, for more details on third-party sick pay.

The following types of sick pay or injury pay are not subject to Social Security and Medicare taxes:

1. Payments received under a workers' compensation act, or under a statute in the nature of a workers' compensation act.
2. Payments, or portions of payments, attributable to the employees' contributions to a sick pay plan.
3. Payments on account of sickness or injury made by, or on behalf of, an employer more than six months after the last calendar month in which the employee worked for the employer.

Vacation Pay

Vacation pay is wages and is subject to Social Security, Medicare and income tax withholding. When vacation pay is paid in addition to regular wages for the vacation period, withhold on the vacation pay as a supplemental wage payment. See Section 7, "Supplemental Wages," in Publication 15.

Military Differential Pay

Military differential pay is payment:

- Made by an eligible employer to a qualified individual for any period the individual is called to active duty in the uniformed services for a period of more than 30 days, and
- Represents part or all the wages the individual would have received from the employer if the individual were performing services for the employer during that time.

Differential wage payments are treated as wages for income tax withholding but aren't subject to Social Security, Medicare or FUTA taxes. Employers should report differential wage payments in Box 1 of Form W-2. For more information about the tax treatment of differential wage payments, see IRS Revenue Ruling 2009-11.

Deceased Employee's Wages

If an employee dies during the year, the employer must report the accrued wages, vacation pay and other compensation paid after the date of death. Also, report wages that were available to the employee while they were alive, regardless of whether the wages were in the employee's possession, as well as any other regular wage payment, even if it is necessary to reissue the payment in the name of the estate or beneficiary. How the payment is reported depends on the year in which payment is made.

Payment made in the year of death - If you made the payment after the employee's death but in the same year the employee died, you must withhold Social Security and Medicare taxes on the payment and report the payment on the employee's Form W-2 only as Social Security wages (box 3) and Medicare wages and tips (box 5) to ensure proper Social Security and Medicare taxes withheld in boxes 4 and 6. Do not show the payment in box 1.

Payment made after the year of death - If you made the payment after the year of death, do not report it on Form W-2 and do not withhold Social Security and Medicare taxes.

Whether you made the payment in the year of death or after the year of death, report it in box 3 of Form 1099-MISC, Miscellaneous Income, as a payment to the estate or beneficiary. Use the name and taxpayer

identification number (TIN) of the estate or beneficiary on Form 1099-MISC.

See the Instructions for Form W-2 and Publication 559, Survivors, Executors, and Administrators, for more information on the treatment of payments on behalf of a decedent.

Back Pay

Back pay is pay received in a tax year for actual or deemed employment in an earlier year. For Social Security coverage and benefit purposes, **all** back pay is wages, except amounts specifically and legitimately designated otherwise, such as interest, penalties and legal fees. For tax purposes, back pay is treated as wages in the year received and is reported on Form W-2 for that year. Income, Social Security and Medicare tax withholding apply in the year of payment at the rates in effect for that period.

SSA treatment of back pay under a statute - Under the law, the SSA credits back pay awarded under a statute (for example, under the Americans with Disabilities Act or Fair Labor Standards Act) to an individual's earnings record in the periods the wages should have been paid. However, payments of back pay under a statute will be posted to the employee's Social Security earnings record in the year reported on Form W-2 unless the employer or employee notifies the SSA in a special, separate report. If this is done, SSA can then allocate the statutory back pay to the appropriate periods for purposes of retirement benefit calculations. This is important because wages not credited to the proper year may result in lower Social Security benefits or failure to meet the requirements for benefits. See Publication 957, Reporting Back Pay and Special Wage Payments to the Social Security Administration, for more information.

Workers' Compensation

Amounts received by police officers, firefighters and other employees or their survivors for personal injuries or sickness incurred in the course of employment are excludable from income, Social Security and Medicare taxes if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act that provides compensation to employees for personal injuries or sickness incurred during employment.

This exclusion does not apply to retirement plan benefits based on age, length of service or prior contributions to the plan, even if the individual retired because of an occupational sickness or injury.

Noncash Payments

Generally, noncash payments are wages subject to income, Social Security and Medicare tax. The dollar value of wages paid

in a medium other than cash should be computed based on the fair market value of the property at the time of the payment. The fair market value may be based on the prevailing value of the item in the locality or on a reasonable value established for other purposes. Special rules may apply to noncash fringe benefits.

Fringe Benefits

Fringe benefits, which generally include any compensation other than cash wages or salary, must be included in an employee's wages unless the law provides an exception. A fringe benefit is a form of pay for the performance of services. For example, you provide an employee with a fringe benefit when you allow the employee to use a business vehicle to commute to and from work.

Provider of benefit - You're the provider of a fringe benefit if it's provided for services performed for you. You're considered the

provider of a fringe benefit even if a third party, such as your client or customer, provides the benefit to your employee for services the employee performs for you. Thus, you are responsible for any employment tax liability related to the fringe benefit if it’s provided for services performed for you.

Examples of employer-provided fringe benefits include, but are not limited to:

- Vehicles for personal use
- Meals
- Health or life insurance
- Tickets to entertainment or sporting events
- Holiday gifts
- Personal use of employer facilities
- Transportation (commuting) benefits and passes

- De minimis (minimal) benefits
- Tuition reduction
- Educational assistance
- Dependent care assistance
- Employee discounts
- Employer-provided cell phones
- Moving expense reimbursements
- Achievement awards

The tax treatment of some of these benefits is determined by specific statutes; others fall under general rules for broader categories of fringe benefits. Publication 15-B, Employer's Tax Guide to Fringe Benefits, addresses fringe benefits for all employers. In addition, Publication 5137, Fringe Benefit Guide, addresses fringe benefits for government employers.

Business Expense Reimbursements – Accountable Plan

Payments to employees for travel and other ordinary and necessary expenses of the employer's business generally are wages subject to Social Security and Medicare taxes and income tax withholding unless they are made under an accountable plan. There are three requirements for a reimbursement to be treated as being paid under an accountable plan:

1. The expenses must qualify as deductible business expenses incurred while performing services for the employer,
2. The employee must adequately account for the expenses to the employer within a reasonable period of time, and
3. The employee must return any amounts received that exceed

expenses within a reasonable period of time.

See Publication 15 and Publication 5137 for more information on accountable plans.

The use of per diem rates at or below the federal rate for travel expenses can reduce and simplify the recordkeeping requirements for accounting for these expenses. See Publication 463, Travel, Gift, and Car Expenses, or Publication 5137 for more information on per diem reimbursement systems.

Reimbursements Not Made Under Accountable Plan

If an employer provides reimbursements that do not comply with the accountable plan rules, these amounts are treated as wages and subject to employment taxes the same as other pay of the employee.

Retirement Plans

Regardless of Social Security coverage, most public employees are covered by some form of retirement plan. The terms of these plans may vary, but in general provide for tax-deferred income placed in trust for the benefit of employees. These plans may involve employee or employer contributions, or both. Under certain provisions of the Internal Revenue Code, contributions may be deferred from tax until they are withdrawn. The term "qualified" is used to describe private-sector plans under IRC Section 401 that meet specific provisions of ERISA that enables them to offer certain tax advantages to the participants. Many public employees, however, are covered by nonqualified plans, generally under IRC Sections 403(b) or 457, discussed below and at Government Retirement Plans Toolkit.

Income Tax Withholding on Qualified Retirement Plans

For income tax withholding purposes, employer and employee contributions made under qualified plans (up to the maximum allowable for the year) are deferred from income tax. The employee is subject to tax on distributions of these amounts when they are withdrawn from the plan. In most cases, withdrawals not rolled over into another plan are subject to mandatory income tax withholding on distribution.

Employer "Pick-Up" Contributions

IRC Section 414(h)(2) allows state and local government entities with IRC Section 414(d) governmental plans to treat contributions that have been designated as employee contributions, but are "picked up" (paid) by the employer, to be treated as employer contributions, and therefore as excludable from income. These "picked up" contributions are also exempt from Social Security and

Medicare tax if they aren't made under a salary reduction agreement. For more information on the conditions required for employer pick-up, see IRC Section 414(h)(2) or search for "Employer pick-up contributions" on IRS.gov.

Section 403(b) Plans

Plans under IRC Section 403(b), also called tax-sheltered annuities, are available to certain employees of public schools, employees of tax-exempt organizations and certain ministers. These plans resemble qualified plans in many respects. Many public school employees are covered by 403(b) plans in addition to receiving Social Security coverage under a Section 218 Agreement.