

# Federal-State Reference Guide

(IRS Publication 963)

A Federal-State Cooperative Publication

- **Social Security Administration**
- **Internal Revenue Service**
- **National Conference of State Social Security Administrators**

Providing guidelines for social security and Medicare coverage and tax withholding requirements for state, local and Indian tribal government employees and public employers.

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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 Insurance Contributions Act (FICA) tax withholding issues. The *Guide* was first published by the Internal Revenue Service (IRS) in July 1995 with special assistance from the State of Colorado, and is a cooperative effort of the Social Security Administration, 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, social security and Medicare coverage and benefits, Section 218 Agreements, employment tax laws, and other tax issues. The tax information is generally applicable to Federal agencies, although there are some exceptions and Section 218 Agreement information is not applicable to these entities.

Beginning with the 2005 edition, the *Federal-State Reference Guide* has been produced annually, primarily as a web-based document. The most recent version can be downloaded and printed by accessing the IRS Federal, State and Local Governments (FSLG) website at [www.irs.gov/govt/fslg](http://www.irs.gov/govt/fslg). This website also contains information about other related tax topics, upcoming events, the FSLG Newsletter, and contacting the IRS. All IRS forms and publications referred to in this publication can be ordered free from the IRS at (800) 829-3676 or can be downloaded from the IRS website at [www.irs.gov](http://www.irs.gov). For general or account-related questions, Customer Account Services is available at (877) 829-5500, Monday through Friday.

This publication also includes information to assist 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; however, tribes are not eligible for section 218 Agreements, and other special provisions apply. If you have questions about Indian Tribal governments, please visit the office of Indian Tribal Governments (ITG) website at [www.irs.gov/tribes](http://www.irs.gov/tribes) or telephone your local IRS ITG office. This website also contains Publication 4268, Employment Tax Desk Guide, containing further information which specifically addresses employment tax issues for tribal governments.

At the end of each chapter, Frequently Asked Questions related to the topic are included. At the end of each answer, the primary contact for more information is indicated – (IRS, SSA, or STATE)

The *Federal-State Reference Guide* is intended for informational and reference purposes only. Under no circumstances should the content be used or cited as authority for assuming, or attempting to sustain, a technical position with respect to employment tax, social security benefits, or other legal issues. The Internal Revenue Code (IRC), Social Security Act (Act) and related regulations, rulings and case law are the only valid citations of authority for technical matters.

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## **Chapter 1**

# **Social Security and Government Employers**

Federal tax requirements generally apply on the same basis to public as to private employers. However, there are some differences, arising mostly from the unique history to social security and Medicare coverage for state and local government employees. These provisions involve special provisions for the application of these taxes as well as some special withholding and 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 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 regarding the Federal government's authority to tax state and local governments. Beginning in 1951, states were allowed to 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. Since 1987, the IRS is responsible for collecting this tax 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. Most state employees participate in social security; the major exceptions are state employees of Alaska, Colorado, Louisiana, Maine, Massachusetts, Nevada and Ohio.

The largest proportion of uncovered government employees work at the local level. The majority of uncovered local government public employees are police officers, firefighters and teachers. Approximately one-fourth of the nation's 23 million public employees are not covered for social security.

The following table includes the major historical developments since state and local employees first became eligible for social security coverage in 1951.

## Key Dates

<b>January 1, 1951</b>	Beginning this date, states could voluntarily elect social security coverage for public employees not covered under a public retirement system by entering into a Section 218 Agreement with SSA.
<b>January 1, 1955</b>	Beginning this date, states could extend social security coverage to employees (other than police officers and firefighters) covered under a public retirement system.
<b>July 1, 1966</b>	Beginning this date, employees covered for social security under a Section 218 Agreement are automatically covered for Medicare.
<b>April 20, 1983</b>	Beginning this date, coverage under a Section 218 Agreement cannot be terminated unless the governmental entity is legally dissolved.
<b>April 1, 1986</b>	State and local government employees hired on or after this date, not already covered, are mandatorily covered for Medicare, unless 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.
<b>January 1, 1987</b>	Beginning this date, State Social Security Administrators were 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 Federal Insurance Contributions Act (FICA) taxes directly to the Internal Revenue Service (IRS) in the same manner as private employers.
<b>July 2, 1991</b>	Beginning this date, most state and local government employees became subject to mandatory social security and Medicare coverage, unless they are (1) members of a public retirement system, or (2) covered under a Section 218 Agreement.
<b>August 15, 1994</b>	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 <a href="#">SSA website</a> .) States were authorized to amend their Section 218 Agreements to increase the FICA exclusion amount for election workers to a statutorily mandated threshold. The Act also amended Section 218 of the Act 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 specifically authorized to do so.)
<b>October 21, 1998</b>	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.
<b>March 2, 2004</b>	Social Security Protection Act of 2004 (Public Law 108-203) enacted, requiring public employers to disclose to newly hired public employees that they are earning retirement benefits not covered by social security, closing the Government Pension Offset loophole.

## 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 coverage for an entity and whether it is in compliance with all applicable laws merely because of the status of a similar entity, either in the same or a different state. For Section 218 coverage questions, contact your State Social Security Administrator (see [www.ncsssa.org](http://www.ncsssa.org)). For mandatory (non-section 218) coverage questions, contact an IRS FSLG Specialist (see [www.irs.gov/govts](http://www.irs.gov/govts) for a directory). Related information can also be found at the SSA State and Local Government Employers website at [www.ssa.gov/slge](http://www.ssa.gov/slge).

The following chapters discuss the types of employment and the rules for taxation in greater detail. In general, however, to determine the correct coverage for a group of employees, a government employer must review the following:

If a Section 218 Agreement applies:

1. When did the state voluntarily 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 with respect to any coverage group(s), before April 20, 1983?
5. Has the state elected to provide Medicare-only for a particular entity?

If not covered by Section 218:

1. Does the state or political subdivision have any employees who were hired prior to April 1, 1986, and 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” (or “FICA replacement plan”) refers to a retirement system administered by a state, political subdivision, or instrumentality thereof that meets the requirements of section 3121(b)(7)(F) of the IRC. See [Revenue Procedure 91-40](#) in the Appendix. 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](#).*

## Determining Social Security and Medicare Coverage of State and Local Government Employees

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 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 prior to April 1, 1986.

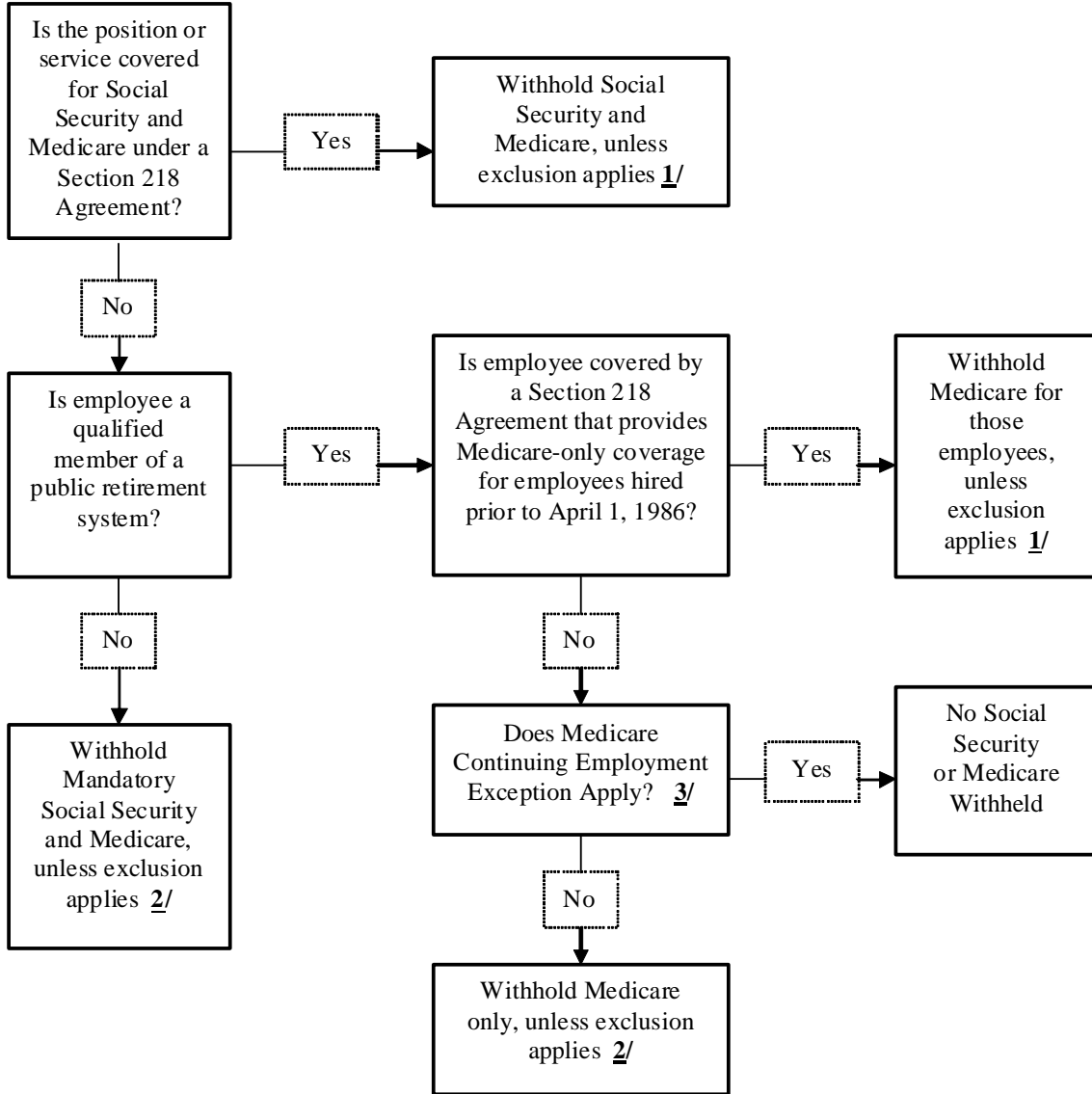
**Step 3:** Determine whether the retirement system has a Section 218 Agreement that provides Medicare-only coverage for employees hired prior to April 1, 1986. If “yes,” the employee is covered for Medicare only. If “no,” proceed to the next step.

**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.

**The following flowchart illustrates the above steps.**

*Note: Section 218 coverage is based on the position an employee occupies. Mandatory coverage is based on the situation of the individual employee. If the position is covered under a Section 218 Agreement, any employee occupying that position is covered. This is the first coverage consideration for an employer. If, however, the position is not covered under an Agreement, then the employer must determine whether mandatory FICA coverage applies. To do this, the employer must first determine whether the employee is a member of a public retirement system. This is an important distinction to understand when determining whether and how Section 218 or mandatory FICA coverage applies to an employee.*

## SOCIAL SECURITY AND MEDICARE COVERAGE OF STATE AND LOCAL GOVERNMENT EMPLOYEES



**1/ Section 218 Mandatory and Optional Exclusions** (see Chapter 5)

**2/ Mandatory Exclusions from FICA** (see Chapter 5)

**3/ Medicare Continuing Employment Exception** (see Chapter 5)

**NOTE:** This chart is meant as a guide only and is not a substitute for discussing complex Section 218 coverage situations with your State Social Security Administrator or FICA taxation issues with your IRS FSLG Specialist.



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

The **Social Security Administration** is responsible for administering the Social Security Act and interpreting its provisions, as well as interpreting Section 218 Agreements. SSA also administers benefits and maintains individual earnings records. [See Chapter 7, Social Security Administration.](#)

The **Internal Revenue Service** is responsible for administering the Internal Revenue Code, 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** is the designated official legally appointed to act for the state in negotiations with the Social Security Administration. 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 concerning the administration of the Agreement. Each state's Section 218 Agreement ("Agreement"), and Social Security Regulation 404.1204, provide a legal obligation for each state to designate such an official. In many states, however, the actual day-to-day responsibilities are delegated to the staff of the designated state official.

The state is responsible for notifying SSA of any changes regarding its designated state official. That official should send a notification to the SSA Regional and Parallel Social Security Offices for that state.

For Section 218 Agreement purposes, the State Administrator:

- Administers and maintains the Federal-state Section 218 Agreement that governs voluntary social security and Medicare coverage by state and local government employers in the state;
- Negotiates modifications to the original Agreement to include additional coverage groups, corrects errors in modifications; conducts referendums and identifies additional political subdivisions that join a covered retirement system;
- Maintains in a secure location the state's master Agreements, modifications, dissolutions and intrastate agreements;
- Provides SSA with notice and evidence of the legal dissolution of covered state or political subdivision entities;
- Resolves coverage and taxation questions related to the Agreement and modifications with SSA and IRS;

- Negotiates with SSA the resolution of social security contribution payment and wage reporting questions concerning wages paid before 1987;
- Provides information to state and local public employers covered under Agreements in accordance with the Act; and
- Provides information to state and local public employers in accordance with the state's enabling legislation, policies, procedures and standards regarding non-section 218 entities. The degree of interaction with non-section 218 entities varies from state to state.

The State Administrator serves as the main resource to state and local employers for information and advice about social security coverage, taxation and many reporting issues. SSA, IRS, public employers and employees should contact the designated Administrator to help resolve questions as to who is and is not covered.

The State Administrator staff has information regarding state law, Federal law and regulations, retirement system rules, personnel rules, and how all these interrelate to provide social security protection to public employees.

A detailed explanation of State Administrator responsibilities is contained in the SSA website at <https://secure.ssa.gov/apps10/poms.nsf/lrx/1910001130>.

### **Audits and Reviews of Public Employers**

When the IRS or SSA conducts an audit or review of a public employer, the State Administrator for that state may be contacted to clarify the employer's status. If the employees are covered under a Section 218 Agreement; this will include determining the specific exclusions (mandatory **and** optional) that are applicable to that entity, and therefore must be taken into account during the audit or review. This includes any exclusions that are unique to individual employees (for example, whether any employees are subject to the Medicare continuing employment exemption).

### **National Conference of State Social Security Administrators (NCSSSA)**

With the enactment of Section 218 to the Social Security Act in 1950, states could exercise the option of providing social security coverage for state and local employees. By the end of 1951, 30 states had executed Section 218 Agreements with the Federal government. The responsibility for administering the social security program varied from state to state, depending on each state's enabling legislation.

State Administrators began to operate in an area where no precedent existed. It became apparent that a forum was needed where the administrators could address the many problems and questions posed by the new program. The first forum between State Social

Security Administrators and Federal officials was held in January 1952, in Bloomington, Indiana. As a result, the National Conference of State Social Security Administrators (NCSSSA) was established to provide a unified state perspective at the Federal level to for problem solving and to maintain an open forum for the development of new policy.

The network of social security coverage statutes, withholding requirements, reporting obligations and associated employment tax regulations require constant monitoring and interpretation. The NCSSSA works with the Federal officials to ensure that legislative and regulatory changes address state and local concerns. It also provides leadership to state and local governments through accurate interpretation of Federal laws and regulations, communication of Federal tax policy, and resolution of problems arising at the state and local level. The NCSSSA hosts national workshops and annual meetings where SSA and IRS officials address the concerns of state and local government representatives in a face-to-face format. NCSSSA officials represent public sector employers on various SSA and IRS committees and work groups.

For further information about the NCSSSA, contact your State Social Security Administrator. (A list is available at NCSSSA's website, [www.ncsssa.org](http://www.ncsssa.org).)

The following chapters detail the responsibilities of state and local employers with respect to employment taxes and social security coverage. The next chapter addresses the definition of a government entity.

## Frequently Asked Questions

- 1) **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 pursuant to the provisions of Section 218 of the Social Security Act. This Agreement provides social security and Medicare, or Medicare-only, coverage for 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 list of state administrators under Chapter 8, **State Social Security Administrators**, or on-line at the [NCSSSA website](http://www.ncsssa.org). [SSA/STATE]
- 2) **How may a Section 218 Agreement affect employees covered by a public retirement system?** An Agreement may provide social security and Medicare coverage for employees already covered by a public retirement system. This agreement may provide social security coverage and Medicare coverage for:

- a. Employees covered by a 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 coverage provisions, but are optional exclusions under Section 218 Agreements, such as student services, services of election workers who earn less than the threshold amount.
  - c. Election workers, by establishing a dollar threshold for social security coverage lower than that set by the statutory requirement.
  - d. Employees hired before April 1, 1986, who are qualified participants in a public retirement system and 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 (e.g., services previously optionally excluded), to cover ineligible, 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 retirement system. [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 cannot be terminated. Is this true?** Yes. Since April 20, 1983, coverage obtained under a Section 218 Agreement by law, 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 participants in a public retirement system, are covered under *mandatory* social security. Mandatory social security coverage (coverage required by statute) ceases if the employees subsequently become qualified participants in a public retirement system. [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 this purpose. See IRC section 7871. [IRS]
- 6) **I have a question regarding social security and Medicare coverage requirements for employees of my city. Whom do I contact?** The State Social Security Administrator should always be an entity’s first contact on any questions regarding coverage under social security or Medicare. If additional assistance on coverage is needed, the SSA should be consulted. Questions about whether services are subject to mandatory social security and Medicare taxes should be directed to the IRS. See [Chapter 8, State Social Security Administrators](#). [STATE]

- 7) **What is the responsibility of State Social Security Administrators with respect to 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, responsibilities for non-Section 218 entities vary from state to state. Some state administrators may not interact with non-Section 218 entities while others may perform monitoring, quasi-regulatory and enforcement functions. If a non-Section 218 entity needs information regarding coverage under an agreement, the State Social Security Administrator should be contacted. [STATE]
- 8) **If an entity has a Section 218 Agreement in effect, and joins the state's public employee retirement system, does Section 218 coverage continue?** Section 218 coverage continues for all employees. 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 alter the coverage under the Section 218 Agreement. [SSA]

## Chapter 2

# Government Entities and Federal Taxes

The Bureau of the Census estimated that there were 89,476 units of local government in the United States in 2007. These units of government employ more than 20% of the American workforce.

This chapter discusses the different types of government entities and their legal basis 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 primary tax difference from other taxpayers is the general exemption from income tax. IRC Section 115 excludes from gross income any income derived from the exercise of or administration of any public function. Governments are subject to income tax only on unrelated business income. For more information, see [Publication 598](#), Tax on Unrelated Business Income of Exempt Organizations.

## State Government

Although states are recognized as entities by the U.S. Constitution, 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 includes the 50 states, Puerto Rico, the Virgin Islands, and interstate instrumentalities. It does not include the District of Columbia, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands.

### 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 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 within the state
- Regulation of business within the state
- Education

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 with this shared responsibility include:

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

## **Local Government and Subdivisions**

Local governments are generally political subdivisions of states and differ from state and Federal governments in that their authority is not based directly on a constitution. Each state constitution describes in detail a procedure for establishing 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, district, etc. The legal significance of these terms may vary from state to state.

### **Authority**

The authority of local governments varies greatly. 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

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
- Public safety
- Building and repairing local roads and streets
- Providing police and fire protection
- Collecting garbage and recycling
- Maintaining schools

- 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 created by or pursuant to state statute and 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. Questions concerning the status of an instrumentality, for social security and Medicare purposes, should be directed to the IRS. Questions concerning a specific Section 218 Agreement should be addressed to the State Administrator or the SSA. Questions relating to social security benefits should be directed to the SSA Parallel Social Security Office (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. See 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, an interstate instrumentality is treated as a state.

For an interstate instrumentality to cover its employees with a retirement system, a referendum must be held prior to the execution of the 218 agreement. All interstate instrumentalities are authorized to divide a retirement system either on the basis of the desires of the members, or by a majority vote referendum (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 continues to withhold and report such taxes.

In Revenue Ruling 57-128, the IRS addressed the question of whether an organization is wholly-owned by one or more states or political subdivisions. In making this determination, the following factors are taken into consideration:

- 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 organizations is vested in public authority or authorities
- Whether express or implied statutory or other authority is necessary for its creation and/or use of the instrumentality, and whether such authority exists
- The degree of financial autonomy and the source of operating expenses

### **Characteristics of Instrumentalities**

Schools, hospitals and libraries, as well as associations formed for public purposes, such as soil and water conservation, may be instrumentalities, 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.

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 IRS 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, 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, 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, CB 1969-2, 182]

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

**Example:** A fire association was organized pursuant to 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, CB 1970-2, 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 in order to secure fire protection. Members of volunteer fire departments organized under the laws of Pennsylvania are employees of the political subdivision. [Revenue Ruling 70-484, CB1970-2, 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, 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 tribes; but, within those limits, the tribes retain attributes of sovereignty over both their members and their territory.

### 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

Generally, Indian tribes provide government services, such as transportation, education, and medical care to reservation Indians.

For more information, see the IRS [Indian Tribal Governments website](#).

Generally, Indian tribal governments should follow general rules that apply to nongovernmental entities for employment tax. [Publication 15](#), 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. See IRC section 3306(c)(7) and [Section 3](#). Thus, Federally-recognized Indian tribes are not subject to the FUTA tax, unless they so elect. 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). Indian tribe includes any subdivision, subsidiary, or business enterprise wholly-owned by an Indian tribe. See IRC section 3306(u).

Amounts paid to members of Indian tribal councils for services performed as council members are not wages for purposes of FICA and income tax withholding (although such amounts are includible in gross income). Revenue Ruling 59-354, 1959-2 C.B. 24.

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).

Extensive information specifically addressing Indian tribal governments and employment tax issues can be found in Publication 4268, *Employment Tax Desk Guide*, on the Indian Tribal Governments (ITG) [website](#).

## Frequently Asked Questions

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

Recognized government entities are exempt from income tax. If the entity is covered by social security under mandatory coverage or a Section 218 Agreement, the employees are generally subject to employment tax and information reporting requirements on the same basis as other taxpayers. However, certain forms of government employment have special exemptions. [IRS]

**2) Can the IRS issue a letter indicating that our entity is a tax-exempt government?** In order for a government entity to receive a determination of its status as a political subdivision, instrumentality of government, or whether its revenue is exempt under Internal Revenue Code section 115, it must obtain a letter ruling by following the procedures specified in [Revenue Procedure 2011-1](#) or its successor. There is a fee associated with obtaining a letter ruling. [IRS]

As a special service to government entities, IRS will issue a governmental information letter" free of charge. This letter describes government entity exemption from Federal income tax and cites applicable Internal Revenue Code sections pertaining to deductible contributions and income exclusion. Most organizations and individuals will accept the governmental information letter as the substantiation they need. [IRS]

## Chapter 3

# Wage Reporting and Employment Taxes

This chapter briefly covers the forms of compensation that are included in employee wages and the tax withholding requirements that apply to these payments. It then addresses the basic tax filing responsibilities of 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 and employment subject to income tax withholding under section 3401, and by social security and Medicare taxes under section 3121.

The social security and Medicare taxes, also referred to as the Federal Insurance Contributions Act, or FICA taxes, consist of Old-Age, Survivors and Disability Insurance (social security) and Medicare Hospital Insurance (Medicare) taxes. Internal Revenue Code (IRC) section 3101 imposes tax on the employee, and section 3111 imposes tax on the employer. State or local entities covered by social security and/or Medicare must withhold and pay over the employee share of the taxes and must pay the employer share. Under section 3402, employers are generally required under section 3402 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 items, focusing on some that are of particular interest to government employers.

**Note:** Workers are subject to social security, Medicare, or income tax withholding only if they are employees of the organization paying them. The process for determining whether workers are employees is the subject of [Chapter 4](#).

Employers are subject to requirements for withholding, depositing, and filing employment taxes on wages they pay. These requirements are discussed in detail in [Publication 15](#), Employer's Tax Guide (Circular E), which is mailed to all employers annually. This chapter highlights some key requirements and matters of special interest to governmental 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,

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.

The Social Security Administration establishes the maximum amount of wages subject to the social security tax per year. For 2012, this amount is \$110,100. The amount is adjusted each year. (Since 1994, there has been no wage base limit for Medicare tax.)

## Social Security and Medicare Tax Rates and Limits

Social Security and Medicare Tax				
Social Security (OASDI) Tax Information	2009	2010	2011	2012
Employee Rate	6.20%	6.20%	4.20%	6.20%*
Employer Rate	6.20%	6.20%	6.20%	6.20%*
Maximum Wages*	\$106,800	\$106,800	\$106,800	\$110,100
Medicare Tax Information				
Employee Rate	1.45%	1.45%	1.45%	1.45%
Employer Rate	1.45%	1.45%	1.45%	1.45%
Maximum Wages	All Wages			
<p><i>* Note: The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduced, for calendar year 2011, the OASDI payroll tax by 2 percentage points, applied to the portion of the tax paid by the worker. Pending legislation may also modify the rate for calendar year 2012. Check <a href="http://irs.gov">irs.gov</a> for updated information on the rates applicable to 2012.</i></p>				

## Statutory Exceptions to Social Security and Medicare Coverage

Government employment not covered by a public retirement system (see [Chapter 6](#)) is generally subject to social security and Medicare coverage under IRC 3121(b)(7)(F). However, this section of the Internal Revenue Code provides some statutory exceptions that exclude certain services from the definition of employment for purposes of mandatory social security coverage. These exceptions include services performed by):

**3121(b)(7)(F)(i)** – individual employed to be relieved from unemployment

**3121(b)(7)(F)(ii)** – inmate or hospital patient

**3121(b)(7)(F)(iii)** – individual serving on a temporary basis because of emergency

**3121(b)(7)(F)(iv)** – election official or worker, for amounts below a designated threshold

**3121(b)(7)(F)(v)** –employee compensated solely on a fee basis

In some cases where social security coverage is provided by a Section 218 Agreement, the exclusion for some of these groups may apply differently. These are discussed in greater detail in [Chapter 5](#).

## **Other Forms of Cash Compensation**

In addition to stated salary or wages, employees may receive cash designated as special payments. These are some common other forms of cash compensation:

### **Sick Pay**

Sick pay is an amount paid to an employee because of sickness or injury. Sick pay is generally subject to social security and Medicare taxes and income tax withholding if paid by the employer. The employer withholds from sick pay based on the employee's Form W-4. 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 an agent of the employer or an insurer, and the terms of an agreement between the employer and agent or insurer.

If the third-party payer does not withhold income tax, the employee may request income tax withholding by completing and giving to the third party Form W-4S, Request for Federal Income Tax Withholding from 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 law,
2. Payments, or portions of payments, attributable to the employees' contributions to a sick pay plan,
3. Payments made for the same sickness or injury more than six months after the last calendar month in which the employee worked.

See [Publication 15-A](#) for more details on third-party sick pay.

### **Vacation Pay**

Vacation pay is wages and is subject to social security and Medicare tax and income tax withholding. When vacation pay is made in addition to regular wages for the vacation

period, withhold as if the vacation pay were a supplemental wage payment, discussed later.

### **Military Differential Pay**

Military differential pay is any payment made by an employer to an individual during the period that the individual is called to active duty in the uniformed services for a period of more than 30 days, and represents part or all of the wages the individual would have received from the employer if the individual were performing service for the employer.

Prior to 2009, military differential pay was not treated as wages and qualified employee benefit plans were not required to treat differential pay as compensation for purposes of the limitations on benefits and contributions applicable to those plans. Employers previously reported military differential payments in box 3 of Form 1099-MISC. However, the Heroes Earnings and Relief Tax Act of 2008 redefines military differential pay as wages, reportable on Form W-2.

After December 31, 2008, the following rules apply:

1. Differential wage payments made to an individual on active duty for more than 30 days are subject to income tax withholding, but not to social security and Medicare (FICA) or unemployment tax (FUTA).
2. Employers may use either the aggregate or the separate method to calculate income tax withholding in these situations. For a discussion of these methods, see section 7, “Supplemental Wages”, in [Circular E](#), Employer’s Tax Guide.
3. The amounts of differential wages must be reported on Form W-2.

### **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. If the employer made the payment in the same year that the employee died, the payment and social security and Medicare taxes must be reported on Form W-2 as social security wages (box 3) and Medicare wages and tips (box 5). The social security and Medicare taxes withheld should appear in boxes 4 and 6. Do not show the payment in box 1.

If the payment was made *after* the year of death, it should not be reported on Form W-2 and social security and Medicare taxes should not be withheld. 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 Revenue Ruling 86-109, 1986-2 C.B.196.

See the [Instructions for Forms W-2 and W-3](#) for general information on reporting wages. See [Publication 559](#) for more information on the treatment of payments to 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.

If the back pay is awarded *under a statute*, the period for which back pay is credited as wages for social security purposes is different from the tax year it is reported. However, payments of back pay under a statute will remain 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 allocate the statutory back pay to the appropriate periods. See IRS [Publication 957](#), Reporting Back Pay to the Social Security Administration, for more information.

## **Worker's 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 and 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.

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.

Workers' compensation benefits are fully excluded from gross income and are not subject to employment taxes, income tax withholding or reporting. Amounts received under a statute in the nature of a workers' compensation act, however, may be subject to employment taxes and reporting.

## **Noncash Payments**

Generally, noncash payments are wages subject to social security and Medicare. 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 upon a reasonable value established for other purposes. Special rules may apply to noncash fringe benefits, discussed below.

## **Fringe Benefits**

Generally, fringe benefits, which generally include any compensation other than cash wages or salary, must be included in an employee's wages unless an exception is provided

by law. Examples of employer-provided fringe benefits include vehicles for personal use, meals, health or life insurance, tickets to entertainment or sporting events, etc. Some common tax-exempt benefits are discussed below.

The IRS office of Federal, State and Local Governments (FSLG) has created a [Taxable Fringe Benefits Guide](#) specifically for government employers. For a more comprehensive discussion of fringe benefits, you can view or download this publication from the [FSLG website](#).

### **Business Expense Reimbursements**

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 and withholding unless paid under an *accountable plan*. There are three requirements for a reimbursement procedure to be treated as 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 IRC section 62(c), section 1.62-2 of the Income Tax Regulations, and [Publication 15](#) 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](#) or the FSLG [Fringe Benefit Guide](#) for more information on per diem reimbursement systems.

### **Employer-Provided Vehicles**

An employee is allowed to exclude from income the value of any property or services provided by the employer to the extent that, if the employee paid for the property or services, the payment would be allowable as a business expense deduction. This is called a working condition fringe benefit. See IRC section 132(a)(3).

If an employer provides an employee with unrestricted use of a vehicle, the employee receives a noncash fringe benefit and the value of the use is required to be included in income. The value of the vehicle for the tax year is included in income unless the employee substantiates its business use. See IRC section 274(d) and section 1.274-5T, Income Tax Regulations.

There are three methods for determining the value of the personal use of a vehicle:

- Cents-per-mile rule
- Commuting rule
- Lease value rule

The requirements for each of these rules are discussed in IRS [Publication 15-B](#), and in the FSLG [Taxable Fringe Benefits Guide](#).

Under certain circumstances, the value of a “qualified nonpersonal use vehicle” can be excluded from income as a working condition fringe benefit. A qualified nonpersonal use vehicle is one that, due to its nature, is not likely to be used more than a minimal amount for personal purposes. This includes, for example, a clearly marked police, fire, or public safety officer vehicle, a flatbed truck, a school bus, ambulance, etc., when used for its intended purpose. An employee is not required to substantiate the business use of a qualified nonpersonal use vehicle in order to exclude its value from income. See IRC section 274(d)(i) or Publication 15-B.

### **Clothing Provided by Employer**

The value of work clothing provided by the employer is not taxable to the employee if: 1) the employee must wear the clothing as a condition of employment, and 2) the clothes are not suitable for everyday wear. It is not enough that the employee wear distinctive clothing; the employer must specifically require the clothing as a working condition. Nor is the test met because the employee does not, in fact, wear the work clothes away from work. The clothing must not be suitable for taking the place of your regular clothing. The value and upkeep of work clothes provided to firefighters, health care workers, law enforcement officers or letter carriers is nontaxable to the employee. Similarly, the value of safety shoes or boots, safety glasses, hard hats and work gloves provided and maintained by the employer are not taxable if the payments or reimbursements are substantiated under the accountable plan rules.

### **Health Benefits**

Under IRC sections 105 and 106, employer-provided health benefits, including reimbursement and insurance, are excluded from the income of the employees. This applies to any employer-paid system, whether or not provided under a written plan or available to all classes of employees. A health reimbursement arrangement (HRA) may provide for the carryover of benefits from year to year, and may specify the types of medical benefits that are covered. An HRA can only be financed by employer contributions, and cannot involve an employee election to participate. For more information, see [Publication 969](#), Health Savings Accounts and Other Tax-Favored Health Plans.

### **Cafeteria (Section 125) Plans**

Cafeteria plans, including flexible spending arrangements, are benefit plans under which employees can choose from among cash and certain qualified benefits. Under IRC section 125, benefits provided under a cafeteria plan are subject to social security and Medicare

taxes on the same basis as the specific benefits would be if provided outside the plan. If the employee elects qualified benefits, employer contributions are excluded from wages for income tax.

The following benefits may be included in a cafeteria plan:

- Accident and health benefits (but not Archer medical savings accounts or long-term care insurance)
- Adoption assistance
- Dependent care assistance
- Group-term life insurance coverage (including costs that cannot be excluded from wages)
- Health savings accounts, including distributions to pay long-term care services

Generally, qualified benefits under a cafeteria plan (including health and accident insurance) are not subject to social security and Medicare taxes or income tax withholding. The cost of group-term life insurance of up to \$50,000 provided by an employer is excludable from income and social security, and Medicare wages. However, the cost of group-term life insurance that exceeds \$50,000 of coverage is includible in income and is subject to social security and Medicare taxes, but not to income tax withholding, even when provided as a qualified benefit in a cafeteria plan. The cost of group-term life insurance that is includible in income only because the insurance exceeds \$50,000 of coverage is considered a qualified benefit. Adoption plans are also subject to social security and Medicare taxes. See IRS [Publication 15-B](#) for details.

If an employee elects to receive cash instead of any qualified benefit, that amount is treated as wages subject to all employment taxes.

Health benefits provided under a cafeteria plan may include insurance or a flexible spending account for qualifying medical expenses. However, benefits must be used before the end of the year or they are forfeited, as discussed above. An employer may have both an HRA and a cafeteria plan, but the salary reductions cannot be used to directly or indirectly fund an HRA (see [Notice 2005-42](#)).

Any amounts paid for health benefits pursuant to a salary reduction election are considered paid by the employer; therefore, the employee is not entitled to exclude from income any amounts paid as “reimbursements” to the employees for benefits under the plan. See [Revenue Ruling 2005-24](#) for more information on the interaction between an HRA and various reimbursement arrangements.

### **Meals and Lodging Furnished by Employer**

The value of meals is excludable **if** they are furnished on the business premises of the employer **and** are provided for the convenience of the employer.

The value of lodging is excludable if it meets the test, stated above, for meals, **and** if the employee is required to accept the lodging as a condition of employment. See [Publication 15-B](#) for more information.

## **Retirement Plans**

Regardless of social security coverage, most public employees are covered by some form of retirement plan. These plans vary greatly, but in general provide for tax-deferred income placed in trust for retirement. These plans may involve employee or employer contributions, or both. Under certain provisions of the IRC, contributions may be deferred from tax until they are withdrawn. Plans covered under IRC section 401 are considered “qualified,” meaning they meet specific provisions of the Employee Retirement Income Security Act (ERISA) that enable them to offer certain tax advantages. Many public employees, however, are covered by nonqualified plans, generally under IRC sections 403(b) or 457, discussed below.

### **Income Tax Withholding on Qualified Retirement Plans**

For income tax withholding purposes, employer and employee contributions (up to the maximum allowable for the year) are deferred from income tax. The employee will be subject to tax on distributions of these amounts when they are withdrawn from the plan.

### **Employer “Pick-Up” Contributions**

Section 414(h)(2) allows state government entities with section 401(a) plans to treat contributions designated as employee contributions, but which are “picked up” (paid) by the employer, to be treated as employer contributions, and therefore as exempt from social security and Medicare. For more information on the conditions required for employer pick-up, see IRC 414(h)(2) and the article “Chief Counsel Guidance on Salary Reductions” in the [July 2007 FSLG Newsletter](#).

### **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 certain tax-exempt organizations, and certain ministers. Many public school employees are covered by 403(b) plans in addition to receiving social security coverage under a Section 218 Agreement.

Employer contributions to tax-sheltered annuities under section 403(b) for public school employees, are exempt from social security and Medicare taxes. They resemble qualified plans in many respects. Eligible participants may defer amounts from income tax up to an annual limit (\$17,000 in 2012). This amount may be increased for certain employees with more than 15 years service. In addition, additional tax-deferred “catch-up” contributions may be made to employees age 50 or older.

Employee contributions, including those made by salary reduction arrangements, are subject to social security and Medicare tax.

For more information, see [Publication 571](#) and the [section 403\(b\) page](#) on the IRS Employee Plans website..

### ***Section 457 (Nonqualified) Plans***

Many public employees participate in nonqualified, or section 457, plans. These plans can be established by state and local governments or tax-exempt organizations. If they meet the requirements of IRC section 457(b), they are considered “eligible” plans; if not they are considered “ineligible” and are governed by IRC section 457(f).

### ***Section 457(b) – Eligible Plans***

Governmental 457(b) plans must be funded, with assets held in trust for the benefit of employees. Plans eligible under 457(b) may defer amounts from income tax up to an annual limit (\$110,100 in 2012). In addition, “catch-up” contributions may be made to employees age 50 or older. Social security and Medicare taxes generally apply to all employer and employee contributions. For further information regarding social security and Medicare tax withholding and reporting on amounts deferred into eligible deferred compensation plans, see the [section 457\(b\) page](#) on the IRS Employee Plans website.

Amounts deferred from wages into an eligible section 457(b) deferred compensation plan are not subject to income tax withholding until they are distributed from the plan or made available to the participant or beneficiary. For further information regarding income tax reporting and withholding upon amounts deferred into and distributed from eligible governmental deferred compensation plans, see the [section 457\(b\)](#) of the IRS Employee Plans page, and Section IV of [Notice 2003-20](#).

### ***Section 457(f) – Ineligible Plans***

Nonqualified state or local government plans that do not meet the tests of 457(b) are ineligible, or 457(f), plans. There is no limit on the annual deferrals on these plans, but to defer taxation all amounts must be subject to substantial risk of forfeiture. Distributions are generally subject to social security and Medicare taxes at the later of the time 1) when the services giving rise to the related compensation are performed, or 2) when there is no substantial risk of forfeiture of the rights to the amounts.

## **Employer Reporting Responsibilities**

Basic Federal tax requirements that generally apply to all employers are discussed below. For a more detailed explanation, see [Circular E, Employer's Tax Guide](#).

## Employer Identification Number

IRS identifies individual taxpayers by using taxpayer identification numbers (TINs). For individuals, the TIN is the social security number. State and local entities use Employer Identification Numbers (EINs) assigned by IRS to identify their tax returns. The EIN should be used on all employment tax returns (i.e., Form 941), information returns (i.e., Form W-2) and correspondence with the IRS. Generally, each county, city, school district and other governmental unit will have a unique EIN. However, this is not always the case within state governments. Many state agencies may use an EIN assigned to another agency; some larger state agencies may use a unique EIN.

When two entities are combined, such as when one municipality annexes another, or when school districts are merged, the EIN of the annexed area or abolished district should no longer be used, as it is no longer a separate entity. A continuing entity that absorbs or annexes another can retain its EIN. However, if a new entity is created from the dissolution of two or more preexisting entities, a new EIN should be obtained. When an unincorporated area is incorporated, it becomes a separate entity and must obtain its own EIN.

To obtain a new EIN, complete [Form SS-4](#), Application for Employer Identification Number. Once you have received an EIN, ensure that it is accurate and complete on each tax document submitted. When an incorrect EIN is used, credit for tax payments can be delayed or applied incorrectly.

**Note:** For tax years prior to 1987, SSA assigned EINs beginning with the digits “69” to report earnings, but these are no longer used. Prior to 1987, these numbers were assigned for new modifications to Section 218 Agreements, and then used to process wage reports. Many states have a filing system based upon the 69-number and, therefore, continue to sequentially assign 69-numbers for internal recordkeeping purposes.

## Form W-2

An employer is responsible for issuing Form W-2, Wage and Tax Statement, to each employee from whom income, social security or Medicare tax was withheld, or would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4. The aggregate amounts are reported on Form W-3, Transmittal of Wage and Tax Statements. For more information, see the [Instructions for Forms W-2 and W-3](#).

An employer uses Form 941, Employer’s Quarterly Federal Tax Return (or for certain employers, the annual Form 943 or 944) to report wages paid and taxes withheld. After the calendar year ends, employers prepare individual employee reports on Forms W-2, Wage and Tax Statement with Form W-3, Transmittal of Wage and Tax Statements, showing the total wages paid and taxes withheld for each employee during the year. An employer reports wage information to SSA for crediting to the employees’ earnings records. This is done either by sending SSA Copy A of the paper Form W-2 with a covering Form W-3, or by sending the Form W-2 information in the form of electronic reports. Employers who file 250 or more Forms W-2 are required to file returns electronically.

If you need to talk directly to SSA about an electronic file or other wage reporting problem, you may contact an Employer Services Liaison Officer (ESLO) through the [SSA website](#) or call 1-800-772-6270 for assistance from an earnings report technician. Specifications for electronic reporting of Form W-2 information can be found at the [SSA employer page](#) or by calling the ESLO for your state.

## **Form 941**

Form 941, Employer's Quarterly Federal Tax Return, is used to report total wages, wages subject to social security and Medicare tax, and Federal income tax. Agricultural employers file Form 943, Employer's Annual Tax Return for Agricultural Employers. Form 944, discussed below, is an annual version of the form, an option for employers with the smallest payrolls. Generally, annual Form 941 or Form 943 totals must match the aggregate wages shown on all Forms W-2 issued to employees for the same period.

To prepare Form 941, the total wages and compensation for the quarter must be determined. Wage payments are included in the quarter in which they are paid. For example, an employee works for the county in a pay period ending on March 20, but is not paid until April 5. In this situation, the employee's wage payment is included in the second quarter when the payment is made, not the first quarter when the work was done. Total wages and compensation entered on line 2 of Form 941 includes all payments to employees. Examples of these payments include:

- 1) Wages, salaries, commissions, fees, and bonuses
- 2) Vacation allowances
- 3) Dismissal pay and severance pay
- 4) Tip income
- 5) Noncash payments, including goods, lodging, food, clothing or services given instead of cash.

Wages from which social security and Medicare tax must be withheld may differ from total wages. This may be because certain amounts are not included in wages for income tax purposes, but are subject to social security and Medicare tax (for example, deferred compensation in an IRC section 3121(v)(2) nonqualified deferred compensation plan). Another common reason is that earnings that exceed the annual wage base are not subject to the OASDI portion of social security tax. The total income tax withheld (line 3) includes all Federal income tax withheld from all employees for the calendar quarter covered by the return.

Form 941 must be filed with the IRS by the last day of the month following the reporting quarter. For example, the first quarter return covering January through March is due by April 30. If all taxes are deposited when due, the employer has 10 additional days after the due date to file the return. If the return is not filed by this date, the employer may be subject to penalties and interest in addition to the tax due on the return.



## **Form 944**

Certain taxpayers with small payrolls may report their employment taxes on an annual rather than a quarterly basis. The IRS will notify these taxpayers of their changed requirement. Instead of the quarterly Form 941, they can file an annual Form 944, Employer's Annual Employment Tax Return. An employer may contact the IRS to request to file a Form 944 instead of a Form 941. See Revenue Procedure 2009-51. The deposit requirements, discussed below, are the same as for quarterly filers. For more information on eligibility, see [Publication 15](#) or the [Instructions for Form 944](#).

Form 944 filers can opt out of the requirement and file the quarterly Form 941. See the instructions for more information. For purposes of this requirements discussed in this chapter, references to Form 941 are also applicable to filers of Form 944.

## **Form 941-X**

Employers correct errors to Form 941 or 944 by filing Form 941-X, or Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund, or Form 944-X, Adjusted Employer's ANNUAL Federal Tax Return or Claim for Refund. Form 941-X is a stand-alone return that should be filed as soon as the error is discovered. The return for the period when the error is discovered is not affected. Additional requirements are discussed in the [Instructions for Form 941](#) and in the [Instructions for Form 941-X](#).

*Note:* Prior to 2009, employers corrected previously reported amounts on Form 941 by showing the adjustments on a separate statement (generally Form 941c) and making an adjustment to the liability for Form 941 for the quarter in which the error was discovered. Beginning January 1, 2009, Form 941c is obsolete.

## **Special Reporting Situations for Government Employers**

These are some circumstances commonly facing government employers that involve special reporting rules.

### **Multiple Employers and the Wage Base**

Because each employer must withhold on wages up to the annual maximum, an employee who works for more than one employer in one calendar year may have excess social security taxes withheld. In order to get a refund of the excess social security tax withheld by the employers, the employee shows the overpayment on Form 1040. Employers are not responsible for making any adjustments and cannot claim a refund in this situation, because each employer is responsible for withholding and paying social security tax on wages paid to each employee up to the wage base.

For the purpose of determining responsibility for reporting wages, a state is considered to be one employer and each political subdivision is considered a separate employer. An employee who transfers from one state agency to another during a calendar year does not change employers. In this case, the state should withhold and pay social security tax only up to the wage base for that employee. However, an employee who transfers from a state agency to a political subdivision of the state, a city or county, has changed employers. Each employer must withhold and pay social security tax up to the wage base for that employee, regardless of other employment.

### **Medicare Qualified Government Employment (MQGE)**

Because they provide coverage under a public retirement system, some state and local employers will have employees who are not subject to social security but are subject to Medicare tax. This is referred to as Medicare Qualified Government Employment (MQGE). MQGE Forms W-2 are filed separately from those for employees covered by social security and Medicare, or from Forms W-2 having no social security or Medicare wages. Paper MQGE Forms W-2 must be transmitted with a covering Form W-3 with “Medicare Govt. Emp.” checked in box b. See the Instructions for Forms W-2 and W-3 or contact your ESLO for more information.

**Note:** *Electronically transmitted records should be grouped to follow a “Code RE” record with an Employment Code of “Q”. All other W-2 records should be grouped to follow a Code RE record with an Employment Code of “R”. Do not group MQGE W-2 records and non-MQGE W-2 records together after a single Code RE record. See SSA [Publication 42-007](#), Specifications for Filing Forms W-2 Electronically (EFW2).*

### **Employees Covered for MQGE and FICA**

If they are employed in more than one capacity, some state and local employees may be subject to both Medicare-only withholding and full social security and Medicare in the same reporting year. When an employee is in a continuous employment relationship with the same employer for the year, and the employer has both types of employees, the employer has two reporting options. The employer may:

1. Prepare a single Form W-2 with the total annual wages in box 1, the total Medicare wages and taxes from BOTH positions in box 5 and box 6. Social security and Medicare wages and taxes are entered in box 3 and box 4. (SSA prefers that this method be used in order to reduce errors), or
2. Use a separate Form W-2 for wage data from the Medicare-only position and a second Form W-2 for FICA wage data from the positions with both social security and Medicare coverage.

### **Information Reporting for Election Workers**

If an election workers’ compensation is less than a statutorily established amount (\$1,500 for calendar year 2012), it is generally not subject to mandatory social security and

Medicare tax. See IRC sections 3121(b)(7)(F)(iv) and 3121(u)(2)(B)(ii)(V). However, under a state's 218 Agreement an election workers' compensation may be subject to social security and Medicare taxes at a level below the statutory amount. Compensation of election workers is not subject to income tax withholding.

If an election worker's wages are subject to withholding of social security and Medicare tax, Form W-2 reporting is required for all compensation, regardless of the amount. If an election workers' compensation is not subject to withholding of social security and Medicare tax, Form W-2 reporting is required for payments that aggregate \$600 or more in a calendar year. See [Revenue Ruling 2000-6](#) for a discussion of information reporting with respect to election workers.

## **Information Returns**

Government entities are responsible for reporting various nonwage payments on information returns. Payments for nonemployee compensation are discussed in the [Instructions for Form 1099-MISC](#). Governments must file Form 1099-G, Certain Government Payments, for certain payments, including tax refunds and certain grants. See the [Instructions for Form 1099-G](#) for more information. A variety of information returns are required to report various other types of payments. Any entity, including a governmental organization, conducting a trade or business, is required to file information returns for certain of payments. In most cases, these payments are reported on Form 1099-MISC, Miscellaneous Income.

IRC 6041(a) states that all persons engaged in a trade or business and making payment in the course of the trade or business to another person of rent, of \$600 or more in any year must issue an information return indicating the amount of such income and the name and address of the recipient of such payment. The return with respect to certain payments of compensation to an employee is made on Forms W-2 and W-3; never use Form 1099-MISC to report payments for services by an employee. The recipient of the payment is required to furnish to you the entity's name, address and identification number. You should obtain this information before payments are made. This identification number must be included on the information return.

## **Depositing Taxes**

A balance due on the return of less than \$2,500 may be paid with the return. In general, employers are required to deposit Federal employment taxes if the total tax liability for Form 941 for the current or previous quarter is \$2,500 or more. These taxes are required to be deposited using the Electronic Federal Tax Payment System (EFTPS). You can no longer make deposits using paper coupons.

**Note:** As of November 30, 2009, Federal agencies can no longer use FEDTAX II for deposits and must use EFTPS. [Publication 966](#) provides a general introduction to the EFTPS system.

Guidance for the depositing of income tax withheld upon distributions from eligible section 457(b) plans (and for the reporting of such deposits) are provided in Section IV.E of Notice 2003-30.

### **When to Deposit**

An employer will use either the monthly or the semiweekly schedule for deposit of Federal employment taxes. These schedules indicate when a deposit is due after a tax liability arises (e.g., payday). Before the beginning of each calendar year, employers must determine which of the two deposit schedules they are required to use. The deposit schedule used is based on the total tax liability reported on Form 941 or Form 943 during a four-quarter lookback period as discussed below. The deposit schedule is not determined by how often employees are paid.

### **Lookback Period**

The deposit schedule for a calendar year is determined from the total taxes reported on Forms 941 (line 8) in a four-quarter lookback period. The lookback period begins July 1 and ends June 30 of the preceding year. If the employer reported \$50,000 or less of taxes for the lookback period, it is a monthly schedule depositor; if it reported more than \$50,000, it is a semiweekly schedule depositor.

The rules for making deposits are summarized in the table on the next page.

<b>Summary of Federal Tax Deposit (FTD) Rules</b>		
<b>If the employer is a...</b>	<b>And the payroll date is...</b>	<b>Then a deposit must be made:</b>
Monthly schedule depositor ( <i>\$50,000 or less during the lookback period</i> )	Any time during the month	On or before the 15 <sup>th</sup> of the month
Semiweekly schedule depositor ( <i>More than \$50,000 during the lookback period</i> )	Saturday, Sunday, Monday, Tuesday	On or before the following Friday
	Wednesday, Thursday, Friday	On or before the following Wednesday
<p><b><u>Special Rules:</u></b></p> <p><b>\$2,500 Rule:</b> Accumulated taxes less than \$2,500 in a quarter do not have to be deposited if paid with a timely filed return.</p> <p><b>\$100,000 Next Day Rule:</b> \$100,000 or more within a deposit period must be deposited on the next banking day. Monthly depositors become semiweekly depositors on the next day and remain so for the remainder of the year and all of the following year.</p> <p><b>Accuracy of Deposits Rule:</b> An employer who inadvertently underdeposits will not be penalized if the shortfall does not exceed \$100 or 2% of the amount of employment taxes required to be deposited. Balance due must be deposited by a shortfall make-up date. See IRS <a href="#">Publication 15</a>, for details.</p> <p><b>Deposits on Banking Days Only:</b> If a deposit is required to be made on a day that is not a banking day, the deposit is considered timely made if it is made by the close of the next banking day. In addition to Federal and state bank holidays, Saturday and Sunday are treated as non-banking days.</p> <p><b>Special Rules for Non-banking Days:</b> Semiweekly depositors have at least three banking days following the close of the semiweekly period to deposit taxes accumulated during the semiweekly period. For more information, see IRS Publication 15.</p>		

### **Deposit Requirements for Nonpayroll (Form 945) Tax Liabilities**

The deposit rules and dollar thresholds to figure when deposits for nonpayroll tax withholding are the same as they are for employment taxes; however, they are computed and paid separately. Do not combine Form 945 with deposits for employment tax liabilities (Form 941 or Form 944). See the instructions for Form 945 for details on reporting nonpayroll withholding.

For more information on the deposit rules, see IRS [Publication 15](#). For more information on using the Electronic Federal Tax Payment System (EFTPS), see IRS [Publication 966](#).

## Calculating Federal Income Tax Withholding

Employers are generally required to withhold Federal income tax from the wages paid to employees. The withheld amount is credited to the employees' individual income taxes.

The amount of Federal income tax withheld on an employee depends on five factors:

1. Payroll period,
2. Employee marital status,
3. Amount of wages,
4. Number of withholding allowances claimed by the employee, and
5. Additional amounts the employee requests to have withheld.

[Publication 15 \(Circular E\)](#), furnished to each employer every year, contains the tax withholding tables and percentage tables to use to determine actual withholding based on the above criteria. Refer to Publication 15 for specific instructions on calculating withholding from your employees.

### New Withholding Requirement for Governments Beginning in 2013

Internal Revenue Code section 3402(t) and final regulations require that after December 31, 2012, payments by Federal, state, and certain local government entities for property or services, with some exceptions, are subject to 3% income tax withholding.

All Federal agencies and state governments are subject to the provisions. However, state political subdivisions and instrumentalities of state government are not subject to the requirements if the total annual payments (not including exempt payments) are less than \$100,000,000.

In general, the total annual payments for the second preceding year is used to determine whether the total has been met. However, there is an alternate rule that allows averaging of four of five years. See the [Final Regulations](#) for section 3402(t) for more information.

Under a de minimis rule, withholding is not required on single payments of less than \$10,000. Under an anti-abuse rule, payments that are divided for the purpose of avoiding the requirements will be regarded as one payment.

Payments made to other governmental or tax-exempt entities, income assistance payments, payments to employees, payments for public welfare, grants for a public purpose, or made in hardship and emergency situations, and payments subject to other forms of withholding are not subject to the provisions. Payments for interest and real property are also exempt.

The withheld amounts are a credit against the tax liability of the recipient, and will be shown on Form 1099-MISC that the payer must issue after the end of the tax year. The payer reports the amounts withheld on Form 945, and follows deposit rules for that form. This is similar to procedures for backup withholding or withholding on wages.

Final Regulations were published as TD 9514 on June 6, 2011. For more information and updates, see the [FSLG website](#).

## **Federal Unemployment Tax Act**

The Federal Unemployment Tax Act (FUTA) provides a Federal-state insurance system for workers who lose their jobs. Most private employers pay both a Federal and state unemployment tax. States and their political subdivisions are exempt from paying tax under FUTA. However, state and local government employees, with certain exceptions, must be covered by state unemployment insurance. Contact your state employment or labor agency for more information.

## **Form SSA-1945**

Effective January 1, 2005, all state and local government employers who hire new employees not covered by social security are required to provide Form SSA-1945, Statement Concerning Your Employment in a Job Not Covered by Social Security, to the new employee before employment begins. For more information, go to [www.ssa.gov](http://www.ssa.gov).

## **Interest and Penalties**

Tax that is not paid when due or in the manner required may be subject to civil penalties as well as interest on the amount due.

## **Employment Tax Penalties**

The following are the most commonly assessed penalties related to employment tax. There are penalties for filing a return late and paying or depositing taxes late, unless there is reasonable cause.

<b>IRC Section</b>	<b>Penalty Assessed For:</b>	<b>Penalty Rates:</b>
6651(a)(1)	Failure to file a tax return (failure to timely file)	5% of the tax due per month up to 25%
6651(a)(2)	Failure to pay tax shown on the return (failure to timely pay) (imposed if the amount of tax shown on the return is not paid on or before the prescribed date)	0.5% (one half of one percent) of the tax due per month up to 25%
6651(c)	Both failure to timely file and failure to timely pay	When both penalties apply for any month, the failure to file penalty is assessed at 4.5%
6652(b)	Failure to report tips	Imposes a penalty for tip income unreported to the employer; the penalty is 50% of the employee social security and Medicare tax on the unreported tip income
6656	<b>Deposit penalties:</b>	
	1-5 days late	2%
	6-15 days late	5%
	More than 15 days late, but paid by the 10 <sup>th</sup> day after notice and demand (Notice and demand date is the assessment date)	10%
	Taxes still unpaid after the 10 <sup>th</sup> day following notice and demand	15%
	Failure to deposit electronically	10%
6662	Underpayment of employment taxes due to disregard of the rules and regulations (accuracy-related)	20% of the underpayment attributable to negligence or disregard of rules and regulations
6672	Failure to withhold or pay over trust fund taxes	100% of unpaid tax (see below)

### **Trust Fund Recovery Penalty**

Under section 6672, if withheld taxes that must be withheld are not withheld or are not deposited or paid, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so.

A responsible person can be an officer or employee of a government or a volunteer. A responsible person also may include one who signs checks for the business or otherwise has authority to cause the spending of funds. “Willfully” means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows that the required actions are not taking place.



## Information Reporting Penalties

The following are the most commonly assessed penalties as they relate to information reporting:

IRC Section	Penalty	Rate for Returns Required To Be Filed January 1, 2011, or Later*
6721	Failure to file correct information returns on or before the required filing date or failure to include all information required to be shown on the return (or where there is incorrect information shown)	The penalty for failure to file information returns without all required and correct information (including missing, incorrect and/or unissued TINs) is \$100 for each failure to a maximum of \$1,500,000 per calendar year
6722	Failure to furnish correct payee statements on or before the date prescribed to the person to whom such statement is required to be furnished, or a failure to include all of the information required to be shown on the payee statement or where the information is incorrect	When there is failure to furnish a timely and correct payee statement, the penalty is \$100 for each failure, not to exceed \$1,500,000 per calendar year
6723	Failure to comply with other specific information reporting requirements on or before the prescribed time (usually related to failure to furnish a TIN)	When there is failure to comply with any information reporting requirement, the penalty is \$50 for each failure, not to exceed \$100,000 per calendar year

\* - Reduced penalties may apply for returns filed within 30 days, by August 1, or for entities with gross receipts no more than \$5,000,000. See the [Instructions for Certain Information Returns](#) for more information.

## Interest

Interest is assessed on any taxes due and unpaid, in addition to any penalties that may be imposed. Specific provisions allow an employer who has made an undercollection or underpayment of social security and Medicare taxes or income tax withholding to make an interest free-adjustment (IRC section 6205(a)(1)). The following two requirements must be met:

- 1) Correction of the error must be made in the period in which the error was ascertained, and
- 2) Payment of the tax must be made no later than the due date of the return for the return period in which the error was ascertained. In addition, additional tax due as a result of an IRS examination or ruling may qualify for an interest-free adjustment.

## Frequently Asked Questions

- 1) **If board members are paid nominal amounts, for example, under \$1,000 per year, must social security and Medicare taxes be withheld?** Elected and most appointed officials are employees of the public entity they serve, and are generally subject to the rules that apply to other workers. Withhold social security and Medicare taxes for any official who is either 1) covered under a Section 218 Agreement, or 2) not a qualified participant in a public retirement system, and therefore subject to mandatory coverage. Any official elected or appointed after March 31, 1986, is subject to Medicare. [IRS]
- 2) **What is the statute of limitations date for an adjustment or claim for refund of payroll taxes?** The general rule is that an adjustment or claim for refund of any overpayment of Federal payroll taxes must be filed within three years from the date the return was due or three years from the date it was filed, if that date is later. For this purpose, a quarterly Form 941 is considered filed on April 15 of the following calendar year, if it is in fact filed by that date.[IRS]
- 3) **What is the social security tax treatment of prison inmate labor?** Generally, services performed by inmates for the state or local political subdivision that operates the prison are excluded from coverage, whether or not performed outside the confines of the prison. This is because inmates usually are not in an employment relationship with the state or political subdivision. Services performed by inmates, as part of the rehabilitative and therapeutic program of the institution, are not usually performed as employees. Services performed by inmates for an entity other than the state or local governmental unit, e.g., a work-release program, may be covered if an employment relationship exists. The relevant factor for determining social security coverage is whether an employer/employee relationship exists between the inmate and the non-governmental employer, not the place where the inmate is incarcerated. Services performed by inmates outside the institution for the same unit of government that operates it are considered performed *in the institution*. See also the article “Amounts Paid to Inmates” in the January 2006 [FSLG Newsletter](#). [IRS]
- 4) **Are the services of police officers and firefighters considered emergency services and therefore excluded from social security and Medicare coverage?** Police officers and firefighters are **not** considered emergency workers under the mandatory exclusion from social security and Medicare coverage. This exclusion applies only to services of an employee who was hired because of an unforeseen emergency to work in connection with that emergency on a temporary basis (for example, an individual hired to battle a major forest fire or to provide emergency assistance in other similar disasters such as volcano eruption, severe ice storm, earthquake or flood). Regular, long-term police and fire employees would be

subject to the same rules as other public employees to determine whether they are covered by social security. [IRS]

- 5) **How are tax deposits made?** As of January 1, 2011, taxes may no longer be made with paper coupons at Federal tax depositories. They must be made electronically, or, in some cases, may be paid with the tax return. See [Publication 15](#), Circular E. [IRS]

## Chapter 4

# Determining Worker Status

It is critical for any entity paying compensation to know whether its workers are employees. For government employers, statutes or the existence of a Section 218 Agreement may dictate whether a worker is considered an employee, but, in general, when making a determination about worker status, the primary question is whether the worker is an employee or an independent contractor under the common-law standard. Generally, *when workers are employees*, the government entity that employs them must withhold and pay employment taxes. Employment taxes consist of Federal income tax withholding, Old-Age, Survivors and Disability Insurance (OASDI), or social security tax and the Hospital Insurance tax (Medicare tax). The social security tax and Medicare tax make up the Federal Insurance Contributions Act (FICA) contributions, which are paid through employer and employee shares. State and local governments generally pay the social security tax on employees covered under Section 218 Agreements and on employees not covered by a public retirement system (mandatory coverage), and generally pay the Medicare portion on all other employees hired after March 31, 1986. Wages paid by state and local governments are not subject to taxes under the Federal Unemployment Tax Act (FUTA) but state unemployment taxes may apply.

*When workers are independent contractors*, the governmental entity may have information-reporting and backup withholding responsibilities, but it is not required to withhold and pay employment taxes on behalf of those workers.

This chapter deals with the general rules for determining whether workers are employees, and the laws that apply to different categories of public employment.

## Workers Covered Under Section 218 Agreements

As discussed in [Chapter 1](#), states can enter into agreements with SSA to provide social security and Medicare coverage for their employees pursuant to section 218 of the Social Security Act (Section 218 Agreements). If a position is covered by a Section 218 Agreement, then anyone holding that position is an employee; therefore, the first question for a government to ask in determining whether individuals are employees is whether the worker is in a position covered under a Section 218 Agreement. If section 218 coverage applies, this fact takes precedence over other considerations, including the common-law tests discussed below and mandatory coverage rules.

If a group of workers is covered under a Section 218 Agreement, the Agreement cannot be terminated or modified to exclude that coverage group. Employees who are not covered under a Section 218 Agreement are generally subject to social security and Medicare unless they participate in a public retirement system, discussed in [Chapter 6](#). However, Medicare taxes generally apply to wages of all state and local government employees

hired after March 31, 1986. See [Chapter 5, Social Security and Medicare Coverage](#), for further information.

Indian tribal governments are not treated as states for purposes of Section 218. See IRC section 7871. For more information about social security coverage and tribal governments, see the IRS Indian Tribal Governments [website](#).

## **Common-Law Standard**

IRC 3121(d)(2) states that an employee is “any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee.” The IRS has interpreted the common-law test for determining whether a worker is an employee as whether the service recipient (i.e., the government entity) has the right to direct and control the worker as to the manner and means of the worker’s job performance. In other words, does the entity have the right to tell the worker not only what shall be done, but how it shall be done?

All the facts and circumstances must be considered in deciding whether a worker is an independent contractor or an employee. The facts fall into three main categories:

- 1) Whether the entity has the right to control the behavior of the worker;
- 2) Whether the entity has financial control over the worker; and
- 3) The relationship of the parties, including how they see their relationship.

These facts are discussed below, with emphasis on governmental situations.

## **Behavioral Control**

Under this category, facts show whether the entity has a right to direct and control how the worker performs the specific task for which he or she is engaged. Many times, when workers perform their tasks satisfactorily, the entity does not appear to exercise much control. The critical question, however, is whether there is a **right to control**. If the entity has the right to do so, it is not necessary that it actually direct and control the manner in which the services are performed.

The following table addresses the elements of behavioral control with respect to government employees:

**Instructions,  
Training and  
Required  
Procedures**

An employee is generally subject to the government entity's instructions about when, where, and how to work. The employer has established policies, which the workers are required to learn and follow. Daily or ongoing instructions regarding the expected tasks are especially indicative of employer status. Training is a classic means of explaining detailed methods and procedures to be used in performing a task. Periodic or ongoing training about procedures to be followed and methods to be used indicates that the employer wants the services performed in a particular manner. This type of training is strong evidence of an employer-employee relationship. For instance, police and firefighters must be trained to comply with departmental rules and regulations. They do not have the independence characteristic of independent contractors. Other examples include a state statute requiring that animal control officers receive state-sponsored training, or a statute requiring that inspectors of sanitary facilities be trained and state-certified. These facts are indicative of a right to control. Election workers are trained to follow uniform procedures established for the polling place. They are directed by a supervisor. These facts suggest they would typically be employees. Government employees often work subject to regulations and manuals, which specify how their jobs are to be done. Teachers are required to receive periodic training in departmental policies. They are required to attend meetings, to follow an established curriculum, to use certain textbooks, to submit lesson plans, and to abide by departmental policies concerning professional conduct. However, some types of training or minimal instructions may be provided to either an employee or an independent contractor, including orientation or information sessions about a government entity's policies and voluntary programs for which there is no compensation.

**Government  
Identification**

Government workers may be required to identify themselves by wearing a uniform, driving a marked vehicle, etc. When an individual represents himself or herself as an agent of a government, that gives the individual an appearance of authority. Wearing a uniform, displaying government identification, or using forms and stationery that indicate one is representing a government are highly indicative of employee status.

**Nature of  
Occupation**

The nature of the worker's occupation affects the degree of direction and control necessary to determine worker status. Highly-trained professionals such as doctors, accountants, lawyers, engineers, or computer specialists may require very little, if any, instruction on how to perform their specific services.

Attorneys, doctors and other professionals can, however, be employees. In such cases, the entity may not train the individuals or tell them how to practice their professions, but may retain other kinds of control, such as requiring work to be done at government offices, controlling scheduling, holidays, vacations, and other conditions of employment. Again, you should consult state statutes to determine whether a professional position is statutorily created. On the other hand, professionals can be engaged in an independent trade, business, or profession in which they offer their services to the public, including work for government entities. In this case, they may be independent contractors and not employees. In analyzing the status of professional workers, evidence of control or autonomy with respect to the financial details is especially important, as is evidence concerning the relationship of the parties as discussed below.

**Evaluation Systems** Evaluation systems are used by virtually all government entities to monitor the quality of work performed. This is not necessarily an indication of employee status. In analyzing whether a government entity's evaluation system provides evidence of the right to control work performance, consider how the evaluation system may influence the workers' behavior in performing the details of the job. If there is a periodic, formal evaluation system that measures compliance with performance standards concerning the details, the system and its enforcement are evidence of control over the workers' behavior.

## Financial Control

This second category includes evidence of whether the entity controls the business and financial aspects of the workers' activities. Employees do not generally have the risk of incurring a loss in the course of their work, but generally receive a salary for as long as they work. An independent contractor has a genuine possibility of profit or loss. Facts showing possibility of profit or loss include: significant investment in equipment, tools or facilities; unreimbursed expenses, including the requirement of providing materials or hiring helpers; working by the day or by the job rather than on a continuous basis; having fixed costs that must be paid regardless of whether the individual works; and payment based on contract price, regardless of what it costs to accomplish the job.

The following table addresses the elements of financial control.

**Method of Payment** The method of payment must be considered. An individual who is paid a contract price, regardless of what it costs to accomplish the job, has a genuine possibility of profit or loss. An individual who is paid by the hour, week, or month is typically an employee. However, this is not always the case; for example, independent contractor attorneys usually bill by the hour. An individual who is paid by the unit of work, such as a court reporter, may or may not be an independent contractor, depending on the facts.

**Offering Services to the Public** Another factor favoring independent contractor status exists when the individual makes his or her services available to the public or a relevant segment of the market. Relevant questions that indicate this include:

- Does the individual advertise?
- Does the individual use a private business logo?
- Does the individual maintain a visible workplace?
- Does the individual work for more than one entity?

**Corporate Form of Business** If the individual is incorporated and observes corporate formalities associated with this status, this makes it unlikely that he or she is an employee of the government entity. (A corporate officer will be an employee of the corporation.) The mere fact of incorporation or use of a corporate name, however, does not transform an employee into an independent contractor. The corporation must serve an intended business function or purpose, or be engaged in business.

**Part-Time Status** The fact that workers work on a part-time or temporary basis, or work for more than one entity, does not make them independent contractors. A part-time, temporary or seasonal worker may be an employee or an independent contractor under the common-law rules.

## **Relationship of the Parties**

The third category used to determine worker status is evidence of the relationship between the parties, including how they view their relationship. The relationship of the parties is generally evidenced by examining the parties' agreements and actions with respect to each other, paying close attention to those facts that show not only how they perceive their relationship, but also how they represent their relationship to others.

For example, a fact illustrating how the parties perceive their relationship is the intent of the parties as expressed in a written contract. A written agreement describing the worker as an independent contractor is evidence of the parties' intent, and in situations where it is unclear whether a worker is an independent contractor or employee, the intent of the parties, as reflected in the contract, may resolve the issue.

However, a contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative. The substance of the relationship, not the label, governs the worker's status. See Employment Tax Regulation §31.3121(d)-1(a)(3)). The following items may reflect the intent of the parties:

- Filing a Form W-2 for an individual indicates the entity's belief that the worker is an employee.
- A worker doing business in corporate form, with observance of corporate formalities, indicates the worker is not an employee of the government entity.
- Providing employee benefits, such as paid vacation, sick days and health insurance, is evidence that the entity regards the individual as an employee. The evidence is strongest if the worker is provided with benefits under a tax-qualified retirement plan, section 403(b) annuity or cafeteria plan because, by statute, these benefits can be provided only to employees.

The following table addresses the elements of the relationship of the parties.



<b>Discharge or Termination</b>	The circumstances under which a business and a worker can terminate their relationship have traditionally been considered useful evidence concerning the status of the worker. However, business practices and legal standards governing worker termination have changed since these general principles developed. Under a traditional analysis, a government entity's ability to terminate the work relationship at will, without penalty, provided a highly effective method to control the worker. The ability to fire at will is indicative of employee status. In the traditional independent contractor relationship, the government entity could terminate the relationship only if the worker failed to provide the intended product or service, thus indicating that the business did not have the right to control how the work was performed. In the current environment, a government entity rarely has complete flexibility in discharging employees. The reasons a government entity can terminate an employee may be limited by law, by contract, or by its own practices. Consequently, inability to freely discharge a worker, by itself, no longer constitutes persuasive evidence that the worker is an independent contractor.
<b>Termination of Contracts</b>	Historically, a worker's ability to terminate work at will was considered to illustrate that the worker merely provided labor and tended to indicate an employer-employee relationship. In contrast, if the worker terminated work, and payment could be refused, or the worker could be sued for nonperformance, this traditionally tended to indicate an independent contractor relationship. Today, however, it is more common that independent contractors may enter short-term contracts for which nonperformance remedies are inappropriate, or may negotiate limits on their liability for nonperformance. For example, professionals, such as doctors and attorneys, are typically able to terminate their contractual relationship without penalty. Accordingly, the worker's protection from liability for terminating the relationship does not necessarily indicate employee status.
<b>Non-performance of Employees</b>	Employers may successfully sue employees for substantial damages resulting from their failure to perform the services for which they were engaged. As a result, the existence of limits on a worker's ability to terminate the relationship, by itself, is less relevant in determining worker status. On the other hand, a government entity's ability to refuse payment for unsatisfactory work continues to be characteristic of an independent contractor relationship. Because the meaning of the right to discharge or terminate is so often unclear, and depends primarily on contract and labor law, these facts should be viewed with great caution.
<b>Permanency</b>	The permanency of the relationship between the worker and service recipient is somewhat relevant to determining whether there is an employer-employee relationship. If a worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence of intent to create an employment relationship. However, a long-term relationship may also exist between a government entity and an independent contractor. There may be a long-term contract, or contracts may be renewed regularly due to superior service, competitive costs, or lack of alternative service providers. Part-time, seasonal or temporary workers may also be employees under the common law. The fact that workers do not have full-time, permanent status is irrelevant to their classification.

## **Common-Law Standard - Summary**

In many worker classification cases, some facts will support independent contractor status and others will support employee status. Independent contractors are rarely totally unconstrained in the performance of their contracts, and employees almost always have some degree of autonomy. The determination of a worker's status, therefore rests on the weight given to the facts as a whole, keeping in mind that no one factor is determinative.

### **Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding**

In difficult cases, the IRS can provide a determination as to whether a worker is an employee or an independent contractor. To obtain a determination from the IRS, file [Form SS-8](#). Either a governmental entity or a worker may submit Form SS-8. The IRS will acknowledge receipt of the Form SS-8 and will also request information from the worker. If a contract has been executed between the worker and the entity, a copy of the contract should be submitted with Form SS-8. In some cases, the IRS will contact the State Social Security Administrator to determine whether the entity and position are covered by a Section 218 Agreement. The IRS will generally issue a formal determination to the entity and will send a copy to the worker.

*Note: The SS-8 determination is not an examination and does not reopen a closed examination or change the findings for years examined.*

### **Employee Status for Income Tax Withholding**

The primary legal basis for defining government employees for income tax withholding purposes lies in IRC §3401(c), which states, “the term employee includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof.” Therefore, an officer, employee, or elected official of a state or local government is an employee for income tax withholding purposes. As explained above, for purposes of social security and Medicare (FICA) taxes, employee status is determined under the common-law control test, unless a Section 218 Agreement is in place and specifically covers the position. The regulations under IRC 3401(c) contain nearly identical language to the regulations under IRC 3121(d)(2), reciting the same “right to control” text that appears in 31.3121(d)-1(c). See Regulations 31.3401(c)-1.

### **Classification Issues Involving Government Employee**

The following discussion addresses some special worker classification situations involving governmental employees.

## Public Officials

The term “public official” refers to someone who has authority to exercise the power of the government and does so as an agent and employee of the government. The Internal Revenue Code does not define the term “public official,” but Regulation §1.1402(c)-2(b), explaining the applicability of self-employment tax, indicates that holders of “public office” are not in a trade or business and therefore not subject to self-employment tax. This Regulation states that the performance of the functions of a public office does not constitute a trade or business. An exception applies for certain public officials paid solely on a fee basis ([see Chapter 5](#)). Otherwise holders of public office are excepted from self-employment tax and are presumed to be employees receiving wages. The regulations give the following specific examples of positions that constitute “public office”:

- Mayor
- Member of a legislature or elected representative (e.g., elective office)
- County commissioner
- State or local judge, or justice of the peace
- County or city attorney, marshal, sheriff, constable
- Registrar of deeds
- Tax collector or tax assessor
- Road commissioners
- Members of boards and commissions, such as school boards, utility districts, zoning boards, and boards of health

In *Metcalf & Eddy v. Mitchell*, 269 U.S. 514 (1926), the U.S. Supreme Court addressed the definition of a public official, liable for Federal income tax. (Until 1939, compensation to state and local government officials was not subject to Federal income tax). The Court held that a public official performs a governmental duty exercised pursuant to a public law. A public office is a position created by law, holding a delegation of a portion of the sovereign powers of government to be exercised for the benefit of the public. Officials will generally have the characteristics of common-law employees. The *Metcalf* case concluded that a worker who is compensated for services performed for a government may be an independent contractor and is not necessarily a public official or an employee.

Questions may therefore arise as to whether workers performing services for a government are contractors, or act as agents and employees of the government and hold public office.

If there is some question as to whether a worker is a public official and employee, a critical factor to consider is whether there is a provision of the state constitution or a statute establishing the position. State statutes should be reviewed to determine whether they establish enough control for the individual to be classified as an employee under the common-law test. A statute may state that a specific position is that of a public official, in which case there is likely to be a right to control sufficient to make the individual an employee. Statutes may specify the duties of a public office and generally establish the officer's superiors and subordinates, if any. Statutes establish an official's term of office and sometimes the compensation. They may require that a public official take an oath of

office. Statutes often establish general and specific penalties for dereliction of duty. For instance, members of boards who are paid for each meeting they attend may face termination if they fail to attend a certain number of meetings.

**Example.** State A establishes the position of city attorney by statute and defines it as that of an officer and employee. This statute defines the duties of the position. The city attorney is required to direct all litigation in which the city is a party, including prosecution of criminal cases; to represent the city in all legal matters in which the city or a city officer is a party; to attend meetings of the commissioners, advise commissioners, mayors, etc., on all legal questions, and approve all contracts and legal documents. A city manager appoints, supervises and controls the work of the city attorney. The city attorney must take an oath of office. These facts show the importance of state statutes in establishing a right of direction and control over a public official and thus classifying the individual as a common-law employee.

### **Elected Officials**

Under section 3401, elected officials are employees for income tax withholding purposes. For social security and Medicare purposes, elected officials (also referred to as “individuals in elective positions”), are subject to a degree of control that typically makes them employees under the common law. Elected officials are responsible to the public, which has the power to vote them out of office. Elected officials may also be subject to recall by the public or a superior official. Very few appointed officials have sufficient independence to be considered independent contractors. In any event, under section 3401, elected officials are employees for income tax withholding purposes.

### **Difficulty of Care Payments and Chore Workers**

Workers who perform in-home domestic services for recipients of public assistance are sometimes referred to as chore workers. Under common-law rules, these workers are typically employees of the individuals for whom they provide services because they work in the service recipients’ homes under their direction. In some cases, state health and welfare agencies assume responsibility for reporting and paying social security and Medicare, FUTA and income tax withholding with respect to these workers. The agencies report these taxes on Forms 941 as agents for the service recipients. See Notice 95-18, 1995-1 C.B. 300 and Revenue Procedure 80-4, 1980-1 C.B. 581. Agencies must have an employer identification number separate from the one used to report taxes of its own employees for this purpose. The state agent may engage a reporting agent or subagent to perform the reporting and payment of employment taxes that the state agent would otherwise perform on behalf of the service recipient. See [Notice 2003-70](#) for updated proposed procedures.

## **Volunteer Firefighters**

Compensation paid in an employer-employee relationship is taxable wages (unless an exclusion applies), regardless of whether the workers are termed “volunteers.” In some cases, rather than receive salaries, firefighters may receive amounts intended to reimburse them for expenses. They may also receive other cash or in-kind benefits that may be wages. Unless these reimbursements are paid under an *accountable plan*, discussed in [Chapter 3](#).

The requirements apply slightly differently with mileage or per diem allowances where an amount is deemed to be substantiated. (See [Publication 15](#).) Amounts that are termed *reimbursements* but that are not paid under an accountable plan are subject to income and social security and Medicare taxes. Therefore, a *per diem* or fixed amount paid to a firefighter (or other worker), that does not reimburse actual, documented expenses, is includible in income and subject to income tax withholding, social security and Medicare.

The services of volunteers are generally not eligible for the exclusion from FICA for emergency workers, discussed in [Chapter 5](#). IRC §3121(b)(7)(F)(iii) provides that services performed by employees on a temporary basis in the case of fires, storm, snow, earthquake, flood or other similar emergency are exempt from employment. Firefighters who are on call and work regularly but intermittently do not qualify for the emergency worker exclusion. This exception applies only for temporary workers who respond to unforeseen emergencies.

## **Medical Residents**

Medical residents are generally common-law employees of the hospitals for which they work, and therefore are subject to social security and Medicare taxes (unless they are excepted by a Section 218 Agreement). However, IRC 3121(b)(10) provides an exception for students employed by a school, college, or university (SCU) who are enrolled and regularly attending classes at the SCU.

Revenue Procedure 2005-11 established that, in order for medical residents to meet this exception, several conditions must be met. The worker must be an employee of the SCU, with educational activities as the primary function of the institution. The work must be less than full-time; and education, not employment, must be the predominant aspect of the employee’s relationship with the employer.

For more information, see Regulation 31.3121(b)(10)-2 and [Revenue Procedure 2005-11](#).

## **Identity of the Employer for Tax Purposes**

In certain cases it is clear that the work in question is performed by employees, but it may not be clear which of two or more entities, organizations, or individuals is the employer.

This situation may arise when workers are supplied or paid by one entity but work under the direction of another (such as leased workers).

The term employer is defined, for income tax withholding and reporting purposes, as the person for whom an individual performs any service, of whatever nature, as an employee (IRC §3401(d)). An exception applies if the person for whom the individual performs the services does not have control of the payment of the wages. In this situation, the term employer means the person having legal control of the payment of the wages. See IRC §3401(d)(1) and Regulation 31.3401(d)-1(f).

When a question is raised about the identity of the employer, all facts relating to the employment must be considered. If there is any provision in a statute or ordinance that authorizes the employment of the individual, and the individual is hired under this authority, the individual is generally an employee of that governmental entity. Any statutory provisions relating to the relationship should be reviewed. If there is no applicable statutory authority, the identity of the employer must be determined under the common-law control test.

## **Employee Status for Other Purposes**

A state or Federal agency may make determinations of employee status for workers' compensation, minimum wage, or other purposes. The state or Federal agency may apply different standards from those used to determine worker classification for Federal employment tax purposes. Characterizations of individuals as employees based on state or non-tax laws should be weighed with caution, and in some cases disregarded, because the laws or regulations involved may use different definitions of an employee for their purposes.

## **Independent Contractor Reporting Responsibilities**

Independent contractors are subject to social security and Medicare taxes under the Self-Employment Contributions Act (SECA). Generally, payments to independent contractors of \$600 or more during a calendar year must be reported on Form 1099-MISC, Miscellaneous Income. Independent contractors are required to provide a taxpayer identification number (TIN) to the entity that pays them. Form W-9, Request for Taxpayer Identification Number, contains the required certification and can be used for this purpose.

For more information about requirements for information reporting to independent contractors, see the [Instructions for Form 1099-MISC](#).

Workers who have been determined to be employees will need to file amended returns if they filed Schedule C and paid self-employment tax (SECA). A worker who is determined to be an employee but was treated as an independent contractor by the entity uses Form 8919, Uncollected Social Security and Medicare Tax on Wages, to figure and report the

employee share of the FICA tax. Entities that misclassify employees as independent contractors may be held liable for back taxes, penalties and interest.

### **Worker Providing Services as an Employee and as an Independent Contractor**

When individuals provide services as employees, they may not be employees with respect to all services they provide. For example, a teacher may be retained to remove snow from school property. This individual may be an independent contractor in the snow-removal activity. In order to determine whether the snow-removal activity is an independent trade or business, apply the common-law rules. Revenue Ruling 58-505, 1958-2 C.B. 728, explains that, for an individual to work in two capacities (employee and contractor), the services must not be interrelated. In other words, an individual does not work in two capacities when the same type of work, such as legal services, is divided into two components, one in an employee capacity, one in an independent contractor capacity. The services and remuneration for the two activities must be separate. If the services or compensation are interrelated, then the individual is not acting in two separate and distinct capacities.

### **Section 530 Relief**

Section 530 of the Revenue Act of 1978 (Section 530) terminates an entity's Federal employment tax obligation, if certain requirements are met. Section 530 terminates liability for the entity's employment taxes, including social security and Medicare, income tax withholding, and any penalties attributable to the liability. See [Revenue Procedure 85-18](#).

State and local government entities may be entitled to relief under Section 530. If the services provided by the workers at issue are not covered by a Section 218 Agreement, then employment tax relief under Section 530 is available to the entity, provided that the requirements are satisfied. If the services are covered by a Section 218 Agreement, then relief under Section 530 for FICA taxes is not available. However, if the requirements for relief are met, the entity may obtain relief from liability for income tax withholding for prior years. Nevertheless, Section 530 relief from income tax withholding will not apply with respect to wages paid after the date on which the entity is advised that the workers are covered under the Section 218 Agreement. This is because the entity would have begun withholding FICA taxes, which constitutes treatment of the workers as employees. See Revenue Procedure 85-18, section 3.03(C) and 3.04.

Section 530 provides relief for an entity that treated workers as nonemployees if the entity had a reasonable basis for the classification and acted consistently on that basis. To qualify for Section 530 relief, the entity must fulfill two conditions:

- 1) have filed all Federal tax returns (including information returns) on a basis consistent with treatment of the worker as a nonemployee; and
- 2) not have treated the worker, or any other worker in a substantially similar position, as an employee.

Section 530 provides three safe harbors for satisfying the reasonable basis requirement:

- 1) published ruling or judicial precedent;
  - 2) prior IRS examination of the taxpayer; and
  - 3) longstanding recognized practice of a significant segment of the industry.
- Alternatively, an entity may establish some other reasonable basis. For more information, see [Revenue Procedure 85-18](#).

## **Tax Consequences for Workers**

In some cases, a government entity may be entitled to relief under Section 530, but workers may find, through a determination letter or some other means, that they have been misclassified and are employees. Section 530 relief does not extend to workers. It does not convert them from employees to independent contractors. Misclassified employees are liable for the employee share of social security and Medicare rather than for SECA (self-employment) tax. If they have been filing income tax returns as independent contractors, they should file amended returns for years for which the statute of limitations is open. As employees, they are not entitled to deduct employee business expenses on Schedule C. Since their employers are entitled to continue treating them as independent contractors, the workers will not be subject to income tax withholding and will have to make estimated tax payments.

For more information about the requirements for Section 530 relief, see [Publication 1976](#), *Do You Qualify for Relief Under Section 530?*

*Note: Section 530 is not part of the IRC. It was originally intended as an interim relief measure, but was extended indefinitely in 1982.*

## **Frequently Asked Questions**

- 1) **What are the consequences of misclassifying a worker?** Generally, when an employer erroneously classifies an employee as an independent contractor and does not withhold Federal payroll taxes, the employer could be liable for the employer and employee shares of all applicable Federal payroll taxes, as well as various penalties and interest. See [Chapter 4](#). [IRS]



- 2) **What do you do if you cannot determine whether a worker is an employee?** The state or local entity and/or the worker can request a formal determination by submitting to the IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. When Form SS-8 is submitted to the IRS, all the facts are analyzed and the determination of the worker's status is presented to the worker and the service recipient. See [Chapter 4](#). [IRS]
- 3) **Are volunteers considered employees?** The common-law tests apply to determining the status of individuals regardless of whether they are deemed "volunteers." If an individual considered a volunteer meets the common-law tests, any form of compensation or benefit he or she receives is considered wages, unless a specific exception applies.
- 4) **What effect does the presence of a Section 218 Agreement have on worker status?** If an existing Section 218 Agreement classifies a position as that of an employee, covered by the agreement, then that an individual in that position is an employee, subject to FICA and income tax withholding; the common-law tests are not considered. Positions not covered by a Section 218 Agreement and should be evaluated under the common-law tests.

## Chapter 5

# Social Security and Medicare Coverage

State and local government employers are subject to specific laws and regulations that determine whether their employees are covered for social security and Medicare. A public employee may be covered for social security and Medicare, Medicare only, or may be exempt from both. The flowchart “Social Security and Medicare Coverage of State and Local Employees” in [Chapter 1](#) illustrates the process for determining social security and Medicare coverage for an individual. This chapter addresses various categories of employees and rules by which coverage is established, including the process for obtaining coverage under a Section 218 Agreement. As a supplement to the social security coverage information provided in this publication, refer to the [State and Local Government Employers page](#) on the SSA website .

All state and local government employees fall into one of three categories with respect to social security coverage:

- 1) Employees under Section 218 coverage (also called “voluntary coverage”).** The employees are covered for social security by a voluntary Section 218 Agreement between the State Administrator and the SSA. They may or may not participate in a public retirement system. This chapter discusses coverage under Section 218 Agreements.
- 2) Employees under mandatory social security coverage.** The employees are required to be covered for amounts deemed wages, because they are not members of a qualifying public retirement system and are not covered by a Section 218 Agreement. This generally applies to all otherwise uncovered government employment after July 1, 1991.
- 3) Employees with no social security coverage.** The employees are covered by a qualifying public retirement system, and are therefore exempt from mandatory social security. They are not covered by a Section 218 Agreement. (Public retirement systems are discussed in [Chapter 6](#).)

Each of the three categories of employees is discussed below.

## 1) Employees Under Section 218 Coverage

State and local government employees can be covered for social security and Medicare through a Section 218 Agreement (Agreement) between the state and SSA. This agreement may provide any of the following:

- Coverage for groups of employees covered by a retirement system, and groups of employees who are not covered..
- Coverage for services that are excluded from mandatory coverage provisions, but are optional exclusions under Section 218 Agreements, such as student services and services of election workers who earn less than the threshold amount mandated by law for a calendar year.
- Medicare Hospital Insurance (HI)-only coverage for employees hired prior to April 1, 1986, who are members of a public retirement system.

Each state’s original Agreement incorporates the basic provisions, definitions, and conditions for coverage. Additional coverage can be provided by modifications. Each modification, like the original Agreement, is binding upon all parties. The initiative for securing coverage lies with the State Social Security Administrator.

In order to establish an Agreement, there must be authority under Federal and state law (state enabling legislation) to enter into an Agreement and to extend coverage under an Agreement. The types and extent of coverage provided under an Agreement must be consistent with Federal and state laws.

State and local government employees who are covered under an Agreement have the same benefit rights and responsibilities as employees who have mandatory social security coverage. The cost to the employer of providing social security protection for state and local government employees is the same as for employees mandatorily covered under FICA.

Coverage under an Agreement must be provided for employees by groups. An Agreement may be modified to increase, but *not* to decrease, the extent of coverage. (An exception applies to election worker services and solely fee-based positions; see **Section 218 Optional Exclusions** below.)

### **Termination of Agreements**

Before legislation was enacted in 1983, states could terminate coverage for any group of employees covered under the state’s Section 218 Agreement. A state did this by providing a two-year advance notice to the Federal government. Once it was terminated, the coverage for this group of employees could not be reinstated. The 1983 Social Security Amendments rescinded this provision of the Act and prohibited states from terminating coverage on or after April 20, 1983, but permitted states to cover again any group terminated before this date.

### **Coverage Groups**

Coverage under Section 218 Agreements can be extended only to groups of employees, known as coverage groups. Once an employee position is covered under a Section 218 Agreement, any employee filling that position is a member of the coverage group for

social security and Medicare. There are two types of coverage groups: **1) absolute, or non-retirement, coverage groups** (employees not in a retirement system); and **2) retirement system coverage groups**. Each state decides, within Federal and state law, which groups to include under its Agreement and when coverage begins. The state can choose to cover non-retirement system groups, retirement system groups, or both.

### **Absolute Coverage Groups (Non-Retirement System Groups)**

This group includes the services of all employees in positions not covered by a retirement system except those whose services are mandatorily or optionally excluded from social security and Medicare coverage. They may also be referred to as **non-retirement system groups** or **Section 218(b)(5) groups**. A state may extend Section 218 coverage to an absolute retirement system group without considering the desires of the employees. An absolute coverage group may consist of any of the following:

- 1) All employees of a state engaged in performing services in connection with governmental (nonproprietary) functions
- 2) All employees of a state engaged in performing services in connection with a single proprietary function
- 3) All employees of a political subdivision of a state engaged in performing services in connection with governmental (nonproprietary) functions
- 4) All employees of a political subdivision of a state engaged in performing services in connection with a single proprietary function
- 5) Certain civilian employees working with the National Guard of a state
- 6) Individuals employed under an agreement between a state and the United States to perform services as inspectors of agricultural products

### **Retirement System Coverage Group**

A retirement system coverage group consists of employees working in positions covered by a public retirement system (Section 218(d)(4) of the Act). Such a group may be provided social security and Medicare coverage under an Agreement only if approved by a referendum. The Act gives the state the option, for referendum purposes, of breaking down a retirement system into its components. If a retirement system covers positions of employees of one or more political subdivisions of the state, the state has the following choices. It may hold a referendum for:

- 1) All employees in positions under the retirement system
- 2) State employees in positions under the system
- 3) Employees of one or more political subdivisions in positions under the system
- 4) Any combination of the groups in (2) and (3)
- 5) Employees of a hospital that is an integral part of a political subdivision
- 6) Employees of two or more hospitals (each hospital must be an integral part of the same political subdivision; or
- 7) Employees of each institution of higher learning

The referendum for retirement system employees may be conducted on a majority vote basis in all states, and on a divided system basis in certain states.

### **Majority Vote Referendum**

Under this type of referendum, social security and Medicare coverage may be extended to employees in positions covered by a retirement system only if a majority of the eligible employees vote in favor of such coverage. A majority of *all* of the eligible employees under the system (not a majority of the eligible employees voting), must vote in favor of coverage. All states are authorized by Federal law to use the majority vote referendum procedures. Although the referendum itself is a state matter, Federal law requires that the following conditions be met to establish coverage:

- 1) Eligible employees are given not less than 90 days notice of the referendum
- 2) An opportunity to vote is given and limited to eligible employees
- 3) The referendum is held by secret ballot
- 4) The referendum is supervised by the governor (or his/her designee)
- 5) A majority of the retirement system's eligible employees vote for coverage

### **Divided System Retirement Referendum**

The Act authorizes certain states and all interstate instrumentalities to divide a retirement system established by the state, a political subdivision thereof, or an interstate instrumentality into separate coverage groups based on whether the employees in positions under that system want social security coverage. The states having this authority under Section 218(d)(6)(c) of the Act are:

Alaska	Illinois	New Jersey	Tennessee
California	Kentucky	New Mexico	Texas
Connecticut	Louisiana	New York	Vermont
Florida	Massachusetts	North Dakota	Washington
Georgia	Minnesota	Pennsylvania	Wisconsin
Hawaii	Nevada	Rhode Island	

These “divided vote” states may choose between a divided system vote and a majority vote referendums.

States authorized to use the divided vote retirement system referendum to extend coverage may use either of two voting procedures:

- 1) Polling all eligible members and dividing the system into two parts, with each member placed in either the “Yes” or “No” group based on his or her choice (simplified one-step referendum), or

- 2) Subdivide the retirement system into two parts or systems – “Yes” and “No” groups - based on individual members’ choices and then conduct a majority vote referendum among the employees who chose coverage.

The conditions for a divided vote referendum are the same as those given for the majority vote referendum with one exception - the ballots are not secret, because the individuals choosing coverage must be identified.

Employees who become members of the retirement system after the referendum (division) date and before the execution of the modification extending coverage to the retirement system coverage group may be given a coverage choice at the discretion of the state.

The referendum procedures must be conducted under the direction of the State Social Security Administrator.

### **Continuation of Coverage After Termination of Entity**

If an entity with a Section 218 Agreement terminates its existence as a governmental unit, or is merged or consolidated into another entity, the social security coverage treatment of the employees is governed by the following rules.

**Absolute Coverage Group** – Social security and Medicare coverage for non-retirement system groups continues as long as the governmental entity exists. This is true even if the positions are later placed under a retirement system. (This provision includes police and firefighter positions that were first covered as an absolute coverage group.)

**Majority Vote Retirement System Group** – Following a favorable majority vote referendum, services under the retirement system, including positions brought under the retirement system in the future, are compulsorily covered for social security under the State’s Section 218 agreement. Social security and Medicare coverage will continue as long as the governmental entity exist, even though the positions are later removed from under the retirement system, the system is abolished, or the positions are placed under an additional retirement system.

**Divided Vote Retirement System Group** – If the use of procedure (2) above – the original two-step referendum – results in a favorable majority, then the entire “Yes” group and all future members of the retirement system are covered.

As a result of procedure (1) – the simplified one-step referendum – all those retirement system members who voted “Yes” and all future retirement system members are covered for social security. If all current retirement system members vote against social security coverage (the “No” group), then only future retirement system members will be covered for social security and make up the “Yes” group.

Under a divided retirement system, employees carry the “no” or “yes” vote with them if they transfer to another position within the same retirement system coverage group.

Social security coverage is not terminated because the positions are later covered under an additional retirement system. However, if the divided vote retirement system is later abolished or positions are removed from coverage under it, the “Yes” group (those employees who voted “Yes” in the referendum and those subsequently hired retirement system members) continue to be covered for social security. New employees hired into positions after the removal from, or abolishment of, the former retirement system, are covered for social security because they would not be considered new members of that former retirement system.

## **Section 218 Coverage Exclusions**

When a state or local government entity voluntarily enters into the state’s Section 218 Agreement with the Social Security Administration, it is important to determine which employee services will be excluded from social security coverage.

Certain services – known as **mandatory exclusions** – are excluded from voluntary social security coverage by Section 218(c)(6) of the Social Security Act.

Other services, however, are **optional exclusions** under Section 218(c)(3), (5) and (8) and, therefore, may be covered under a voluntary Section 218 Agreement if the entity chooses. Therefore, coverage under a Section 218 Agreement supersedes all other considerations. If optional exclusion services are covered under a Section 218 Agreement, these amounts are subject to social security and Medicare tax.

## **Mandatory Section 218 Exclusions**

Federal law requires the exclusion of the following services from section 218 coverage under the Social Security Act (Section 218(c)(6)):

- **Services performed by individuals hired to be relieved from unemployment.** The exclusion does not include services performed by individuals under work-training or work-study programs that are designed to provide work experience and training to increase the employability of the person, because the primary intent of such programs is not to relieve them from unemployment.
- **Services performed in a hospital, home or other institution by a patient or inmate thereof as an employee of a state or local government.** Generally, services performed by inmates in a state prison or local jail are excluded from coverage, whether or not the services are performed outside the confines of the prison or jail, because the inmates are normally not in an employment relationship with the state or political subdivision. However, services performed by inmates outside the prison or jail for an entity other than the state or local government

operating the prison or jail, such as on a work-release program, may be covered if an employment relationship exists. The employer is determined under the common-law rules, discussed in [Chapter 4](#). *Note: Services performed by patients or inmates as part of the rehabilitative or therapeutic program of the institution are not usually considered performed by employees.*

- **Services performed by an employee hired on a temporary basis in case of fire, storm, snow, earthquake, flood or similar emergency.** This does not include workers considered temporary for other reasons, or those who deal with emergencies on a regular or continuing basis. It includes only those who are hired in response to a specific emergency.
- **Other services that would be excluded if performed for a private employer because the work is not defined as employment under Section 210(a) of the Social Security Act.** This includes services performed by a nonresident alien temporarily residing in the U.S. holding an F-1, J-1, M-1 or Q-1 visa, when the services are performed to carry out the purpose for which the alien was admitted to the U.S. (A state may optionally include certain agricultural services under a Section 218 Agreement.) See the section **Foreign Students, Teachers and Apprentices** later
- **Services performed by transportation system employees who are covered for Social Security under Section 210(k) of the Social Security Act.**

*Caution:* Mandatory exclusions apply to **voluntary** social security coverage situations (via a Section 218 Agreement) and should not be confused with the different set of exclusions that applies to **mandatory** social security coverage situations.

## Section 218 Optional Exclusions

Under a Section 218 Agreement, a state has the option to exclude from social security coverage the services listed below when they are performed by members of any coverage group, including retirement system coverage groups. If the Agreement does not specifically exclude these services, they are covered.

The following are positions and services that may be optionally excluded:

- **All services in any class or classes of elective positions.** These are positions filled by an election; they also may be referred to as “elected officials.” The election may be by a legislative body, a board or committee, or by the qualified electorate of a jurisdiction. The method of selection must constitute an election under state law. The election may be conducted by open voting by the electorate at large or by a chosen body from a list of candidates. Generally, elective positions fall into three classes: executive, legislative, and judicial. (See Note below)



- **All services in any class or classes of part-time positions.** A part-time position is one for which the number of work hours normally required by the position in a week or a pay period is less than the normal time requirements for the majority of the positions in the employing entity. The part-time position exclusion is based on the normal time requirements of the position and not the time spent by an employee in the position. Where the part-time position exclusion is taken, the state should include a definition of part-time in the modification if one has not been previously established.

*Note:* The definition of “part-time” under a Section 218 Agreement provisions may be different from the definition of “part-time” used to determine whether an individual is a qualified participant in a public retirement system (discussed in [Chapter 6](#)).

**Example:** A city provides social security coverage to some of its employees under a Section 218 Agreement, but excludes services performed in part-time positions. The Section 218 Agreement defines part-time positions as positions normally requiring less than 50 hours of service per month. The city must apply the definition in the Section 218 Agreement to determine which employees are excluded from social security coverage under the Agreement. Any employees excluded from coverage under the Agreement may then be subject to mandatory coverage.

- **All services in any class or classes of positions compensated solely by fees received directly from the public, by an individual who is treated by the municipality as self-employed.** See the section **Fee-Based Public Officials**, later.
- **Agricultural labor, but only those services that would be excluded if performed for a private sector employer.** A state which initially excludes agricultural labor may later modify its agreement to cover it. However, if agricultural labor is not excluded initially, it cannot be excluded later. If a state has not taken the agricultural exclusion, then all remuneration for agricultural labor is covered for social security.
- **Services performed by students enrolled and regularly attending classes at the school, college or university for which they are working.**
- **Services performed by election officials or election workers paid less than the calendar year threshold amount mandated by law.** (If the state's Section 218 Agreement does not have an election-worker exclusion or the entity has an Agreement that does not exclude election workers,

social security and Medicare taxes apply from the first dollar paid.) See the section **Election Officials and Election Workers**, later.

*Note: Effective July 2, 1991, elective and part-time positions, although optionally excluded under a Section 218 Agreement, must be covered under a qualifying public retirement system or else they will be covered for social security under the mandatory social security provisions.*

Optional exclusions can be taken by the state in any combination and applied to both the absolute and the retirement system coverage groups. Any services a state excludes can be included later if permitted by Federal and state law and the state's Agreement. Generally, if one of the types of work listed above has been included in a coverage group, it cannot later be removed from coverage, except for services performed by (1) election officials or election workers and (2) solely fee-based positions.

*Note: The 1972 Amendments to the Social Security Act allowed states a limited period to exclude services in part-time positions and services performed by students where this exclusion was not taken initially. An additional window to make this election was provided by Public Law 105-277 enacted October 21, 1998, which allowed states a limited period to exclude the services of students employed by the public school, college or university where they are regularly attending classes. In those states exercising this option, the student exclusion was effective July 1, 2000. Where a state used either or both of these special one-time provisions for excluding services that had been covered previously, it cannot again cover these services under a Section 218 Agreement.*

Optional exclusions apply only to voluntary social security coverage under a Section 218 Agreement; there are no optional exclusions from mandatory coverage.

Mandatory social security coverage ceases for a state or local government employee when he or she becomes a member of a qualifying public retirement system.

## **2) Employees Under Mandatory Social Security Coverage**

Public Law 101-508 mandated full social security coverage beginning July 2, 1991, for state and local government employees who are not members of a qualifying public retirement system and who are not covered under a Section 218 Agreement, unless a specific exclusion applies under the law.

If an employee is mandatorily covered for social security, then becomes a member of a public retirement system and is covered under a Section 218 Agreement, the employee is covered from that point forward for social security under that Agreement.

The determination of whether an employee is covered by mandatory social security is made on an individual basis. For example, a Section 218 Agreement may exclude part-time positions, and a public retirement system may exclude part-time employees for the same entity. If an employee excluded from section 218 coverage because of work

performed in a part-time position, as defined under the agreement, is also excluded from membership in a public retirement system because of part-time status, that employee is subject to mandatory social security.

**Example:** A city has a Section 218 Agreement that excludes part-time positions requiring less than 18 hours of work a week. City cafeteria positions require employees to work only 3 hours per day, or 15 hours per week. The city's public retirement system does not allow membership for employees unless they work 25 hours or more per week. The cafeteria workers are subject to mandatory social security.

### **Exclusions from Mandatory Social Security Coverage**

Employees not covered by a Section 218 Agreement or a public retirement system are generally subject to social security and Medicare on employment, with the following exclusions established by Section 210(a) of the Social Security Act:

- **Services performed by individuals hired to be relieved from unemployment.** The exclusion does not include services performed by individuals under work-training or work-study programs that are designed to provide work experience and training to increase the employability of the person, because the primary intent of such programs is not to relieve the individual from unemployment.
- **Services performed in a hospital, home or other institution by a patient or inmate thereof as an employee of a state or local government.** Generally, services performed by inmates in a state prison or local jail are excluded from coverage. This is true whether or not the services are performed outside the confines of the prison or jail, because the inmates are not normally in an employment relationship with the state or political subdivision. However, services performed by inmates outside the prison or jail for an entity other than the state or local government operating the prison or jail, such as on a work-release program, may be covered if an employment relationship exists. The Social Security Administration determines the employer under the common-law rules, discussed in [Chapter 4](#). *Note: Services performed by patients or inmates as part of the rehabilitative or therapeutic program of the institution are generally not employment.*
- **Services performed by an employee hired on a temporary basis in case of fire, storm, snow, earthquake, flood or similar emergency.** This does not include workers considered temporary for other reasons, or those who deal with emergencies on a regular or continuing basis. It includes only those who are hired in response to a specific emergency with no intention of permanent employment.
- **Services performed by a nonresident alien temporarily residing in the U.S. holding an F-1, J-1, M-1 or Q-1 visa, when the services are performed to**

carry out the purpose for which the individual was admitted to the U.S. See the section **Foreign Students, Teachers and Apprentices** below.

- **Services in positions compensated solely by fees that are subject to self-employment tax (SECA), unless a Section 218 Agreement covers these services.** See the section **Fee-Based Public Officials**, below.
- **Services performed by students enrolled and regularly attending classes at the school, college or university where they are working, unless a Section 218 Agreement covers student services.**
- **Services performed by election officials or election workers paid less than the calendar year threshold amount mandated by law, unless a Section 218 Agreement covers election workers.** See the section **Election Officials and Election Workers**, below.
- **Services that would be excluded if performed for a private employer because the work is defined as employment under Section 210(a) of the Social Security Act, unless a Section 218 Agreement covers certain agricultural services.**

*Note: Coverage under a Section 218 Agreement takes precedence over employment circumstances. When considering whether the mandatory social security coverage and exclusion rules apply to a worker's services, first determine whether the services are covered by a Section 218 Agreement.*

### **Election Officials and Election Workers**

Prior to the 1967 Social Security Amendments, there was no specific provision for the exclusion of election officials or election workers. The Social Security Act was amended for years beginning with 1968 to allow states to modify their Agreements to exclude the services of election officials and election workers whose pay was below a mandated threshold amount.

The Federal Insurance Contributions Act (FICA) tax exclusion for election officials and election workers is \$1,500 for the calendar year beginning January 1, 2012, unless those wages are subject to social security and Medicare under the state's Section 218 Agreement.

If the entity is covered by a Section 218 Agreement, the Agreement determines the treatment of election workers for FICA purposes. The Agreement may specify a lower threshold amount for election officials and election workers (for example, \$50 a calendar quarter or \$100 a calendar year). In these states, the social security and Medicare tax applies when the amount specified in the state's Agreement is met. States may modify the Agreement to exclude the services of election officials and election workers paid less than the threshold amount mandated by law. Such modifications are effective in the

calendar year the modification is mailed or delivered to the Social Security Administration.

If the Section 218 Agreement does not exclude election workers from coverage, or provide a threshold for coverage, social security and Medicare taxes apply from the first dollar paid. If the entity is not covered under a Section 218 Agreement, the rules for mandatory social security and Medicare under Section 210(a)(7)(F) of the Social Security Act apply.

The election official/worker thresholds under mandatory social security for calendar years prior to 2012 are as follows:

2009-2012	\$1,500
2008	\$1,400
2006-2007	\$1,300
2002-2005	\$1,200
2000-2001	\$1,100
1995-1999	\$1,000
1978-1994	\$ 100

For 1968 through 1977, the threshold was \$50 per calendar quarter.

Generally, Form W-2 is required for these workers; however, if the worker received only wages for election work and the total is less than \$600 total for the year, Form W-2 is not required and no withholding of social security or Medicare tax is required. [Revenue Ruling 2000-6](#) provides reporting instructions for election officials and election workers.

Contact the State Social Security Administrator concerning the status of election officials and election workers under the state's Section 218 Agreement. Additional information and threshold amounts can be found at the [SSA website](#).

### **Fee-Based Public Officials**

A fee-based public official receives and retains remuneration directly from the public. An individual who receives payment for services from government funds in the form of a wage or salary is not a fee-based public official, even if the compensation is called a fee. See Revenue Ruling 74-608, 1974-2 C.B. 275, which indicates that fees received by fee-based public officials are subject to SECA (self-employment) tax.

### ***Fee-Basis Exclusion – Positions Compensated Solely by Fees***

Services in positions compensated solely by fees are excluded from coverage under Section 218 Agreements (unless the state specifically included these services) and are covered as self-employment and subject to SECA.

***Fee-Basis Exclusion – Position Compensated by Salary and Fees***

Generally, a position compensated by a salary and fees is considered a fee-basis position if the fees are the principal source of compensation, unless a state law provides that a position for which any salary is paid is not a fee-basis position. A state may exclude services in positions compensated by both salary and fees from social security/Medicare coverage under Section 218 Agreements. If the state makes this exclusion, none of the compensation, including the salary, is covered wages under the state’s Section 218 Agreement. In this case, the salary payment, while excluded under the Agreement, would be subject to mandatory social security if the official is not a qualified participant in a public retirement system.

**Police Officers and Firefighters**

Generally, state statutes and court decisions establish the definition of police officer and firefighter positions. For social security purposes, the terms do not include services in positions that, although connected with police and firefighting functions, do not meet the definitions of police officer and firefighter positions.

*Note: Police officers and firefighters are **not** considered emergency workers for purposes of the mandatory exclusion from social security and Medicare coverage for such workers. This exclusion applies only to services of an employee who was hired because of an unforeseen emergency to do work in connection with that emergency on a temporary basis to provide emergency assistance in fires or other disasters such as severe ice storm, earthquake, volcano eruption or flood.*

Beginning August 16, 1994, all states were allowed to extend social security and Medicare or Medicare-only coverage to police officer and firefighter positions covered under a retirement system through a referendum procedure conducted by the state. (Prior to that date, only 23 states, and all interstate instrumentalities, were specifically authorized to do so.) Those states were:

Alabama	Kansas	North Carolina	Tennessee
California	Maine	North Dakota	Texas
Florida	Maryland	Oregon	Vermont
Georgia	Mississippi	Puerto Rico	Virginia
Hawaii	Montana	South Carolina	Washington
Idaho	New York	South Dakota	

As noted earlier, all states may use the majority vote referendum procedure. Some states are also authorized under the Act to use the divided retirement system referendum, discussed earlier. (Interstate instrumentalities may use the majority or divided retirement system referendum procedures.)

## **Police and Firefighter Positions Not Covered Under a Retirement System**

If police officer and firefighter positions are not covered under a retirement system, these positions are mandatorily covered for social security and Medicare unless the positions were already covered under a Section 218 Agreement as part of a non-retirement system coverage group.

## **Foreign Students, Teachers and Apprentices**

Individuals admitted to the United States under an F-1, J-1, M-1 or Q-1 visa are generally exempt from both social security and Medicare taxes. Wages earned within the United States are subject to income tax, whether or not the workers are U.S. citizens.

Nonresident students who are not U.S. citizens, permanent residents or resident aliens for tax purposes may be able to take advantage of treaty exemptions to exclude a portion of their U.S. source income from withholding. For more information on specific treaty provisions, contact the IRS or SSA. The following IRS Publications have additional information on social security and Medicare coverage for foreign workers:

- [515](#), Withholding of Tax on Nonresident Aliens and Foreign Entities
- [519](#), U.S. Tax Guide for Aliens
- [901](#), U.S. Tax Treaties

## **3) Employees With No Social Security Coverage**

The final category of workers includes those who are not subject to any voluntary or mandatory social security coverage at all. This can only occur where the workers are covered by a qualifying public retirement system. Employers of these workers will not withhold social security taxes or show any “social security wages” on Form W-2. Qualifying public retirement systems are the subject of [Chapter 6](#).

## **Identifying Covered Employment**

In addition to determining whether specific employees are members of a social security coverage group, questions may arise as to whether positions constitute employment subject to the rules. These determinations may be based on decisions regarding specific issues to which either Federal or state law is applicable. It is important to know whether Federal or state law is applied in making a determination on a specific issue. Generally, questions involving interpretation or application of state law are resolved by the authorized legal officers of the state in accordance with applicable state and local laws, regulations and the state court decisions. The jurisdiction for some of the major questions that arise is shown below:

**Federal Law:**

Does an employer-employee relationship exist? ([See Chapter 4](#))

Who is the employer?

Are the earnings wages?

What are emergency services?

What are student services?

**State Law:**

Who is an officer of a state or political subdivision?

Is an entity a political subdivision?

Is a function governmental or proprietary?

Is a position under a retirement system?

Which employees are eligible for membership in a retirement system?

Who is an employee for purposes of retirement system participation?

Although Federal law determines whether earnings are wages subject to social security and Medicare, state laws have a bearing on the issue of employment, such as whether a position is that of a public official of a state. Where this is the case, an opinion of the state legal officer may be requested. The state's opinion will be given weight in making the decision, but it will not be determinative of the issue. Before contacting IRS or SSA, contact the State Social Security Administrator for guidance.

**Identity of the Employer for Social Security Coverage Purposes**

Because entities have different social security and retirement plan situations, it is important to determine which of two or more entities, organizations, or individuals is a worker's employer. In some cases, certain individuals, referred to as "leased workers," are supplied or paid by one entity but work under the direction of another. Generally, if there is a provision in a statute or ordinance that creates a position and the individual is hired or elected under this authority, the individual is an employee of the state or political subdivision to which the provision applies. If there is no such authority, the employer is the entity that has the right to control the worker in the performance of the work, i.e., the common-law employer.

The employing entity is responsible for withholding and paying social security and Medicare taxes on its employees' wages, as well as reporting to SSA the amount of wages paid. These withholding, paying and reporting requirements apply to wages of individuals subject to mandatory social security and Medicare, as well as to wages of individuals covered under a Section 218 Agreement. (Refer to [Publication 15](#) for more information.)



## **Indian Tribal Governments and Section 218**

Indian Tribal Governments, while treated as states for many purposes, are not treated as states for social security and Medicare tax purposes (IRC section 7871). Thus, Indian tribal governments do not enter into Section 218 Agreements with SSA and may not participate in a public retirement system as an alternative to paying social security and Medicare tax under the provisions of IRC section 3121(b)(7)(F).

## **Mandatory Medicare Coverage**

Prior to April 1, 1986, the only way for state and local government employees to be covered for Medicare was by voluntary Section 218 Agreements between the states and the Federal government. This changed with the enactment of the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985, which mandated that almost all state and local employees hired or rehired after March 31, 1986, must be covered for Medicare, and pay Medicare taxes regardless of their membership in a retirement system. Employees covered by social security under a Section 218 Agreement are automatically covered for Medicare. Public employees already covered under a Section 218 Agreement are covered under Medicare and subject to the tax. Employees who are not covered by social security but are subject to the Medicare-only portion of FICA are referred to as Medicare Qualified Government Employees (MQGE). Reporting for these employees is discussed in [Chapter 3](#).

Employees who have been in continuous employment with the employer since March 31, 1986, who are not covered under a Section 218 Agreement nor subject to the mandatory social security and Medicare provisions, remain exempt from both social security and Medicare taxes, provided they are members of a public retirement system. (See **Continuing Employment Exception**, below.)

The flowchart “Social Security and Medicare Coverage for State and Local Government Employees” in [Chapter 1](#) shows how to determine whether Medicare coverage applies.

## **Continuing Employment Exception**

Services performed after March 31, 1986, by an employee who was hired by a state or political subdivision employer before April 1, 1986, are exempt from mandatory Medicare tax if the employee is a member of a public retirement system and meets *all* of the following requirements:

- The employee was performing regular and substantial services for remuneration for the state or political subdivision employer before April 1, 1986,
- The employee was a bona fide employee of that employer on March 31, 1986,
- The employment relationship with that employer was not entered into for purposes of avoiding the Medicare tax, and

- The employment relationship with that employer has been continuous since March 31, 1986. In general, the following employment changes are considered continuous employment and would qualify for the exception:
  - 1) From a state agency to another state agency in the same state.
  - 2) From an employer of one political subdivision to an employer in the same political subdivision.

The following are **not** considered continuous employment for this purpose:

- 1) From a state agency to a political subdivision of that state.
- 2) From a political subdivision to a state agency.
- 3) From one political subdivision to another.
- 4) From a state agency to an agency of another state.

See [Revenue Ruling 86-88](#) and [Revenue Ruling 88-36](#) in the Appendix for more information about the continuing employment exception.

The Centers for Medicare & Medicaid Services (CMS) is the Federal agency that administers the Medicare program. For more information about the administration of the Medicare program, see the CMS [website](#).

### **Services Not Subject to Mandatory Medicare Coverage**

The following are not subject to mandatory Medicare tax even though the services are performed by an employee hired after March 31, 1986. (*Note: These are the same services that are excluded from mandatory social security coverage, discussed earlier.*)  
:

- Services performed by individuals hired to be relieved from unemployment. (This does not include many programs financed from Federal funds where the primary purpose is to give the employee work experience or training.)
- Services performed in a hospital, home or other institution by a patient or inmate thereof as an employee of a state or local government employer.
- Services performed by an employee on a temporary basis in case of fire, storm, snow, earthquake, flood or other similar emergency.
- Services performed by non-resident aliens with F-1, J-1, M-1 and Q-1 visas.
- Services in positions compensated solely by fees that are subject to SECA, the Self-Employment Contributions Act (unless Section 218 Agreement covers these services).
- Services performed by a student enrolled and regularly attending classes at the school, college or university where they are working (unless Section 218 Agreement covers student services).
- Services performed by an election worker or official whose pay in a calendar year is less than the amount mandated by law (unless Section 218 agreement covers election workers).

- Services that would be excluded if performed for a private employer because it is not work defined as employment under Section 210(a) of the Social Security Act (unless Section 218 Agreement covers certain agricultural services).

See the sections on **Mandatory Exclusions** and **Optional Exclusions** in this chapter for more details on these exclusions.

## Voluntary Medicare Coverage

A Section 218 Agreement can be executed to provide Medicare-only coverage for employees who are qualified participants in a public retirement system and not covered under a Section 218 Agreement and not subject to the mandatory Medicare provisions. Contact your State Social Security Administrator for further information. (See a list of state administrators at [ncsssa.org](http://ncsssa.org).)

## Frequently Asked Questions

- 1) **Are any services excluded from mandatory social security and Medicare coverage?** Yes. However, some services excluded under provisions of the Internal Revenue Code may be covered by a Section 218 Agreement. See [Chapter 5](#), [IRS, SSA]
- 2) **If a local government has a qualifying public retirement system and does not have a Section 218 Agreement, can employees elect to participate in social security on a voluntary basis?** No. An employee can only participate in social security if the position is covered either by the mandatory provisions or by a Section 218 Agreement. [SSA]
- 3) **Does a college student employed by a university during the summer months qualify for the student social security and Medicare exception from mandatory social security if he/she is not regularly enrolled and attending classes at the university during that time?** If an individual is not enrolled in classes during school breaks of more than five weeks, including summer breaks, the student social security and Medicare exception does not apply (other than during payroll periods of a month or less that fall wholly or partially within the academic term). See [Revenue Procedure 98-16](#), Sections 6.04 and 6.05, and the article, “Medical Residents and FICA”, in the July 2010 [FSLG Newsletter](#) for further details. [IRS]
- 4) **Are elected and appointed officials considered employees?** For income tax purposes, elected (or elective) and most appointed officials are defined by statute as employees of the public entity they serve, e.g., mayors, members of the legislature, county commissioners, city council members and board or commission members. In general, elected and appointed officials meet the

common-law tests to be considered employees. Some positions may be defined as employment by state statute. Some fee-basis officials are by law treated as self-employed. An elected or appointed official who is an employee is subject to rules for mandatory social security and Medicare unless covered under a Section 218 Agreement or a qualified participant in a retirement system. All officials elected or appointed to their positions after March 31, 1986, are subject to Medicare withholding. See [Chapter 4](#). [IRS]

- 5) **How is “termination of employment” defined for purposes of determining whether the continuing employment exception for Medicare tax is applicable?** Whether an employment relationship has terminated is a question of fact that must be determined on the basis of all the relevant facts and circumstances. Great weight, however, will be given to the personnel rules of the state employer or political subdivision employer to determine whether an employment relationship has been terminated. (Revenue Ruling 86-88.) [IRS]
- 6) **An employee who was hired before April 1, 1986, by the state transferred after March 31, 1986, to another state agency. The transfer was made without terminating the employee’s employment with the state. Does the employee qualify for the continuing employment exception?** Yes. An employee hired before April 1, 1986, by a state employer and who transfers after March 31, 1986, to another state employer of the same state may qualify for the continuing employment exception, provided the transfer was made without a termination of the employee’s overall employment relationship with that state. The same rule applies to an employee hired before April 1, 1986, by a political subdivision employer, who transfers after March 31, 1986, to another employer of that same political subdivision. However, 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 state employer to a political subdivision employer or from a political subdivision employer to a state employer. Likewise, an employee does not qualify for the exception if the employee transfers from a political subdivision employer in one political subdivision to a political subdivision employer in a different political subdivision, or from a state employer in one state to a state employer in a different state. [IRS]
- 7) **Can employees who were hired prior to April 1, 1986, and who are not currently paying into Medicare, enroll in Medicare in the future?** Individual employees can never elect voluntarily to participate in social security or Medicare. State or local public employers can voluntarily choose to cover one or more groups of employees under Medicare-only, even if they are otherwise exempt because of the continuing employment exception. The state or local government (through the state) must enter into a modification of the state’s Section 218 Agreement to elect such coverage. Contact your State Social Security Administrator for further information about a Medicare-only modification. If an individual’s state or local government employment is not covered under social security or Medicare, the individual may not be insured (i.e., have enough work

credits) for Medicare based on his/her own wages. That individual may be entitled to coverage based on sufficient other work that is covered for social security, or Medicare on his/her own earnings record or that of an insured spouse. [SSA]

## Chapter 6

# Social Security and Public Retirement Systems

With the passage of the 1950 Social Security Amendments, states began to enter into voluntary Section 218 coverage agreements with the Social Security Administration. In 1985, Congress legislated mandatory Medicare for state and local government employees hired or rehired after March 31, 1986.

Effective July 2, 1991, Congress made social security coverage mandatory for state and local government employees who are neither covered by a Section 218 Agreement nor qualified participants in a public retirement system (also referred to as a “FICA replacement plan”). States can provide employees with membership in a public retirement system as an alternative to mandatory social security coverage.

This chapter provides information about the requirements a retirement system must meet to qualify as an alternative to social security.

## Public Retirement Systems

The terms “public retirement system,” and “qualified participant” are defined in IRC section 3121(b)(7)(F) and Regulation 31.3121(b)(7)-2. The term “employer” is used to refer to a state, political subdivision, or instrumentality. The term “employee” is used here only to refer to an employee of a state, political subdivision, or instrumentality.

A public retirement system is a pension, annuity, retirement or similar fund or system maintained by a state or local government that provides a retirement benefit to the employee that is comparable to the benefit provided under the Old-Age portion of the Old-Age, Survivors and Disability Insurance (social security) part of FICA. To be a retirement system for this purpose, the plan must provide a minimum retirement benefit.

*Note: A “public retirement system” is not required to be a qualified plan within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA). To avoid confusion, this publication does not use the term “qualified” to refer to public retirement systems. For mandatory coverage purposes, the employee may be a member of any type of retirement system, including a nonqualified system (for example, a section 457 plan), as long as the plan provides the minimum level of benefits required for a public retirement system. These requirements are discussed below and in Regulation 31.3121(b)(7)-2(e) and in Revenue Procedure 91-40.*

Social security is NOT a public retirement system for this purpose.

**Example:** An individual holds two positions with the same political subdivision. The wages earned in one position are subject to social security and Medicare tax pursuant to a Section 218 Agreement; the other position is not covered. The social security system is not a retirement system for this purpose. Thus, mandatory social security coverage applies to service in the other (non-218) position unless the employee is a member of a public retirement system with respect to that position. See Regulation 31.3121(b)(7)-2(e)(1).

In general, there are two types of public retirement systems that may meet the minimum benefit requirement — the **defined contribution** plan and the **defined benefit** plan

## **Defined Contribution Plan**

A defined contribution plan provides an individual account for each participant and provides benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains or losses, etc. that may be allocated to that participant's account. See IRC section 414(i).

A defined contribution plan that satisfies the definition of a retirement system must provide for an allocation to the employee's account of at least 7.5 percent of the employee's compensation during any period under consideration. A variety of plan types could meet the requirement; for example, plans established under IRC sections 401(a), 403(b) or 457. Contributions from both the employer and the employee may be used to make up the 7.5 percent. Matching contributions by the employer may be taken into account for this purpose. A plan with only employee contributions would also satisfy the minimum benefit requirement, provided the contributions constitute at least 7.5 percent of compensation. However, the 7.5 percent cannot include any earnings on the account.

To qualify as a retirement system, a defined contribution plan must use a definition of compensation which is at least equal to base pay, credit employee accounts with a reasonable interest rate, or the accounts must be held in a separate trust subject to fiduciary standards and credited with actual earnings.

### **Definition of Compensation**

For a defined contribution plan, the definition of "compensation" used to determine whether the benefit is sufficient must include at least the employee's base pay, provided that the definition of "base pay" is reasonable. Thus, for example, a defined contribution retirement system may disregard any of the following: overtime pay, bonuses, or single-sum amounts received on account of death or separation from service, amounts received under a bona fide vacation, compensatory time or sick pay plan, or amounts received under severance pay plans. Any compensation in excess of the social security contribution wage base for that year (\$110,100 in 2012) may also be disregarded for this purpose.

**Example:** A political subdivision maintains an elective defined contribution plan that is a retirement system within the meaning of IRS regulations. The plan is on a calendar year. In 2011, an employee contributes to the plan at a rate of 7.5 percent of base pay. Assume that the employee compensation will reach the social security maximum contribution base in October. The employee is a qualified participant in the plan for the entire plan year, even if the employee ceases to contribute to the plan after reaching the maximum contribution base. See Regulation 31.3121(b)(7)-2(e)(2)(iii)(B).

Generally, for an employee who holds more than one position with the same employer, all compensation with that employer is considered in applying the 7.5 percent test. However, at the employer's option, compensation from only one position may be considered, if that position is not part-time, temporary, or seasonal.

### **Reasonable Interest Rate Requirement**

Generally, a defined contribution retirement system must credit the employee's account with earnings at a reasonable rate, under all the facts and circumstances. Alternatively, employees' accounts may be held in a separate trust subject to general fiduciary standards and credited with actual earnings of the trust fund. Whether the interest rate is reasonable is determined after reducing the rate to adjust for the payment of any administrative expenses.

### **Defined Benefit Plan**

A defined benefit plan is any plan other than a defined contribution plan. A defined benefit plan determines benefits on the basis of a formula, generally based on age, years of service and salary level.

A defined benefit retirement system that qualifies as an alternative to social security provides for a retirement benefit to the employee that is comparable to the benefit provided by the social security part of FICA. Generally, a plan meets the requirement if the benefit under the system is at least 1.5 percent of average compensation during an employee's last three years of employment, multiplied by the employee's number of years of service. Apply the formulas in [Revenue Procedure 91-40](#) and the IRS regulations to determine whether a defined benefit retirement system meets this requirement.

### **Who Is a Qualified Participant?**

For an employee to be excluded from mandatory social security coverage, the employing entity must maintain a retirement system within the meaning of IRC section 3121(b)(7)(F). The employee must also be a qualified participant in that system. An entity may maintain a retirement system in which not every employee is a qualified



participant. The definition of a qualified participant for defined contribution and defined benefit systems is similar. Whether an employee is a qualified participant is determined as services are performed.

### **Participant in a Defined Contribution Retirement System**

An employee is a qualified participant in a *defined contribution retirement system* with respect to services performed on a given day if, on that day, the employee has satisfied all conditions (other than vesting) for receiving an allocation to his or her account (exclusive of earnings) that meets the minimum retirement benefit requirement. The benefit must be calculated with respect to compensation during a period ending on that day and beginning on or after the beginning of the plan year of the retirement system. This is the case regardless of whether the allocations were made or accrued before the effective date of IRC section 3121(b)(7)(F).

**Example 1:** A state-owned hospital maintains a non-elective defined contribution plan that is a retirement system within the meaning of IRS regulations. Under the terms of the plan, employees must be employed on the last day of a plan year in order to receive any allocation for the year. Employees may not be treated as qualified participants in the plan before the last day of the year.

**Example 2:** The situation is the same as in Example 1, except that under the terms of the plan, an employee who terminates service before the end of a plan year receives a pro rata portion of the allocation he or she would have received at the end of the year, e.g., based on compensation earned since the beginning of the year. If the pro rata allocation available on a given day would meet the minimum retirement benefit requirement with respect to compensation from the beginning of the plan year through that day (or some later day), the employee is treated as a qualified participant in the plan on that day.

**Example 3:** A political subdivision maintains an elective defined contribution plan that is a retirement system within the meaning of IRS regulations. The plan operates on a calendar year. It has two open seasons—in December and June—when employees can change their contribution elections. In December, an employee elects not to contribute to the plan. In June, the employee elects (beginning July 1) to contribute a uniform percentage of compensation for each pay period to the plan for the remainder of the plan year. The employee is not a qualified participant in the plan during the period January-June, because no allocations are made to the employee's account during that time. If the level of contributions during the period of July-December meets the minimum retirement benefit requirement with respect to compensation during that period, however, the employee is treated as a qualified participant during that period.

**Example 4:** Assume the same facts as in Example 3, except that the plan allows participants to cancel their elections in cases of economic hardship. In October, the employee suffers an economic hardship and cancels the election, effective November 1. If the contributions during the period July-October are high enough to meet the minimum retirement benefit requirement with respect to compensation during that period, the employee is treated as a qualified participant during that period. In addition, if the contributions during the period July-October are high enough to meet the requirements for the entire period July-December, the employee is treated as a qualified participant in the plan throughout the period July-December, even though no allocations are made to the employee's account in the last two months of the year. There is no requirement that the period used to determine whether an employee is a qualified participant on a given day remain the same from day to day, as long as the period begins on or after the beginning of the plan year and ends on the date the determination is being made. See Regulation 31.3121(b)(7)-2(d)(1)(ii).

### **Participant in a Defined Benefit Retirement System**

An employee is a qualified participant in a *defined benefit retirement system* with respect to services performed on a given day if, (1) on that day, the employee is (or ever has been) an actual participant in the retirement system and, (2) on that day, the employee actually has a total accrued benefit that meets the minimum retirement benefit requirement. An employee may not be treated as an actual participant or as actually having an accrued benefit for this purpose to the extent that such participation or benefit is subject to any conditions (other than vesting) that have not been satisfied. The conditions might include a requirement that the employee attain a minimum age, perform a minimum period of service, make an election in order to participate, or be present at the end of the plan year in order to be credited with an accrual.

**Example:** A political subdivision maintains a defined benefit plan that is a retirement system within the meaning of IRS regulations. Under the terms of the plan, service during a plan year is not credited for accrual purposes unless a participant has at least 1,000 hours of service during the year. For purposes of determining whether mandatory social security coverage applies, benefits that accrue only upon satisfaction of this 1,000-hour requirement may not be taken into account in determining whether an employee is a qualified participant in the plan before the 1,000-hour requirement is satisfied. See Regulation 31.3121(b)(7)-2(d)(1)(i).

## **Part-Time, Seasonal, Temporary Employees**

Special rules apply to part-time, seasonal and temporary employees for purposes of determining whether they are qualified participants in a public retirement system. To be exempt from mandatory social security coverage, these employees must not only be qualified participants; *they must be fully vested in their benefits*. This means the benefits cannot be forfeited. If a part-time, seasonal or temporary employee (as defined below) is not a qualified participant in a public retirement system with benefits fully vested from the first day of employment, that employee is subject to mandatory social security and Medicare tax until the employee becomes fully vested.

The special vesting requirement is considered to be met if a part-time, seasonal or temporary employee in a defined benefit plan has the right to receive a single sum payment of at least 7.5 percent of the compensation the employee earned while covered under the retirement system (plus interest) when the employee separates from employment.

### **Part-Time Employees**

For purposes of applying the qualified participant test, part-time employees are those who normally work 20 hours or less per week. This definition of “part-time” should not be confused with a definition of “part-time” that may be provided in a section 218 Agreement. If mandatory coverage applies, part-time positions cannot be excluded; but part-time positions may be excluded from coverage under a Section 218 Agreement, at the option of the state. Contact the State Social Security Administrator to determine the definition of part-time positions under the state’s Section 218 Agreement.

A special rule states that a teacher employed by a post-secondary educational institution (e.g., a community or junior college, post-secondary vocational school, college, university or graduate school) is not considered part-time if the teacher normally teaches classroom hours of one-half or more of the number of classroom hours normally considered to be full-time employment.

**Example:** A community college treats a teacher as a full-time employee if the teacher is assigned to work 15 classroom hours per week. A new teacher is assigned to work eight classroom hours per week. Because the assigned classroom hours of the teacher are at least one-half of the school’s definition of full-time teacher, the teacher is not a part-time employee. See Regulation 1.3121(b)(7)-2(d)(2)(iii).

### **Seasonal Employees**

For purposes of applying the qualified participant test, a seasonal employee is any employee who normally works on a full-time basis less than five months in a year. Thus, for example, individuals who are hired by a political subdivision during the tax return

season in order to process incoming returns and work full-time over a three-month period are seasonal employees. See Regulation 31.3121(b)(7)-2(d)(2)(iii)(B).

### **Temporary Employees**

For purposes of applying the qualified participant test, a temporary employee is one who performs services under a contractual arrangement that is expected to last two years or less. Under this rule, a teacher under an annual contract may or may not be a temporary employee. Possible contract extensions must be considered in determining the duration of a contractual arrangement if there is a significant likelihood that the employee's contract will be extended. Contract extensions are considered likely to occur if, on average, 80 percent of similarly situated employees have had bona fide offers to renew their contracts in the immediately preceding two academic or calendar years. Contract extensions are also considered significantly likely to occur if the employee has a history of contract extensions in the current position. See Regulation 31.3121(b)(7)-2(d)(2)(iii)(C).

### **Individuals Employed in More Than One Position**

If an employee is not covered by a Section 218 Agreement, but is a member of a retirement system with respect to one full-time position, the employee is generally treated as a member of a retirement system with respect to any other position with the same employer.

**Example:** An individual is employed full-time by a county and is a qualified participant in its retirement plan with regard to that employment. In addition to this full-time employment, the individual is employed part-time in another position with the same county. The part-time position is not covered by the county retirement plan. Nevertheless, if the individual is a qualified participant in the retirement plan with respect to the full-time position, the part-time position is excluded from mandatory coverage. See Regulation 31.3121(b)(7)-2(c)(2).

This rule does not apply to employment by two different employers. If an individual is employed full-time by a state and is a member of its retirement plan, and is also employed part-time by a city located in the state, but does not participate in the city's retirement plan. The services of the individual for the city are not excluded from mandatory social security coverage, because the determination of whether services constitute employment for such purposes is made separately with respect to each political subdivision for which services are performed. Section 31.3121(b)(7)-2(c)(2).

Whether an employee is a part-time, seasonal or temporary employee is generally determined on the basis of service in each position. This determination generally does not take into account service in other positions with the same or different public employers. However, all of an employee's service in other positions with the same or different employers may be taken into account for purposes of determining whether an employee

is a part-time, seasonal or temporary employee with respect to benefits under the retirement system provided that:

- The employee's service in the other positions is or was covered by the same retirement system;
- All service aggregated for purposes of determining whether an employee is a part-time, seasonal or temporary employee (and related compensation) is aggregated under the system for all purposes in determining benefits (including vesting); and
- The employee is treated at least as favorably as a full-time employee under the retirement system for benefit accrual purposes.

**Example:** Assume that an employee works 15 hours per week for a county and 10 hours per week for a municipality and that both of these employers contribute to the same statewide public employee retirement system. Assume further that the employee's service in both positions is aggregated under the system for all purposes in determining benefits (including vesting). If the employee is covered under the retirement system with respect to both positions and is treated for benefit accrual purposes at least as favorably as full-time employees, then the employee is not considered a part-time employee of either employer. Therefore his benefits are not required to be immediately vested. See Regulation 31.3121(b)(7)-2(d)(2)(iii)(D).

### **Alternative Lookback Rule**

Under an alternative lookback rule, an employee may be treated as a qualified participant in a retirement system throughout a calendar year if he or she was a qualified participant in the system at the end of the plan year of the system ending in the preceding calendar year.

**Example.** An employee is a qualified participant in a retirement plan of a city on the last day of the plan year, May 31, 2011. If the alternative lookback rule is used, no liability for social security tax exists for the employee for calendar year 2012. See Regulation 31.3121(b)(7)-2(d)(3)

For the first year of participation, an employee who participates in the retirement system may be treated as a qualified participant during the year only if it is reasonable to believe that the employee will be a qualified participant on the last day of the plan year.

### **Former Participants**

In general, the rules regarding qualified participants apply to **former participants** who continue to perform services for the employer or who return after a break in service. Thus, for example, a former employee, with a deferred benefit under a defined benefit retirement system, who is reemployed by the same employer but does not resume participation in the retirement system, may continue to be a qualified participant in the

system after becoming reemployed if the individual's total accrued benefit under the system meets the minimum retirement benefit requirement (taking into account all periods of service, including current service). If this is so, the employer is not required to withhold and pay social security tax, or make additional payments to the retirement system on his behalf. The individual's status as a qualified participant must be continually reevaluated, however, for employment of more than a short period. See Regulation 31.3121(b)(7)-2(d)(4)(i).

### **Rehired Annuitants**

A rehired annuitant is a retiree who is rehired by his or her employer or another employer that participates in the same retirement system as the former employer. A rehired annuitant is either drawing a retirement benefit from that retirement system, or has reached retirement age under the retirement system.

Rehired annuitants are excluded from mandatory social security coverage. Retirees rehired after March 31, 1986, are covered for Medicare regardless of whether they qualify as rehired annuitants.

**Example.** A teacher retires from service with a school district that participated in a statewide teachers' retirement system and did not have a Section 218 Agreement. She begins to receive benefits from the system, and later becomes a substitute teacher in another school district that participates in the same statewide system. The employee is treated as a rehired annuitant and is not subject to social security tax. The teacher is subject to Medicare tax. See Regulation 31.3121(b)(7)-2(d)(4)(ii).

However, if an employee is rehired to perform services in a state or local government position that is covered for social security under a Section 218 Agreement, services in that position are covered for social security.

### **Frequently Asked Questions**

- 1) **What is a “public retirement system” as defined by the IRS?** A “public retirement system” (sometimes referred to as a “FICA replacement system or simply a “retirement system”) is a pension plan maintained by a public employer that meets the requirements of IRC Section 3121(b)(7)(F). See [Revenue Procedure 91-40](#) in the Appendix, and Section 31.3121(b)(7)-2 of the Employment Tax Regulations. These requirements must be met for a retirement system to be used as an alternative to mandatory social security coverage. A retirement system may be a pension, annuity, retirement or similar fund or system established by a state or political subdivision. The system need not be created by the legislature of the state, nor does it have to be a plan under which the benefits are guaranteed by the state constitution. A retirement system can include a group

annuity policy purchased by the state or political subdivision from a private insurance company. Whether a system qualifies as a “public retirement system” does not depend on whether it meets the requirements be a qualified plan within the meaning of the Employees’ Retirement Income Security Act of 1974 (ERISA). [IRS]

- 2) **What does it mean to be a qualified participant in a retirement system?** To be a qualified participant, a member must actually participate in the system. An employee who is eligible for an optional system, but decides not to participate, will be subject to mandatory social security tax. An employer is entitled to treat an employee as a qualified participant if he or she was a qualified participant in the retirement system on the last day of the plan year ending in the previous calendar year. [IRS]
- 3) **How are part-time, seasonal and temporary workers defined for purposes of determining whether they are qualified participants in a public retirement system under IRC section 3121(b)(7)(F)?** A part-time employee normally works 20 hours or less per week. A seasonal employee may work full-time, but for less than five months a year. In the case of teachers above the high-school level, part-time is defined as less than one-half the classroom hours designated as full-time by the school. A temporary employee performs services under a contractual arrangement of two years or less. Possible contract extensions must be considered in determining the duration of a contractual arrangement if there is a significant likelihood that the employee’s contract will be extended. Future contract extensions are considered likely if (1) on average 80 percent of similarly situated employees have had bona fide offers to renew their contracts in the immediately preceding two academic or calendar years, or (2) the contract history of a particular employee indicates that the employee is not a temporary employee. [IRS]
- 4) **Are there special vesting rules for part-time, seasonal and temporary workers?** For part-time, seasonal and temporary employees to be qualified participants in an employer-sponsored retirement plan, they must be immediately and fully (100 percent) vested in the plan. The vesting requirement for a defined contribution plan is met if an employee has a nonforfeitable right to receive a payment equal to 7.5 percent of the compensation the employee earned while participating in the system plus a reasonable rate of interest when the employee separates from service. [IRS]
- 5) **If a local government participates in a statewide retirement system, is the plan considered “established” by the employer?** Yes. Even though the plan is not maintained by the local government, it is offered through the employer and is considered established by the employer. Nevertheless, each local government is a separate employer. [IRS]

- 6) **For new employees, entering a retirement system, is there any waiting period for coverage in which social security and Medicare taxes do not have to be paid?** If a full-time employee can be enrolled in the plan by the first day of the first full calendar month of service, social security and Medicare taxes do not have to be paid during the partial month in which he or she begins work. This rule does not apply to part-time, seasonal and temporary employees. [IRS]
- 7) **Is a retirement system that does not cover all employees a “retirement system” within the meaning of Regulations section 31.3121(b)7-2?** A retirement system is not required to cover all employees; it may be a retirement system for some employees and not for others. The coverage determination is made separately for each individual. [IRS]
- 8) **A teacher who is a participant in a retirement system during the academic year also works a few hours per week in the summer in the school library. The library job is not covered by a Section 218 Agreement or by the public retirement system because it does not fall during the normal 10-month school year. Are the wages for the summer job subject to social security and Medicare taxes?** No. The wages are not subject to social security taxes because the teacher is a qualified participant in the public retirement system with respect to her full-time job. A teacher who is expected to be employed on a continuing basis qualifies for treatment as employed simultaneously in multiple positions with the same entity. Consequently, the determination may be made solely by reference to service in the teacher’s full-time position. The Medicare tax applies, unless the employee is a pre-3/31/86 hire who qualifies for the continuing employment exception. [IRS]
- 8) **A teacher retires from a school district, starts collecting a pension under the state retirement system, and returns to work for the same school district as a bus driver. The bus driving position is not covered by a 218 agreement and is not covered by the state retirement system. Does the employee have to pay social security tax on the wages as a bus driver?** No. The employee is a rehired annuitant. He is deemed to be a qualified participant in the retirement system without regard to whether he continues to accrue a benefit. He is subject to Medicare tax; the continuing employment exception cannot apply because the original employment relationship terminated at retirement. [IRS]



## Chapter 7

# Social Security Administration

This chapter discusses the functions of the Social Security Administration (SSA) and employer reporting responsibilities for reports to the SSA.

SSA is the primary income security agency for Americans. It administers the Federal Old-Age, Survivors and Disability Insurance (OASDI) program, the largest income-maintenance program in the United States. The Supplemental Security Income (SSI) program provides monthly benefits designed to replace, in part, the loss of income due to retirement, disability or death. The SSI program provides or supplements the income of aged, blind or disabled individuals with limited income and resources. Children, as well as adults, can receive payments because of disability or blindness.

## Organization

SSA's organization features centralized management in Baltimore, Maryland, and a nationwide network of 10 regional offices overseeing 1,337 field offices (FO), 138 hearing offices, 36 teleservice centers, 7 processing centers and a national data operations center.

All components within SSA's central office perform a supporting role to SSA FOs by providing direction, guidance and material resources needed by the FOs. FOs are located in cities and rural communities across the nation and are the agency's main personal point of contact with beneficiaries and the public. Additionally, the Social Security Disability Insurance (SSDI) program depends on the work of 54 offices of Disability Determination Services, which include all 50 states, the District of Columbia, Guam and Puerto Rico.

For questions about social security coverage, public employers should first consult with the State Social Security Administrator. Public employers who have questions regarding electronic filing or other SSA reporting processes or reporting applications, should contact the appropriate Employer Services Liaison Officer (ESLO) listed at the [SSA ESLO page](#) on the SSA website. Questions related to tax liability should be directed to the IRS.

Direct inquiries regarding state and local coverage issues to the State and Local Coverage Specialist for your state or territory. A list is provided on the [SSA state and local government employer's page](#). For all other inquiries, go to the [SSA home page](#).

## **Parallel Social Security Office (PSSO)**

The PSSO, in most cases located in the state capital, is the on-site representative of the SSA to the state under the leadership of the Regional Commissioner. The PSSO:

- Conducts day-to-day negotiations with the state;
- Assists the state in drafting Section 218 Agreements and modifications;
- Reviews agreements and modifications from the state for technical accuracy and appropriate documentation before forwarding to the Regional Office; and
- Makes coverage and wage determinations, as appropriate.

To locate a PSSO, use the SSA [local office search](#).

## **Regional Office (RO)**

RO staff works under the direction of the Regional Commissioner (RC). The RO provides leadership and technical direction in the coverage area for the state and local program within the region, consistent with established policy. Within the RO structure is the Assistant Regional Commissioner (ARC), who has ongoing responsibility for state and local coverage activities within the region. The Regional Office:

- Interprets, reviews, processes and executes Section 218 Agreements and modifications;
- Reviews supporting documentation to state notices to remove legally dissolved entities from coverage under Section 218 Agreements;
- Makes and reviews coverage and wage determinations consistent with established policy;
- Provides guidance and advice to states on proposed legislation and regulations that may have impact on the state's Section 218 Agreement;
- Interprets and advises states on established policies and procedures;
- Refers to Central Office questions for which no policy has been established or present policy may require a change that may have national impact;
- Maintains file of original agreements and modifications;
- Maintains the Summaries of State Agreements; and
- Handles inquiries and answers questions about electronic filing and paper reporting of wages.

## **Office of Income Security Programs (OISP)**

OISP is primarily responsible for administering the state and local coverage program. Organizationally, OISP is located under the Deputy Commissioner for Disability and Income Security Programs.

## **Social Security Earnings Records**

The social security number (SSN) is used for posting and maintaining the earnings and employment records of persons covered under the social security program. Employers withhold social security and Medicare taxes from their employees' paychecks and, with the employer tax, deposit these amounts or pay them with the tax return. (See [Chapter 3](#) for information on the deposit rules.) By the end of February (the end of March if Form W-2 data is submitted electronically), employers file wage reports with the SSA showing the wages paid to each employee during the preceding year. SSA shares this information with the IRS. SSA also sends weekly updates to IRS with information on newly established SSN records and corrected information for previously established SSN records. Reported earnings are posted to the worker's earnings record. When a worker or a worker's family member applies for social security benefits, the worker's earnings record is used to determine the eligibility for benefits and the amount of any cash benefits payable. It is thus critical that employers maintain accurate, up-to-date SSN information on their employees to make sure each employee's earnings are correctly posted to that employee's earnings record. Since October 1999, SSA has been sending an annual statement to all workers over age 25 that includes their posted earnings and estimates of benefits, so workers may verify their earnings and better plan for retirement.

Under the Federal Insurance Contributions Act (FICA), social security and Medicare benefits are financed through taxes paid by employees and their employers. The social security and Medicare tax rates are set by law. The tax rate on wages for the Old-Age, Survivors and Disability Insurance (OASDI) program applies to earnings up to an annual maximum amount. This amount, called the earnings base, is adjusted annually based on changes in average wages increase. Medicare Hospital Insurance (HI) taxes are paid on total earnings; there is no wage base limit for Medicare tax. The Supplementary Medical Insurance (SMI) part of Medicare is financed by monthly premiums charged to beneficiaries and by payments from general Federal revenues.

### **Earning Credits**

Individuals become eligible for social security benefits and Medicare hospital insurance based on credits for work covered by social security and/or Medicare. (In 2012, one credit is earned for each quarter with \$1,130 in earnings, for up to four quarters per year.) The amount of earnings required for each credit increases each year to reflect average wage increases. The following table shows the required amounts for recent years.

Credits earned remain on the worker's social security earnings record even if the individual has a period of no earnings. The number of credits an individual needs to be eligible for social security and Medicare benefits depends on age and the type of benefit. Most people need 40 credits (10 years of work) to qualify for benefits. Younger people need fewer credits to be eligible for disability benefits, or for their family members to be eligible for survivors' benefits in case of death.

State and local government employees covered for Medicare HI-only must earn the same number of credits to qualify for Medicare as required for social security benefits. Beginning in 1957, basic pay earned from active military duty or training in the military service may earn social security credits. In addition, military service before 1957 may qualify a person for additional earnings credits. A determination of these additional credits is made at the time a person applies for benefits.

If a question arises concerning the employment relationship of a worker for claims purposes, SSA determines whether there was a common-law employer-employee relationship for the purpose of determining the benefits of the claimant.

### **Retirement Income**

Full social security retirement benefits are payable to individuals with 40 credits (10 years of work) at full retirement age (FRA). An individual can elect social security retirement benefits as early as age 62, but when social security retirement benefits begin before, then the individual's monthly benefit is reduced by a certain percentage. In 2003, FRA began to increase in gradual steps from age 65 to 67. This provision affects people born in 1938 and later.

If an individual receives social security benefits before reaching FRA, benefits are further reduced if the individual continues to work and earn more than an annual exempt amount. The annual exempt amount changes each year. A worker can earn up to that amount and not experience any additional reduction of social security benefits. If the worker is under FRA and earns over the exempt amount, the benefits will be reduced \$1 for every \$2 in earnings above the exempt amount. In the year the individual reaches FRA, benefits will be reduced \$1 for every \$3 in earnings above the exempt amount.

A spouse or former spouse may qualify for benefits upon a worker's retirement or disability. Benefits are paid as early as age 62 or at any age if the spouse is caring for the worker's child. In this case the child must be under 16 or disabled and receive benefits on the worker's record. A spouse's benefits will be one-half or less of FRA monthly benefit.

The table below indicates earnings requirements and exempt amounts for recent years.

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Earnings required for one credit	\$1,050	\$1,090	\$1,120	\$1,120	\$1,130
Exempt annual amount - under full retirement age	\$13,560	\$14,160	\$14,160	\$14,160	\$14,640
Exempt amount - year attaining normal/full retirement age	\$36,120	\$37,680	\$37,680	\$37,680	\$38,880

Full retirement age or older No limits effective January 2000.

*Note: Benefits for divorced spouses age 62 or older may be payable if the insured former spouse is eligible for retirement benefits, even though not yet retired. Unmarried children under the age of 18 (under 19 if in high school) or any age if disabled before age 22 may*

*qualify for social security benefits on a retired or disabled parent's social security record.*

***Note:** Although the full retirement age for social security may vary, Medicare eligibility is age 65 for everyone. Eligibility for HI is based on benefits as a retired worker, as a spouse of a retired or disabled worker or as a spouse of a deceased worker. The individual qualifies even if the individual is not receiving monthly social security retirement benefits because the individual or the individual's spouse continues to work.*

Special rules apply to uninsured persons who are at least 65 but who are not eligible for HI under the regular rules. See [Chapter 5](#).

## **Effect on Benefits from Work not Covered by Social Security**

There are two situations in which receipt of a pension based on employment not covered by social security will affect the amount of social security benefit. Employees who participated in a public retirement system and also have a social security benefit based on another retirement system should be aware of these provisions.

The ***Windfall Elimination Provision (WEP)*** affects the way the social security retirement or disability benefit is computed for some individuals with non-covered employment.

The ***Government Pension Offset (GPO)*** affects the amount of the social security benefit received by a spouse or widow(er).

### **Windfall Elimination Provision (WEP)**

The WEP affects some individuals who receive a monthly pension **based in whole or in part** on work not covered by social security. Before 1983, people who worked mainly in jobs not covered by social security had their benefits calculated as if they were long-term, low-wage workers. If you receive a pension based on work not covered by social security, your social security retirement or disability benefit is computed using a modified benefit formula. The resulting benefit amount is lower than you would receive if you did not also receive a pension based on non-covered employment. The WEP affects how the amount of your retirement benefit is calculated.

The weighting in the social security benefit formula is intended to help people who spend their working lives in low-paying jobs by providing them with a benefit that is higher in relation to their prior earnings than the benefit provided for workers with high career earnings.

Therefore, prior to the WEP, the benefit formula created an unintended advantage for workers who had pensions from non-covered employment in addition to social security coverage. It benefited people who worked for only a portion of their careers in jobs covered by social security but had their benefits computed as if they were long-term, low-

wage workers. WEP was enacted to eliminate this unintended advantage by providing for a different, less heavily weighted benefit formula for persons who receive a pension based on non-covered employment.

The modified formula applies to those who reach age 62 or become disabled after 1985 and first become eligible after 1985 for a monthly pension based in whole or in part on work not covered by social security. You are considered eligible to receive a pension if you meet the requirements of the pension, even if you continue to work.

Workers with relatively low pensions are less affected by the law because the reduction in the social security benefit cannot be more than one-half of that part of the pension attributable to earnings not covered by social security.

The modified formula does not apply to survivor benefits. It also does not apply to:

- A Federal worker performing service on January 1, 1984, who becomes newly covered under social security on January 1, 1984, under the mandatory coverage provision in PL 98-21;
- An employee of a non-profit organization who is exempt from social security coverage on December 31, 1983, and who becomes covered for the first time as an employee of that organization on January 1, 1984, under the compulsory coverage provision of PL 98-21;
- Pensions based on earnings under the Railroad Retirement Act;
- Pensions based entirely on non-covered employment before 1957; or
- Persons who have 30 or more years of substantial earnings under social security.

For more information about, see the SSA [Windfall Elimination Provision](#) page.

### **Government Pension Offset (GPO)**

The Government Pension Offset (GPO) applies to a worker who gets a government pension that is based on employment not covered by social security and is also eligible for social security as a spouse or widow(er). Two-thirds of the government pension is used to offset any spouse's or widow(er)'s social security benefit.

Before the GPO provisions were enacted in December 1977, many government employees qualified for a pension from their government agencies and for a spouse's benefit from social security, even though they were not dependent on that spouse.

This situation was considered unfair to employees in social security covered positions because the SSA requires an individual's social security spouse's or widow(er)'s benefit be offset dollar for dollar by the amount of his/her own social security retirement benefit.

**Example.** A woman eligible for \$600 in social security retirement benefits on her own work record and also eligible for a wife's benefit of \$450 receives only the higher of the two benefits - \$600 in this case. But before enactment of the GPO provision, if that woman was a government employee who did not pay into social security and who earned a \$600 government pension, there was no offset; and she would receive the \$450 social security wife's benefit as well as her \$600 government pension. The GPO provision was enacted to prevent such inequities.

However, prior to 2004, within this GPO provision, a spouse or widow(er) could be exempt from GPO if on the last day of state or local government employment, the individual worked in a position that was covered by both social security and the pension plan. Many teachers, in particular, were able to take advantage of this exemption. Congress further tightened the GPO provision, and on March 2, 2004, the President signed the Social Security Protection Act of 2004.

The Social Security Protection Act of 2004 required that beginning with applications filed April 1, 2004, state and local government workers be covered by social security throughout their last 60 months of employment with the government entity in order to be exempt from the GPO. For applications filed before April 1, 2004, state and local government workers needed to be covered by social security only on the last day of employment with the government entity in order to be exempt from GPO. If the worker's last day of government employment was covered by both social security and the pension system and the last day occurred before July 1, 2004, the worker is exempt from GPO with respect to all current and future applications for spouse's or widow(er)'s benefits. For example, a teacher whose last day of government employment in June 2004 was covered under social security and the pension system would be exempt from the GPO regardless of when he/she filed for benefits.

The Act did provide a transition for workers whose last day of government employment occurred within 5 years after the date of enactment (March 2, 2004). Any state or local government worker whose last day of government employment occurred after June 30, 2004, and before March 2, 2009, could have the requirement for 60 months of social security covered government employment reduced. For these workers, the requirement for 60 consecutive months of social security covered employment was reduced (but not to less than one month) by the total number of months that the worker had in social security covered government service under the same retirement system before March 2, 2004. If the 60-month period was reduced, the remaining months of service needed to fulfill the requirement must have been performed after March 2, 2004.

**Example.** Ms. Jones was working in a non-covered position at the time of enactment, but had previously worked in a social security covered job in the same retirement system for 12 months in 1997. Because she had previously worked in social security covered employment for 12 months, the requirement that her last 60 months of employment be in a social security covered position would be reduced to 48 months, or four years. If Ms. Jones began working after March 2, 2004, in social security-covered

employment under the same retirement system as her prior government work, **and** worked continuously in the covered position for at least the final 48-month period of her employment, **and** her last day of employment was before March 2, 2009, Ms. Jones would have been exempt from the GPO offset.

For all other non-covered state and local government workers, if they first switched to government employment covered by social security and their pension plan after June 30, 2004, they had to work in covered government employment for the entire final 60-month period of their government employment in order to avoid the GPO.

For more information, see the [GPO Fact Sheet](#) on the SSA website.

### **Defining a Pension for WEP or GPO Purposes**

Since July 2, 1991, state and local government employees who are not members of a retirement system must be covered by social security. Mandatory coverage does not apply for any employee already has social security coverage under a Section 218 Agreement. Mandatory social security coverage may cease if the employee becomes a qualified participant in a public retirement system or FICA replacement plan that satisfies the criteria in IRC section 3121(b)(7) and regulations.

In lieu of social security, some public employers have opted for alternative retirement plans instead of a conventional pension plan, such as a deferred compensation plan. This and other alternative plans raise questions about the applicability of WEP and GPO.

A plan is considered a savings plan and is not a pension for WEP/GPO purposes if:

- An employee voluntarily contributes to a plan that is separate from and in addition to a primary retirement plan;
- The employer makes no contributions to the plan;
- The withdrawals from the plan do not exceed the employee's contributions (plus interest); and
- Withdrawals are not based upon age, length of service or earnings.

**Example 1:** A part-time employee for a city is not covered by a 218 Agreement. In July 1991, the employee elected to participate in the state's public employees deferred compensation plan in lieu of mandatory social security coverage. The employee, upon retirement, will receive a payment from the deferred compensation plan based on employee and employer contributions to the plan, as this is the only plan to which the employee contributes. This plan is not considered a savings plan for GPO or WEP purposes and the payment will be considered a pension and subject to the GPO or WEP provisions.

**Example 2:** A state employee is not covered by a 218 Agreement, but is covered by a state employee retirement system and has also elected to make contributions to a deferred compensation plan. The payment from this deferred



compensation plan is separate from and in addition to the primary retirement plan. The employer made no contributions to the deferred compensation plan and the payment from the deferred compensation plan is not based on age, length of service or earnings. While the payment from the retirement system is subject to GPO or WEP, the payment from the deferred compensation plan is not.

SSA Publication 05-10045, covering WEP, and SSA Publication 05-10007 covering GPO are available from the Social Security Administration by calling 1-800-772-1213. These publications can also be downloaded from the [SSA Publications page](#). Employers assisting in retirement planning are urged to provide copies of these publications to their employees.

## **Medicare**

SSA is the primary public contact point regarding eligibility and premium issues for the Centers for Medicare & Medicaid Services (CMS), which is responsible for administering the Medicare program. SSA staff determines, and answers questions regarding, Medicare eligibility. SSA also maintains records of Medicare eligibility and collects Medicare Part B premiums through withholding from social security payments. (See [Chapter 5](#) for more information.)

The Medicare tax supports a Federally-funded health insurance program for people 65 years of age and older and people with certain disabilities. Medicare has four parts:

- Hospital insurance (Part A) that helps pay for inpatient care in a hospital or skilled nursing facility (following a hospital stay), some home health care and hospice care.
- Medical insurance (Part B) that helps pay for doctors' services and many other medical services and supplies that are not covered by hospital insurance.
- Medicare Advantage (Part C) plans, available in many areas. People with Medicare Parts A and B can choose to receive all of their health care services through one of these provider organizations under Part C.
- Prescription drug coverage (Part D) that helps pay for medications doctors prescribe for treatment.

You can get more information about Medicare at the CMS site [www.medicare.gov](http://www.medicare.gov).

## **Medicaid**

In 32 states and the District of Columbia, eligibility for SSI benefits confers automatic entitlement to Medicaid. SSA provides information and referral services in support of Medicaid and is directly funded by the states and CMS.

For more information, see the CMS Medicaid site at [cms.gov/MedicaidGenInfo/](https://www.cms.gov/MedicaidGenInfo/).

## Reporting Wages to SSA

As discussed in [section 3](#), all employers are responsible for collecting social security numbers from employees, filing tax returns to the Internal Revenue Service and filing annual wage reports (Forms W-2) with employees and with the Social Security Administration. To avoid costly errors, it is crucial that Form W-2 filing be accurate.

All Forms W-2 sent to SSA are subject to:

- Balancing and validation programs to determine whether the reports are accurate and can be “read” by SSA systems; and
- Employee name and social security number (SSN) verification.

Reports that have errors, do not match or do not meet edit conditions are returned to the employer (or submitter) for correction and resubmission.

All employers are subject to IRS late filing penalties (see [Chapter 3](#)).

*Note: If the initial report was filed timely and later returned for corrections, the employer will be subject to late filing penalties if the corrected report is not resubmitted by the due date.*

## Electronic Wage Reporting

Employers with Internet access can submit their W-2 files using SSA’s [SSA Business Services Online](#). This option is fast, free and secure. For security, a PIN and a password are required before you submit your W-2 file over this web page; most registrations can be completed on the web page. For more information, visit the [SSA employer page](#) or call your ESLO (see list at website).

## Social Security Statement

SSA sends a statement annually to workers and former workers aged 25 and older who have paid social security taxes during their working years. This statement shows all earnings on which a worker has paid social security taxes during his/her working years. Workers at any age may request a benefit estimate by completing Form SSA-7004 (Request for Social Security Statement). Make this request by calling 1-800-772-1213 or through the [SSA website](#). The statements should be examined closely by the employee to ensure all earnings are properly credited. If the earnings shown on the statement are not correct, the employee should call SSA at 1-800-772-1213.

*Note: Individuals who have worked only in non-covered employment (no social security and Medicare taxes) will not receive a Social Security Statement.*

The Medicare portion of the Social Security Statement reflects the amount of earnings that was taxed and an estimate of the amount of taxes paid to support the Medicare program. The taxes are estimated because SSA does not keep records of Medicare taxes paid. If an employee had both social security earnings and government earnings that qualified for Medicare in the same year, the statement would reflect an estimate of the combined Medicare taxes paid.

Workers may access on-line benefit planning tools at the [SSA planning page](#). These can be used to project potential benefits using various earnings scenarios.

### **Verifying Employee Names and Social Security Numbers**

After wage reports have been entered into SSA's system, each employee name and social security number (SSN) is compared to SSA's records to verify that it is correct. Matched wage reports are updated to the individual employee's record; reports that do not match are identified and the employer or employee is contacted and asked to provide a corrected name or SSN to SSA. Additionally, IRS may impose a penalty of up to \$50 per misreported name and SSN. Accurate crediting of earnings to individual records is essential to the correct payment of social security benefits. This is why obtaining a correct name and SSN is very important. See IRS [Publication 15](#), for a discussion of requirements for new hires.

### **Social Security Number Verification Service**

The Social Security Number Verification Service (SSNVS) is a free, internet-based service of the SSA Business Services Online (BSO) where employers and third-party submitters can verify their employees' names and SSNs against SSA's records. For more information on SSNVS, see the SSA [SSNVS Handbook](#). Employers are required to register with SSA to use the service.

With SSNVS, you may verify up to 10 names and SSNs online and receive immediate results. There is no limit to the number of times the SSN Verification web page may be used within a session. You may upload electronic files of up to 250,000 names and SSNs and will usually receive results the next government business day.

In addition to SSNVS, the BSO offers Registration Services and Employer Services. Registration Services offers a User Identification Number (User ID) assignment, password selection and various registration maintenance functions. Employer Services offers Form W-2 file upload, W-2 and W-2c online key-in functions (no special software or forms required) and the ability to track files and view processing results and notices. See the [BSO page](#) for more information.

*Note: SSNVS should only be used for the purpose for which it was intended. SSA will verify SSNs and names solely to ensure that the records of current or former employees are correct for the purpose of completing Form W-2.*

## **Verifying Employment Eligibility**

Under the Immigration and Nationality Act, employers must verify the identity and employment eligibility of anyone hired for employment in the United States. This includes citizens and non-citizens.

Form I-9, The Employment Eligibility Verification Form, was developed by the former Immigration and Naturalization Service (INS) to verify that persons are eligible to work in the United States. Completion of this form is required for every employee hired after November 6, 1986. The functions of the INS are now carried out by the U.S. Citizenship and Immigration Service (USCIS). The USCIS operates [I-9 Central](#), a free website providing employers and employees access to resources, tips and guidance to properly complete Form I-9 and better understand the Form I-9 process.

USCIS also operates an electronic employment eligibility verification system, E-Verify, for employers. If you have questions about Form I-9, contact E-Verify Customer Support at 1-888-464-4218 or the [E-Verify web page](#).

USCIS Publication M-274, [Handbook for Employers](#), includes Form I-9 and addresses questions relating to the form and employment issues related to immigration. Print copies are available to employers at USCIS regional and district offices, as well as local government printing office bookstores. For questions not addressed in the Handbook, visit the USCIS website at [www.uscis.gov](http://www.uscis.gov) or call (202) 375-5283.

## **Correcting Wage Reports**

Once information returns have been filed with SSA, you must make any corrections using Form W-2c and Form W-3c.

Forms W-2c may be filed on paper or via electronic transmission. As of February 28, 2006, SSA no longer accepts magnetic media submissions for wage reports. Electronic submissions should be formatted following the instructions in SSA [Publication 42-007](#), Specifications for Filing Forms W2 Electronically (EFW2), are available on [SSA's website](#) or from any Employer Service Liaison Officer (ESLO). A list of the ESLOs is also available at this site.

*Note: If you are required to file 250 or more Forms W-2c during a calendar year, you must file them electronically unless IRS grants you a waiver. For information on filing a waiver, contact IRS at 1-800-829-3676, or visit [www.irs.gov](http://www.irs.gov).*

If the employee has a name change, the employee must notify SSA and request a new social security card. **Never** change an employee's name in your payroll system until the employee has shown you a new social security card showing the change. See IRS Publication 15, ([Circular E](#)), for rules on name changes.

If an error is identified before Form W-2 is filed with the SSA, but after providing the form to the employee, changes should be shown on a new original form. This form should be annotated "Reissued Statement" at the top. Be sure to change the information submitted to SSA as well, either by marking the original paper W-2 "VOID" at the top (if you submit on paper) or by correcting the data file before filing electronically.

Form W-3c must accompany Copy A of Form W-2c when it is sent to SSA. A separate Form W-3c must be used for each type of Form W-2 being corrected and must accompany a single Form W-2c, as well as multiple Forms W-2c. Large numbers of Forms W-2c may also be filed electronically. Contact your ESLO for details.

## **Common Reporting Errors**

### *General*

**Incorrect or missing Employer Identification Number (EIN).** SSA and IRS maintain records by the EIN. Reports received with missing or erroneous EINs may be credited to the wrong record and result in IRS assessing penalties for failure to file correct reports.

**Incorrect employee names and social security numbers.** SSA cannot credit earnings to an employee's record unless the employee's name and social security number on the wage report matches the name and number in the SSA files. Use the name exactly as it is shown on the employee's social security card.

**Wage reports for years after employee's death.** Payments on behalf of a deceased employee made after the year of death cannot be credited as wages for social security purposes. Such payments should be reported to the employee's estate on Form 1099-MISC, Miscellaneous Income.

**Errors resulting in out-of-balance reports.** Errors may occur due to application of an incorrect wage base for social security or a wage base limitation to the Medicare wages.

**Tips.** If an employee has tips, they must be reported in the "Social security tips" field (of the Form W-2). They are **not** included in the "Social security wages" field. These two fields are added together by SSA to obtain the total social security earnings.

**Omitted wage or tax fields on wage reports.** All fields must be completed.

### *Paper Form W-2 Reports*

**Wrong tax year form used.** SSA optical scanning and imaging systems are modified annually to meet changes in Form W-2 formats. The version of Form W-2 for the year corrected must be used or SSA may be unable to read the form, or post the earnings to the wrong year.

**Unscannable reports.** Reports that are not scannable by the SSA's optical equipment are more costly to process and subject to error.

**Failure to file Copy A of Form W-2 with SSA.** Employers must always file Copy A of Form W-2 with SSA, unless they submit the same data electronically.

**“Void” indicator on Form W-2 checked in error.** SSA will not credit wages shown on any Form W-2 that is void.

### ***Electronic Reports***

**Wrong tax year entered.** Make sure you show the correct tax year on the code RE records. Dollar totals ("RT" Record) are used by SSA to determine whether the report is in balance and, if not, to show where the error may be found. Make sure you report employee names and social security numbers correctly.

**Missing/Incorrect submitter (Code “RA”).** This information helps SSA properly identify and control each report. It provides contact information for use if there is a problem with the submission.

**Unreadable reports.** Reports must meet the requirements set out in [EFW2](#) to be processable on SSA's electronic equipment. Unprocessable reports will be returned to the transmitter for correction and returned to SSA. Failure to return the correction reports timely may result in IRS penalty assessment.

### ***Form 941 Reports***

**Incorrect or omitted Medicare wage/tip amounts.** Medicare wages/tips must be shown separately from social security wages on Forms 941 filed with the IRS. All Medicare wages/tips are subject to Medicare taxes.

**Showing non-covered amounts as social security and/or Medicare wages.** Examples of non-covered amounts include employee earnings that exceed the wage base for social security and payments to an independent contractor shown as wages. See IRS Publication 15 for other non-covered payments under the heading “Special Rules for Various Types of Services and Payments.”

**Failure to file Form W-2c and/or Form W-3c with SSA when adjusting prior year earnings on Form 941 and/or Form 941c.** Adjustments of tax liability filed with IRS that are based on changes in social security and/or Medicare wages must be matched by the filing of Forms W-2c and W-3c with SSA to allow entry of the wage changes on the employee's social security earnings records.

**Filing of duplicate or partially duplicate Forms 941.** Social security and/or Medicare wages shown on duplicate Forms 941 may lead to costly and otherwise unnecessary reconciliations between SSA, the IRS and the employer.

## Publications and Forms – Social Security Administration

To request SSA publications, telephone 1-800-772-1213 (toll-free), or TTY 1-800-325-0778, or e-mail to <mailto:OPLM.OSWM.RQCT.Orders@ssa.gov>. You can also download most forms and publications from the SSA [employer page](#).

<b><u>Publication/Form</u></b>	<b><u>Title</u></b>
<b>SS-5</b>	Application for a Social Security Card
<b>SSA-7004</b>	Request for Social Security Statement
---	Social Security Number Verification Service (SSNVS) Handbook
<b>SSA 42-007</b>	Specifications for Filing Forms W-2 Electronically (EFW2)
<b>SSA 42-014</b>	Specifications for Filing Forms W-2c Electronically (EFW2)
<b>Form SSA-1945</b>	Statement Concerning Your Employment in a Job Not Covered by Social Security
---	<i>SSA/IRS Reporter</i>  (A newsletter that keeps employers informed of the latest wage and tax reporting news. It is free and mailed quarterly with IRS Form 941 (Employer's Quarterly Federal Tax Return). To obtain a copy, call IRS toll-free at 1-800-829-FORM.)

## Other SSA Services

### SSA Speaker's Bureau

SSA can arrange to have speakers available for wage reporting seminars, pre-retirement sessions and other employer-sponsored onsite meetings with employees to discuss social security matters. For more information, contact any Social Security office or call 1-800-772-1213. For a local SSA office near you, see [SSA contact page](#).

### Statistical Information

SSA's Office of Policy (OP) provides ongoing statistical data and research analyses of the Old-Age, Survivors, and Disability Insurance (OASDI) and Supplemental Security Income (SSI) programs. In quarterly, annual and one-time publications, Office of

Research, Evaluation, and Statistics (ORES) keeps current on major issues that historically or currently have policy implications and program relevance for the nation's major income security programs.

OP has a number of its publications and tables available on the SSA site. Publications may also be requested by calling 1-202-358-6274, by faxing OP at 1-202-358-6192 or by writing to the Division of Information Resources at 500 E Street SW, 8<sup>th</sup> Floor, Washington DC 20254.

### **Employer Training Seminars**

Each year, Employer Service Liaison Officers (ESLOs) provide a series of free training seminars to annual wage reporters. Call your local ESLO to find out when a seminar is held in your area. Or check the website for a list of seminars held around the nation.

### **Key SSA Web Pages**

#### ***Employer Reporting Instructions and Information*** ([www.ssa.gov/employer](http://www.ssa.gov/employer))

This SSA website addresses employer reporting and other interests.

#### ***Social Security Online*** ([www.ssa.gov](http://www.ssa.gov))

SSA's home page that lists available online services such as benefit planners, Social Security Statements, Medicare card replacement, etc.

#### ***State and Local Government Employers*** ([www.ssa.gov/slge](http://www.ssa.gov/slge))

This site is for state and local government employers who are responsible for withholding, reporting and paying social security and Medicare taxes for public employees.

### **Frequently Asked Questions**

- 1) **If the IRS is responsible for answering questions on withholding and paying social security and Medicare taxes, why do we get reporting information from SSA and why do we have to send IRS Forms W-2 to SSA?** SSA is responsible for keeping records of earnings, and for determining eligibility and amounts for individuals applying for retirement, disability or survivor benefits. The amount of benefits is based in part on an individual's earnings over his or her working career. The information on an individual's earnings record is taken directly from the social security and Medicare wage fields on the Form W-2 sent to SSA by the employer. After SSA processes this information, it is forwarded to the IRS. Either IRS or SSA can help you with Form W-2 reporting questions.  
[IRS/SSA]
- 2) **How does an employee verify what the SSA shows on her/his earnings record?** An employee may submit Form SSA-7004, Request for Social Security



Statement, to the SSA. The Social Security Statement is mailed annually to workers and former workers aged 25 and older who have worked in covered employment. There is no charge for this service. You can get Form SSA-7004 from any Social Security Administration office, by calling 1-800-772-1213, or through the SSA website at [www.ssa.gov/mystatement](http://www.ssa.gov/mystatement). [SSA]

- 3) **What information can be provided by SSA to State Social Security Administrators to help them perform their responsibilities?** SSA may provide interpretations of the Social Security Act, Social Security regulations, rulings, the state Section 218 Agreement and its modifications, as they apply to a public employer. [SSA]
- 4) **Whom should I call when I have questions about Annual Wage Reporting?** Call your local SSA Employer Services Liaison Officer. See [Chapter 7](#), or go to the [SSA website](#) for contact information. [SSA]
- 5) **My employees are paying into the State Teachers' Retirement System and some have enough social security credits from former employment to be eligible for social security benefits. Will they receive benefits from both?** Yes, but the Windfall Elimination Provision may reduce social security benefits. Additionally, spouses' benefits may be reduced by the Government Pension Offset formula. See [Chapter 6](#), Social Security and Public Retirement Systems. [SSA]

## Chapter 8

# Internal Revenue Service

The Internal Revenue Service (IRS), an agency of the Department of Treasury, is the Federal agency charged with the administration of the tax laws passed by Congress. For many years, the IRS was organized geographically with a national office in Washington and regional, district and local offices throughout the country. With the Restructuring and Reform Act of 1998, the Internal Revenue Service began a major reorganization in an effort to improve compliance and customer service. This restructuring marked the most sweeping overhaul of the agency since 1952. The reorganization and its impact on Federal, state, and local government entities are discussed in this chapter.

More information about the programs and responsibilities of the IRS is available at [www.irs.gov](http://www.irs.gov).

## Organization

National Headquarters for the Internal Revenue Service, in Washington DC, develops nationwide policies and programs for the administration of the agency. The chief executive of the agency is the IRS Commissioner. Several functions report directly to the Commissioner, including:

- Chief Counsel
- Appeals
- National Taxpayer Advocate
- Communications and Liaison

With the 1998 reorganization, the IRS is now organized around four specific “customer bases,” or groups of taxpayers with generally common interests and needs. Each operating division has a Commissioner and its own Counsel to provide legal expertise and guidance. This structure replaces the system of Regional and District Offices that existed under the previous, geographically-based organization.

The following are the four customer-based operating divisions:

***Wage and Investment (W&I)*** is focused on individual taxpayers.

***Small Business/Self-Employed (SB/SE)*** is oriented to S-corporations, partnerships, small corporations and sole proprietors.

***Large Business and International (LB&I)***, deals with the largest businesses and international tax issues. (This was formerly the Large and Mid-Size Business division).

*Tax Exempt and Government Entities (TE/GE)* serves all government organizations as well as nonprofit and other exempt organizations.

## **Tax Exempt and Government Entities Operating Division**

The Tax-Exempt and Government Entities (TE/GE) Operating Division was established in late 1999 and replaced the former office of Assistant Commissioner (Employee Plans and Exempt Organizations). It serves three distinct customer segments:

Employee Plans (EP)

Exempt Organizations (EO)

Government Entities (GE)

Customers range from small local community organizations and municipalities to major universities, large pension funds, state governments, Federal agencies, Indian tribal governments and issuers of tax-exempt bonds. These organizations represent a large economic sector with unique needs. They are governed by highly complex, highly specialized provisions of the tax law.

The Government Entities segment contains three offices:

Federal, State, and Local Government (FSLG)

Indian Tribal Governments (ITG)

Tax-Exempt Bonds (TEB)

**Federal, State, and Local Governments:** Provides a clear point of contact for all government entities for their tax issues with the primary focus on information return reporting and employment tax issues. FSLG is responsible for administering the tax laws affecting these entities and ensuring compliance. It also develops and delivers communication and education programs and provides easily accessible and equitable voluntary compliance programs for its government customers.

On the Federal, State and Local Governments [website](#) you can find the latest, updated version of this publication, and additional information, including:

- Latest tax developments affecting government entities
- How to contact an FSLG Specialist in your area
- How to e-mail FSLG with a question
- A [toolkit](#) providing all basic Federal tax reporting materials in one location
- Fact sheets and frequently asked questions
- [Quick Reference Guide for Public Employers](#)
- The semiannual [FSLG Newsletter](#)

- Announcements and registration information for educational events
- Explanation of the compliance process (examinations and compliance checks)
- Archived webinar presentations on tax topics
- Links to related sites of interest

### **Customer Account Services**

You can call toll-free at (877) 829-5500 with questions concerning the following as they relate to government entities:

- Account-related questions.
- Request for affirmation letter of tax exemption.
- Request for private letter ruling.
- FSLG telephone numbers
- Local FSLG Offices
- 

Contact your [Local FSLG Office](#) if you have questions regarding the following:

- General information about State-Social Security Administration Section 218 Agreements.
- Worker classification as employee or independent contractor.
- Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.
- Special employment tax rules for public employees (election workers, emergency workers, public officials, etc.)
- Withholding from nonresident aliens.
- Other Federal tax issues for government entities

**Indian Tribal Governments:** Helps Indian tribes deal with their Federal tax matters, and provides a single point of contact for assistance and service. The specialists in this area address issues and provide guidance to Indian tribes, whose concerns may relate to tribal governments as employers, distributions to tribal members, and the establishment of governmental programs, trusts, and businesses. For more information visit the [Indian Tribal Governments website](#).

**Tax-Exempt Bonds:** Provides information to the tax-exempt bond community in the form of education and outreach programs. It encourages voluntary compliance through ruling and agreement. It also administers and conducts the tax-exempt bond examination program. For more information, visit the [Tax Exempt Bond website](#).

## Publications and Forms — Internal Revenue Service

You can download most IRS forms and publications from the [IRS website](#). To order by phone, call 1-800-829-3676 (toll-free). To request forms by fax, call 1-703-368-9694 from your fax machine. Forms and publications are also available at IRS walk-in offices.

<b><u>Publication</u></b>	<b><u>Title</u></b>
<a href="#"><u>1</u></a>	Your Rights as a Taxpayer
<a href="#"><u>15</u></a>	Circular E, Employer's Tax Guide
<a href="#"><u>15-A</u></a>	Employer's Supplemental Tax Guide
<a href="#"><u>15-B</u></a>	Employer's Tax Guide to Fringe Benefits
<a href="#"><u>17</u></a>	Your Federal Income Tax
<a href="#"><u>51</u></a>	Circular A, Agricultural Employer's Tax Guide
<a href="#"><u>80</u></a>	Circular SS, Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands
<a href="#"><u>463</u></a>	Travel, Entertainment, Gift and Car Expenses
<a href="#"><u>509</u></a>	Tax Calendars
<a href="#"><u>515</u></a>	Withholding of Tax on Nonresident Aliens and Foreign Entities
<a href="#"><u>519</u></a>	U.S. Tax Guide for Aliens
<a href="#"><u>521</u></a>	Moving Expenses
<a href="#"><u>571</u></a>	Tax-Sheltered Annuity Plans (403(b) Plans)
<a href="#"><u>594</u></a>	The IRS Collection Process
<a href="#"><u>901</u></a>	U.S. Tax Treaties
<a href="#"><u>910</u></a>	IRS Guide to Free Tax Services
<a href="#"><u>915</u></a>	Social Security Benefits and Equivalent Railroad Retirement Benefits
<a href="#"><u>947</u></a>	Practice Before the IRS and Power of Attorney
<a href="#"><u>957</u></a>	Reporting Back Pay and Special Wage Payments to the Social Security Administration
<a href="#"><u>1542</u></a>	Per Diem Rates
<a href="#"><u>1976</u></a>	Do You Qualify for Relief Under Section 530?
<a href="#"><u>4268</u></a>	Employment Tax Desk Guide (available only at <a href="http://www.irs.gov/tribes">www.irs.gov/tribes</a> )

<b>Form</b>	<b>Title</b>
<a href="#"><u>SS-4</u></a>	Application for Employer Identification Number
<a href="#"><u>W-2</u></a>	Wage and Tax Statement
<a href="#"><u>W-2c</u></a>	Corrected Wage and Tax Statement
<a href="#"><u>W-3</u></a>	Transmittal of Wage and Tax Statements
<a href="#"><u>W-3c</u></a>	Transmittal of Corrected Wage and Tax Statements
<a href="#"><u>W-4</u></a>	Employee's Withholding Allowance Certificate
<a href="#"><u>W-9</u></a>	Request for Taxpayer Identification Number and Certification
<a href="#"><u>941</u></a>	Employer's Quarterly Federal Tax Return
<a href="#"><u>941-X</u></a>	Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund
<a href="#"><u>943</u></a>	Employer's Annual Tax Return For Agricultural Employees
<a href="#"><u>944</u></a>	Employer's Annual Federal Return
<a href="#"><u>944-X</u></a>	Adjusted Employer's Annual Federal Tax Return or Claim for Refund
<a href="#"><u>945</u></a>	Annual Return Of Withheld Federal Income Tax
<a href="#"><u>945-A</u></a>	Annual Record Of Federal Tax Liability
<a href="#"><u>1042</u></a>	Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
<a href="#"><u>1042-S</u></a>	Foreign Person's U.S. Source Income Subject to Withholding
<a href="#"><u>1096</u></a>	Annual Summary and Transmittal of U.S. Information Returns
<a href="#"><u>1099-MISC</u></a>	Miscellaneous Income
<a href="#"><u>8233</u></a>	Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual
<a href="#"><u>8821</u></a>	Tax Information Authorization

The IRS website also offers the following free of charge.

- Forms and Publications on CD/DVD
- IRS press releases and fact sheets
- TeleTax (automated) information on about 100 tax topics (1-800-829-4477)
- Educational Materials

Telephone assistance is available at 1-800-829-1040.

## Frequently Asked Questions

- 1) What information can IRS provide to a governmental unit about its social security coverage and tax liability?** The IRS is responsible for assessing and collecting all taxes, as well as interpreting and applying the tax law. By contacting Customer Account Services, an authorized person can receive tax information about the entity. Your local Federal, State, and Local Government (FSLG) Specialist can assist you with tax law questions, including what services are subject to income and social security taxes. Questions about section 218 Agreement coverage should be directed to your State Social Security Administrator.
- 2) What information can IRS provide to State Social Security Administrators to help them perform their responsibilities, especially when an audit or review is to be conducted of a public employer in his/her state?** Section 6103 of the IRC governs the disclosure of tax information by the IRS to other Federal and state agencies. Without the consent of the taxpayer, no provision in section 6103 authorizes the IRS to share specific taxpayer information with State Social Security Administrators. However, in performing a tax investigation, the IRS may request information from the State Social Security Administrator. [IRS]

# Glossary

**Absolute Coverage Group** Also called a “non-retirement coverage group; for Section 218 coverage purposes, a group of employees whose positions are not covered under a public retirement system; also referred to as a non-retirement system coverage group or a Section 218(b)(5) coverage group.

**Alternative Lookback Rule** – An optional method for determining whether an employee can be treated as a qualified participant in a retirement plan for purposes of mandatory social security. Under this rule, an employer may treat an employee as a qualified participant in the first year of employment if it is reasonable to believe the employee will be a qualified participant on the last day of the plan year. An employer may treat an employee as a qualified participant in a calendar year if the employee was a qualified participant at the end of the previous plan year. See Section 31.3121(b)(7)-2(d)(3), Employment Tax Regulations.

**Continuing Employment Exception** – Exception from Medicare taxes and coverage applicable to services of a state or local government employee who is a participant in a public retirement system and meets all of the following requirements:

- The employee was performing regular and substantial services for remuneration for the employer before April 1, 1986;
- The employee was a bona fide employee on March 31, 1986;
- The employment relationship was not entered into for purposes of avoiding the Medicare tax; and
- The employment relationship with the employer has not been terminated after March 31, 1986.

**Coverage Groups** – Categories of state and local government employees with respect to a Section 218 Agreement. There are two types of coverage groups:

1. Absolute coverage groups, composed of employees in positions not covered under a retirement system; and
2. Retirement system coverage groups, composed of employees in positions covered by a retirement system.

The Social Security Act gives each state the right, within the limits of state and Federal laws, to decide which coverage groups are to be included under its Agreement and any modifications to the Agreement.

**Defined Benefit Plan** – An employer plan that determines retirement benefits under a formula, generally based on age, years of service and salary level.



**Defined Contribution Plan** – An employer plan that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant’s account, and any income, expenses, gains, losses and forfeitures of accounts of other participants that may be allocated to the participant’s account.

**Earned Income Credit (EIC)** - A refundable tax credit for workers who have earned income below specific thresholds.

**Earnings Record** - The information maintained by the Social Security Administration on each individual’s social security and Medicare covered wages and self-employment income. Each individual’s record is accessed by social security number (SSN).

**Employee** – Generally any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee .The term is defined for social security and Medicare purposes in Sections 210(j)(2) and 218(b)(3) of the Social Security Act and IRC section 3121(d).

**Employer Identification Number (EIN)** – A unique nine-digit identification number assigned by IRS to state and local governments, businesses, and other entities for tax-filing and reporting purposes, including withholding and paying FICA taxes. An entity can obtain an EIN by filing Form SS-4, Application for Employer Identification Number, with the IRS.

**Entity** – A separate legal “person,” that is not an individual; includes a corporation, partnership, LLC, or a political unit, including a state, a political subdivision, a wholly-owned instrumentality, a municipality, etc.

**Federal Insurance Contributions Act (FICA)** – Federal statute imposing social security and Medicare taxes on employers and employees.

**Federal Unemployment Tax Act (FUTA)** – Federal statute imposing tax on employers in order to provide for payments of unemployment compensation to workers who have lost their jobs. States and political subdivisions of a state are exempt from paying FUTA, but under state unemployment law, most state and local government employees must be covered for state unemployment insurance.

**Fee-Based Public Official** – A public official who receives and retains remuneration directly from members of the public, e.g., a notary public. An official who receives payment for services from government funds in the form of a wage or salary is not a fee-based public official, even if the compensation is called a fee.

**FICA** - Federal Insurance Contributions Act.

**FICA Replacement Plan** –Alternate name for a public retirement system, as described in the regulations for section 3121(b)(7)(F). Refers to a pension, annuity, retirement, or similar fund or system established by a state or political subdivision for the purpose of providing retirement benefits to employees. See Public Retirement System.

**FRA (Full Retirement Age)** – The age at which unreduced social security benefits are payable. Depending on the date of birth, an individual’s FRA ranges from 65 to 67.

**Full Social Security** – Coverage for both the Old-Age, Survivors, and Disability Insurance (OASDI) program and Medicare Hospital Insurance (HI). Both the employer and employee pay these taxes.

**FUTA** - Federal Unemployment Tax Act.

**Governmental Function** – Activity normally associated with the authority of government, legislative, executive, judicial, such as the control and prevention of crime, promoting the general welfare, and providing for public safety.

**Government Pension Offset (GPO)** – A reduction in the social security benefits that applies to individuals who (1) receive a government pension from work not covered for social security and (2) who are eligible for social security as a spouse or widow(er). Two-thirds of the government pension offsets any spouse’s or widow(er)’s social security benefit.

**HI** - Hospital Insurance (Medicare Part A).

**Identification Number** – A nine-digit number assigned by SSA prior to 1987 to every state and political subdivision included under a Section 218 Agreement, beginning with the prefix “69” (69-NNNNNNN). Many states continue to sequentially assign a 69-number for internal state record keeping purposes to entities brought under Section 218 coverage.

**Indian Tribal Government** – The governing body of any Federally recognized tribe, band, community, village or group of Indians or Alaska Natives that is determined by the Secretary of the Treasury, with the Secretary of the Interior, to exercise governmental functions, under IRC section 7701(a)(40). Under IRC section 7871, an Indian tribal government is treated as a state. Likewise, a subdivision of an Indian tribal government is treated as a political subdivision of a state if that the subdivision has been delegated the right to exercise one or more of the substantial governmental functions of the Indian tribal government. However, a tribal government is not a “state” for purposes of Section 218 and is not eligible for a Section 218 Agreement.

**Interstate Instrumentality** - An independent legal entity organized by two or more states to carry out one or more governmental functions. For purposes of a Section 218 Agreement, an interstate instrumentality has the status of a state.

**IRC** - Internal Revenue Code.

**IRS** - Internal Revenue Service.

**Mandatory Exclusions** - Services that are not covered for social security under Sections 210 and 218 of the Social Security Act.

**Mandatory Medicare (HI)** – Medicare tax and coverage not included as part of a Section 218 Agreement; imposed on all state and local government employees hired or rehired after March 31, 1986.

**Mandatory Social Security** – Required social security coverage for state and local government employees who are not members of a public retirement system and who are not covered by a Section 218 Agreement; effective July 2, 1991.

**Medicare** – Health insurance program for people age 65 and older and certain people with disabilities. Part A (Hospital Insurance – HI) is financed through employer and employee taxes on covered wages/self-employment or by individual payment of monthly premiums. Part B (Supplemental Medical Insurance – SMI) is financed by individuals paying monthly premiums.

**Medicare Qualified Government Employment (MQGE)** – Services of state and local government employees subject to Medicare tax but not to social security tax.

**Modification** – An amendment to an original Section 218 Agreement to extend coverage to additional groups of employees or to implement changes in Federal and state laws. Each modification, like the original Agreement, is a legally binding document.

**MQGE** - Medicare Qualified Government Employment.

**NCSSSA (National Conference of State Social Security Administrators)** – Professional association of State Social Security Administrators, state officials authorized by state law to administer Section 218 Agreements with the Social Security Administration and responsible for all other activities associated with Federal and state laws addressing social security and Medicare coverage of state and local public employers.

**Non-Covered Employment** - Employment not covered by social security under the Social Security Act and the Internal Revenue Code.

**Nonproprietary Function** – Governmental (as opposed to activity in the nature of a private or commercial venture) function of a state or political subdivision, i.e., maintaining order or levying tax.

**Old-Age, Survivors and Disability Insurance Program (OASDI)** – Program administered by the Social Security Administration, providing monthly benefits to retired and disabled workers, their spouses and children, and to survivors of insured workers.

**Optional Exclusions** - Those employee services that Federal law gives states the option to include or exclude from coverage under a Section 218 Agreement.

**Parallel Social Security Office (PSSO)** - The SSA office, usually located in the state capital, responsible for day-to-day negotiations with the states on state and local coverage issues.

**Pension Plan** – A plan that provides systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. Retirement benefits are generally determined by factors such as an employee’s years of service, age, and compensation.

**Political Subdivision** – A separate legal entity of a state that has governmental powers and functions. A political subdivision ordinarily includes a county, city, town, village, school district and other similar governmental entities.

**Proprietary Function** - Function of a governmental entity, such as a business venture for profit or in competition with private industry, or other discretionary act on behalf of citizens, that by its nature is not an integral governmental activity.

**PSSO** - Parallel Social Security Office.

**Public Retirement System** - A pension, annuity, retirement, or similar fund or system established by a state or political subdivision for the purpose of providing retirement benefits to employees. For purposes of determining whether an employee is subject to mandatory social security and Medicare, a “retirement system” in which the employee participates must meet the tests under IRC section 3121(b)(7)(F) and section 31.3121(b)(7)-2(e) of the Employment Tax Regulations. For this purpose, it is irrelevant whether a public retirement system is a “qualified plan” within the meaning of the Employees’ Retirement Income Security Act of 1974 (ERISA).

**Qualified Participant** – An individual who is (or has been) an actual participant in a public retirement system and who has a total accrued benefit under the retirement system that meets the minimum retirement benefit requirements of IRC section 3121(b)(7) and regulations thereunder. Section 31.3121(b)(7)-2(d) of the Employment Tax Regulations establishes standards for defined contribution retirement systems. See [Rev. Proc. 91-40](#) in the Appendix, for safe-harbor formulas for defined benefit retirement systems.

**Retirement System** - See Public Retirement System.

**Retirement System Coverage Group** – A group of employees whose positions are covered under a retirement system by referendum under the provisions of Section 218(d). The retirement system does not need to meet the tests under IRC Section 3121(b)(7)(F) and Section 31.3121(b)(7)-2(e) of the Employment Tax Regulations to secure coverage under an Agreement.

**SECA** - Self Employment Contributions Act.

**Section 218 Agreement** - Voluntary agreement between a state and the Commissioner of Social Security (prior to March 31, 1995, the Secretary of Health and Human Services); allows states to voluntarily provide social security and Medicare or Medicare-only coverage for the services of state and local government employees. The Section 218 Agreements cover positions, not individuals; so that, if the position is covered under the agreement, then any employee filling that position is subject to FICA taxes.

**Self-Employment Contributions Act (SECA)** - Federal statute imposing social security and Medicare taxes on the net earnings of self-employed individuals.

**Social Security Act (Act)** - Federal statute providing Old-Age, Survivors and Disability Insurance (OASDI) and Hospital Insurance (Medicare), as well as other benefits.

**Social Security Administration (SSA)** - An independent agency in the executive branch of the Federal government responsible for administering the Old-Age, Survivors and Disability (OASDI) insurance program and for determining eligibility for Medicare benefits.

**Social Security Statement** – Annual statement issued to workers with information about their individual social security and Medicare earnings as reported by employers with estimates of the different types of benefits for which they and their family may qualify.

**Social Security Number (SSN)** - The identification number assigned by the Social Security Administration to individuals. It must always be used in reporting an individual's earnings and in correspondence regarding specific employees. Each individual's earnings record is maintained under this number.

**State** - For purposes of a Section 218 Agreement, one of the fifty states, Puerto Rico, the Virgin Islands and interstate instrumentalities. The term does not include the District of Columbia, Guam or American Samoa.

**State Social Security Administrator (SSSA)** - The principal state official authorized by state law to administer the Section 218 Agreement with the Social Security Administration and responsible for all other activities associated with applicable Federal and state laws addressing social security and Medicare by state and local public employers in the state.

**Taxpayer Identification Number (TIN)** - The number used to identify employee (SSN) or employer (EIN) for tax reporting purposes.

**Wage Base** - The maximum amount of wages of each worker that is subject to the OASDI portion of social security tax in any calendar year. The social security wage base is adjusted annually. There has been no wage base limit for Medicare since 1994.

**Wholly-Owned Instrumentality** - An entity created by or pursuant to state statute to carry on a governmental function of a state or political subdivision. It is an independent legal entity with the power to hire, supervise, and discharge its employees and, generally, it may sue and be sued, may enter into contracts, and may hold or transfer property in its own name. Normally a wholly-owned instrumentality of a state or political subdivision does not exercise governmental powers, i.e., the police power, the taxing power and the power of eminent domain. An instrumentality can also be created by a state and a political subdivision, by more than one political subdivision, or by more than one state. See “Interstate Instrumentality.”

**Windfall Elimination Provision (WEP)** - A social security benefit formula that may be applied to workers who receive both a social security retirement or disability benefit AND a pension based on work not covered under social security. The WEP benefit formula produces a lower social security retirement or disability insurance benefit.

# Appendix

The following pages contain important documents referred to in the text. Many other related documents may be found at the web sites [www.irs.gov](http://www.irs.gov) and [www.ssa.gov](http://www.ssa.gov).

## **VOLUNTARY AGREEMENTS FOR COVERAGE OF STATE AND LOCAL EMPLOYEES**

### ***Purpose of Agreement***

SEC. 218. [42 U.S.C. 418] (a)(1) The Commissioner of Social Security shall, at the request of any state, enter into an agreement with such state for the purpose of extending the insurance system established by this title to services performed by individuals as employees of such state or any political subdivision thereof. Each such agreement shall contain such provisions, not inconsistent with the provisions of this section, as the state may request.

(2) Notwithstanding section [210\(a\)](#), for the purposes of this title the term "employment" includes any service included under an agreement entered into under this section.

### ***Definitions***

(b) For the purposes of this section--

(1) The term "State" does not include the District of Columbia, Guam, or American Samoa.

(2) The term "political subdivision" includes an instrumentality of (A) a State, (B) one or more political subdivisions of a State, or (C) a State and one or more of its political subdivisions.

(3) The term "employee" includes an officer of a State or political subdivision.

(4) The term "retirement system" means a pension, annuity, retirement, or similar fund or system established by a State or by a political subdivision thereof.

(5) The term "coverage group" means (A) employees of the State other than those engaged in performing service in connection with a proprietary function; (B) employees of a political subdivision of a State other than those engaged in performing service in connection with a proprietary function; (C) employees of a State engaged in performing service in connection with a single proprietary function; or (D) employees of a political subdivision of a State engaged in performing service in connection with a single proprietary function. If under the preceding sentence an employee would be included in more than one coverage group by reason of the fact that he performs service in connection with two or more proprietary functions or in connection with both a proprietary function and a nonproprietary function, he shall be included in only one such coverage group. The determination of the coverage group in which such employee shall be included shall be made in such manner as may be specified in the agreement. Persons employed under section 709 of title 32, United States Code, who elected under section [6](#) of the National Guard Technicians Act of 1968 to remain covered by an employee retirement system of, or plan sponsored by, a State or the Commonwealth of Puerto Rico, shall, for the purposes of this Act, be employees of the State or the Commonwealth of Puerto Rico and (notwithstanding the preceding provisions of this paragraph), shall be deemed to be a separate coverage group. For purposes of this section, individuals employed pursuant to an agreement, entered into pursuant to section 205 of the Agricultural Marketing Act of 1946 (7 U.S.C. 1624) or section [14](#) of the Perishable Agricultural Commodities Act, 1930 (7 U.S.C. 499n), between a State and the United States Department of Agriculture to perform services as inspectors of agricultural products may be deemed, at the option of the State, to be employees of the State and (notwithstanding the preceding provisions of this paragraph) shall be deemed to be a separate coverage group.

### ***Services Covered***

(c)(1) An agreement under this section shall be applicable to any one or more coverage groups designated by the State.

(2) In the case of each coverage group to which the agreement applies, the agreement must include all services (other than services excluded by or pursuant to subsection (d) or paragraph (3), (5), or (6) of this subsection) performed by individuals as members of such group.



(3) Such agreement shall, if the State requests it, exclude (in the case of any coverage group) any one or more of the following:

(A) All services in any class or classes of (i) elective positions, (ii) part-time positions, or (iii) positions the compensation for which is on a fee basis;

(B) All services performed by individuals as members of a coverage group in positions covered by a retirement system on the date such agreement is made applicable to such coverage group, but only in the case of individuals who, on such date (or, if later, the date on which they first occupy such positions), are not eligible to become members of such system and whose services in such positions have not already been included under such agreement pursuant to subsection (d)(3).

(4) The Commissioner of Social Security shall, at the request of any State, modify the agreement with such State so as to (A) include any coverage group to which the agreement did not previously apply, or (B) include, in the case of any coverage group to which the agreement applies, services previously excluded from the agreement; but the agreement as so modified may not be inconsistent with the provisions of this section applicable in the case of an original agreement with a State. A modification of an agreement pursuant to clause (B) of the preceding sentence may apply to individuals to whom paragraph (3)(B) is applicable (whether or not the previous exclusion of the service of such individuals was pursuant to such paragraph), but only if such individuals are, on the effective date specified in such modification, ineligible to be members of any retirement system or if the modification with respect to such individuals is pursuant to subsection (d)(3).

(5) Such agreement shall, if the State requests it, exclude (in the case of any coverage group) any agricultural labor, or service performed by a student, designated by the State. This paragraph shall apply only with respect to service which is excluded from employment by any provision of section [210\(a\)](#) other than paragraph (7) of such section and service the remuneration for which is excluded from wages by subparagraph (B) of section [209\(a\)\(7\)](#).

(6) Such agreement shall exclude--

(A) service performed by an individual who is employed to relieve him from unemployment,

(B) service performed in a hospital, home, or other institution by a patient or inmate thereof,

(C) covered transportation service (as determined under section [210\(k\)](#)),

(D) service (other than agricultural labor or service performed by a student) which is excluded from employment by any provision of section [210\(a\)](#) other than paragraph (7) of such section,

(E) service performed by an individual as an employee serving on a temporary basis in case of fire, storm, snow, earthquake, flood, or other similar emergency, and

(F) service described in section [210\(a\)\(7\)\(F\)](#) which is included as "employment" under section [210\(a\)](#).

(7) No agreement may be made applicable (either in the original agreement or by any modification thereof) to service performed by any individual to whom paragraph (3)(B) is applicable unless such agreement provides (in the case of each coverage group involved) either that the service of any individual to whom such paragraph is applicable and who is a member of such coverage group shall continue to be covered by such agreement in case he thereafter becomes eligible to be a member of a retirement system, or that such service shall cease to be so covered when he becomes eligible to be a member of such a system (but only if the agreement is not already applicable to such system pursuant to subsection (d)(3)), whichever may be desired by the State.

(8)(A) Notwithstanding any other provision of this section, the agreement with any State entered into under this section may at the option of the State be modified at any time to exclude service performed by election officials or election workers if the remuneration

paid in a calendar year for such service is less than \$1,000 with respect to service performed during any calendar year commencing on or after January 1, 1995, ending on or before December 31, 1999, and the adjusted amount determined under subparagraph (B) for any calendar year commencing on or after January 1, 2000, with respect to service performed during such calendar year. Any modification of an agreement pursuant to this paragraph shall be effective with respect to services performed in and after the calendar year in which the modification is mailed or delivered by other means to the Commissioner of Social Security.

(B) For each year after 1999, the Commissioner of Social Security shall adjust the amount referred to in subparagraph (A) at the same time and in the same manner as is provided under section [215\(a\)\(1\)\(B\)\(ii\)](#) with respect to the amounts referred to in section [215\(a\)\(1\)\(B\)\(i\)](#), except that--

(i) for purposes of this subparagraph, 1997 shall be substituted for the calendar year referred to in section [215\(a\)\(1\)\(B\)\(ii\)\(II\)](#), and

(ii) such amount as so adjusted, if not a multiple of \$100, shall be rounded to the next higher multiple of \$100 where such amount is a multiple of \$50 and to the nearest multiple of \$100 in any other case.

The Commissioner of Social Security shall determine and publish in the Federal Register each adjusted amount determined under this subparagraph not later than November 1 preceding the year for which the adjustment is made.

#### ***Positions Covered By Retirement Systems***

(d)(1) No agreement with any State may be made applicable (either in the original agreement or by any modification thereof) to any service performed by employees as members of any coverage group in positions covered by a retirement system either (A) on the date such agreement is made applicable to such coverage group, or (B) on the date of enactment of the succeeding paragraph of this subsection (except in the case of positions which are, by reason of action by such State or political subdivision thereof, as may be appropriate, taken prior to the date of enactment of such succeeding paragraph, no longer covered by a retirement system on the date referred to in clause (A), and except in the case of positions excluded by paragraph (5)(A)). The preceding sentence shall not be applicable to any service performed by an employee as a member of any coverage group in a position (other than a position excluded by paragraph (5)(A)) covered by a retirement system on the date an agreement is made applicable to such coverage group if, on such date (or, if later, the date on which such individual first occupies such position), such individual is ineligible to be a member of such system.

(2) It is hereby declared to be the policy of the Congress in enacting the succeeding paragraphs of this subsection that the protection afforded employees in positions covered by a retirement system on the date an agreement under this section is made applicable to service performed in such positions, or receiving periodic benefits under such retirement system at such time, will not be impaired as a result of making the agreement so applicable or as a result of legislative enactment in anticipation thereof.

(3) Notwithstanding paragraph (1), an agreement with a State may be made applicable (either in the original agreement or by any modification thereof) to service performed by employees in positions covered by a retirement system (including positions specified in paragraph (4) but not including positions excluded by or pursuant to paragraph (5)), if the governor of the State, or an official of the State designated by him for the purpose,

certifies to the Commissioner of Social Security that the following conditions have been met:

- (A) A referendum by secret written ballot was held on the question of whether service in positions covered by such retirement system should be excluded from or included under an agreement under this section;
- (B) An opportunity to vote in such referendum was given (and was limited) to eligible employees;
- (C) Not less than ninety days' notice of such referendum was given to all such employees;
- (D) Such referendum was conducted under the supervision of the governor or an agency or individual designated by him; and
- (E) A majority of the eligible employees voted in favor of including service in such positions under an agreement under this section.

An employee shall be deemed an "eligible employee" for purposes of any referendum with respect to any retirement system if, at the time such referendum was held, he was in a position covered by such retirement system and was a member of such system, and if he was in such a position at the time notice of such referendum was given as required by clause (C) of the preceding sentence; except that he shall not be deemed an "eligible employee" if, at the time the referendum was held, he was in a position to which the State agreement already applied, or if he was in a position excluded by or pursuant to paragraph (5). No referendum with respect to a retirement system shall be valid for purposes of this paragraph unless held within the two-year period which ends on the date of execution of the agreement or modification which extends the insurance system established by this title to such retirement system, nor shall any referendum with respect to a retirement system be valid for purposes of this paragraph if held less than one year after the last previous referendum held with respect to such retirement system.

(4) For the purposes of subsection (c) of this section, the following employees shall be deemed to be a separate coverage group--

- (A) all employees in positions which were covered by the same retirement system on the date the agreement was made applicable to such system (other than employees to whose services the agreement already applied on such date);
- (B) all employees in positions which became covered by such system at any time after such date; and
- (C) all employees in positions which were covered by such system at any time before such date and to whose services the insurance system established by this title has not been extended before such date because the positions were covered by such retirement system (including employees to whose services the agreement was not applicable on such date because such services were excluded pursuant to subsection (c)(3)(B)).

(5)(A) Nothing in paragraph (3) of this subsection shall authorize the extension of the insurance system established by this title to service in any policeman's or fireman's position.

(B) At the request of the State, any class or classes of positions covered by a retirement system which may be excluded from the agreement pursuant to paragraph (3) or (5) of subsection (c), and to which the agreement does not already apply, may be excluded from the agreement at the time it is made applicable to such retirement system; except that, notwithstanding the provisions of paragraph (3)(B) of such subsection, such exclusion may not include any services to which such paragraph (3)(B) is applicable. In the case of any such exclusion, each such class so excluded shall, for purposes of this subsection, constitute a separate retirement system in case of any modification of the agreement thereafter agreed to.

(6)(A) If a retirement system covers positions of employees of the State and positions of employees of one or more political subdivisions of the State, or covers positions of

employees of two or more political subdivisions of the State, then, for purposes of the preceding paragraphs of this subsection, there shall, if the State so desires, be deemed to be a separate retirement system with respect to any one or more of the political subdivisions concerned and, where the retirement system covers positions of employees of the State, a separate retirement system with respect to the State or with respect to the State and any one or more of the political subdivisions concerned. Where a retirement system covering positions of employees of a State and positions of employees of one or more political subdivisions of the State, or covering positions of employees of two or more political subdivisions of the State, is not divided into separate retirement systems pursuant to the preceding sentence or pursuant to subparagraph (C), then the State may, for purposes of subsection (e) only, deem the system to be a separate retirement system with respect to any one or more of the political subdivisions concerned and, where the retirement system covers positions of employees of the State, a separate retirement system with respect to the State or with respect to the State and any one or more of the political subdivisions concerned.

(B) If a retirement system covers positions of employees of one or more institutions of higher learning, then, for purposes of such preceding paragraphs there shall, if the State so desires, be deemed to be a separate retirement system for the employees of each such institution of higher learning. For the purposes of this subparagraph, the term "institutions of higher learning" includes junior colleges and teachers colleges. If a retirement system covers positions of employees of a hospital, which is an integral part of a political subdivision, then, for purposes of the preceding paragraphs there shall, if the State so desires, be deemed to be a separate retirement system for the employees of such hospital.

(C) For the purposes of this subsection, any retirement system established by the State of Alaska, California, Connecticut, Florida, Georgia, Illinois, Massachusetts, Minnesota, Nevada, New Jersey, New Mexico, New York, North Dakota, Pennsylvania, Rhode Island, Tennessee, Texas, Vermont, Washington, Wisconsin, or Hawaii, or any political subdivision of any such State, which, on, before, or after the date of enactment of this subparagraph, is divided into two divisions or parts, one of which is composed of positions of members of such system who desire coverage under an agreement under this section and the other of which is composed of positions of members of such system who do not desire such coverage, shall, if the State so desires and if it is provided that there shall be included in such division or part composed of members desiring such coverage the positions of individuals who become members of such system after such coverage is extended, be deemed to be a separate retirement system with respect to each such division or part. If, in the case of a separate retirement system which is deemed to exist by reason of subparagraph (A) and which has been divided into two divisions or parts pursuant to the first sentence of this subparagraph, individuals become members of such system by reason of action taken by a political subdivision after coverage under an agreement under this section has been extended to the division or part thereof composed of positions of individuals who desire such coverage, the positions of such individuals who become members of such retirement system by reason of the action so taken shall be included in the division or part of such system composed of positions of members who do not desire such coverage if (i) such individuals, on the day before becoming such members, were in the division or part of another separate retirement system (deemed to exist by reason of subparagraph (A)) composed of positions of members of such system

who do not desire coverage under an agreement under this section, and (ii) all of the positions in the separate retirement system of which such individuals so become members and all of the positions in the separate retirement system referred to in clause (i) would have been covered by a single retirement system if the State had not taken action to provide for separate retirement systems under this paragraph.

(D)(i) The position of any individual which is covered by any retirement system to which subparagraph (C) is applicable shall, if such individual is ineligible to become a member of such system on August 1, 1956, or, if later, the day he first occupies such position, be deemed to be covered by the separate retirement system consisting of the positions of members of the division or part who do not desire coverage under the insurance system established under this title.

(ii) Notwithstanding clause (i), the State may, pursuant to subsection (c)(4)(B) and subject to the conditions of continuation or termination of coverage provided for in subsection (c)(7), modify its agreement under this section to include services performed by all individuals described in clause (i) other than those individuals to whose services the agreement already applies. Such individuals shall be deemed (on and after the effective date of the modification) to be in positions covered by the separate retirement system consisting of the positions of members of the division or part who desire coverage under the insurance system established under this title.

(E) An individual who is in a position covered by a retirement system to which subparagraph (C) is applicable and who is not a member of such system but is eligible to become a member thereof shall, for purposes of this subsection (other than paragraph (8)), be regarded as a member of such system; except that, in the case of any retirement system a division or part of which is covered under the agreement (either in the original agreement or by a modification thereof), which coverage is agreed to prior to 1960, the preceding provisions of this subparagraph shall apply only if the State so requests and any such individual referred to in such preceding provisions shall, if the State so requests, be treated, after division of the retirement system pursuant to such subparagraph (C), the same as individuals in positions referred to in subparagraph (F).

(F) In the case of any retirement system divided pursuant to subparagraph (C), the position of any member of the division or part composed of positions of members who do not desire coverage may be transferred to the separate retirement system composed of positions of members who desire such coverage if it is so provided in a modification of such agreement which is mailed, or delivered by other means, to the Commissioner of Social Security prior to 1970 or, if later, the expiration of two years after the date on which such agreement, or the modification thereof making the agreement applicable to such separate retirement system, as the case may be, is agreed to, but only if, prior to such modification or such later modification, as the case may be, the individual occupying such position files with the State a written request for such transfer.

Notwithstanding subsection (e)(1), any such modification or later modification, providing for the transfer of additional positions within a retirement system previously divided pursuant to subparagraph (C) to the separate retirement system composed of positions of members who desire coverage, shall be effective with respect to services performed after the same effective date as that which was specified in the case of such previous division.

(G) For the purposes of this subsection, in the case of any retirement system of the State of Florida, Georgia, Minnesota, North Dakota, Pennsylvania, Washington, or Hawaii

which covers positions of employees of such State who are compensated in whole or in part from grants made to such State under title III, there shall be deemed to be, if such State so desires, a separate retirement system with respect to any of the following:

- (i) the positions of such employees;
- (ii) the positions of all employees of such State covered by such retirement system who are employed in the department of such State in which the employees referred to in clause (i) are employed; or
- (iii) employees of such State covered by such retirement system who are employed in such department of such State in positions other than those referred to in clause (i).

(7) The certification by the governor (or an official of the State designated by him for the purpose) required under paragraph (3) shall be deemed to have been made, in the case of a division or part (created under subparagraph (C) of paragraph (6) or the corresponding provision of prior law) consisting of the positions of members of a retirement system who desire coverage under the agreement under this section, if the governor (or the official so designated) certifies to the Commissioner of Social Security that--

- (A) an opportunity to vote by written ballot on the question of whether they wish to be covered under an agreement under this section was given to all individuals who were members of such system at the time the vote was held;
- (B) not less than ninety days' notice of such vote was given to all individuals who were members of such system on the date the notice was issued;
- (C) the vote was conducted under the supervision of the governor or an agency or individual designated by him; and
- (D) such system was divided into two parts or divisions in accordance with the provisions of subparagraphs (C) and (D) of paragraph (6) or the corresponding provision of prior law.

For purposes of this paragraph, an individual in a position to which the State agreement already applied or in a position excluded by or pursuant to paragraph (5) shall not be considered a member of the retirement system.

(8)(A) Notwithstanding paragraph (1), if under the provisions of this subsection an agreement is, after December 31, 1958, made applicable to service performed in positions covered by a retirement system, service performed by an individual in a position covered by such a system may not be excluded from the agreement because such position is also covered under another retirement system.

(B) Subparagraph (A) shall not apply to service performed by an individual in a position covered under a retirement system if such individual, on the day the agreement is made applicable to service performed in positions covered by such retirement system, is not a member of such system and is a member of another system.

(C) If an agreement is made applicable, prior to 1959, to service in positions covered by any retirement system, the preceding provisions of this paragraph shall be applicable in the case of such system if the agreement is modified to so provide.

(D) Except in the case of State agreements modified as provided in subsection (1) and agreements with interstate instrumentalities, nothing in this paragraph shall authorize the application of an agreement to service in any policeman's or fireman's position.

#### ***Effective Date of Agreement***

(e)(1) Any agreement or modification of an agreement under this section shall be effective with respect to services performed after an effective date specified in such agreement or modification; except that such date may not be earlier than the last day of the sixth calendar year preceding the year in which such agreement or modification, as

the case may be, is mailed or delivered by other means to the Commissioner of Social Security.

(2) In the case of service performed by members of any coverage group--

(A) to which an agreement under this section is made applicable, and

(B) with respect to which the agreement, or modification thereof making the agreement so applicable, specifies an effective date earlier than the date of execution of such agreement and such modification, respectively,

the agreement shall, if so requested by the State, be applicable to such services (to the extent the agreement was not already applicable) performed before such date of execution and after such effective date by any individual as a member of such coverage group if he is such a member on a date, specified by the State, which is earlier than such date of execution, except that in no case may the date so specified be earlier than the date such agreement or such modification, as the case may be, is mailed, or delivered by other means, to the Commissioner of Social Security.

(3) Notwithstanding the provisions of paragraph (2) of this subsection, in the case of services performed by individuals as members of any coverage group to which an agreement under this section is made applicable, and with respect to which there were timely paid in good faith to the Secretary of the Treasury amounts equivalent to the sum of the taxes which would have been imposed by sections 3101 and 3111 of the Internal Revenue Code of 1986 had such services constituted employment for purposes of chapter 21 of such Code at the time they were performed, and with respect to which refunds were not obtained, such individuals may, if so requested by the State, be deemed to be members of such coverage group on the date designated pursuant to paragraph (2).

#### *Duration of Agreement*

(f) No agreement under this section may be terminated, either in its entirety or with respect to any coverage group, on or after the date of the enactment of the Social Security Amendments of 1983.

#### *Instrumentalities of Two or More States*

(g)(1) The Commissioner of Social Security may, at the request of any instrumentality of two or more States, enter into an agreement with such instrumentality for the purpose of extending the insurance system established by this title to services performed by individuals as employees of such instrumentality. Such agreement, to the extent practicable, shall be governed by the provisions of this section applicable in the case of an agreement with a State.

(2) In the case of any instrumentality of two or more States, if--

(A) employees of such instrumentality are in positions covered by a retirement system of such instrumentality or of any of such States or any of the political subdivisions thereof, and

(B) such retirement system is (on, before, or after the date of enactment of this paragraph) divided into two divisions or parts, one of which is composed of positions of members of such system who are employees of such instrumentality and who desire coverage under an agreement under this section and the other of which is composed of positions of members of such system who are employees of such instrumentality and who do not desire such coverage, and

(C) it is provided that there shall be included in such division or part composed of the positions of members desiring such coverage the positions of employees of such instrumentality who become members of such system after such coverage is extended,

then such retirement system shall, if such instrumentality so desires, be deemed to be a separate retirement system with respect to each such division or part. An individual who is in a position covered by a retirement system divided pursuant to the preceding sentence

and who is not a member of such system but is eligible to become a member thereof shall, for purposes of this subsection, be regarded as a member of such system. Coverage under the agreement of any such individual shall be provided under the same conditions, to the extent practicable, as are applicable in the case of the States to which the provisions of subsection (d)(6)(C) apply. The position of any employee of any such instrumentality which is covered by any retirement system to which the first sentence of this paragraph is applicable shall, if such individual is ineligible to become a member of such system on the date of enactment of this paragraph or, if later, the day he first occupies such position, be deemed to be covered by the separate retirement system consisting of the positions of members of the division or part who do not desire coverage under the insurance system established under this title. Services in positions covered by a separate retirement system created pursuant to this subsection (and consisting of the positions of members who desire coverage under an agreement under this section) shall be covered under such agreement on compliance, to the extent practicable, with the same conditions as are applicable to coverage under an agreement under this section of services in positions covered by a separate retirement system created pursuant to subparagraph (C) of subsection (d)(6) or the corresponding provision of prior law (and consisting of the positions of members who desire coverage under such agreement).

(3) Any agreement with any instrumentality of two or more States entered into pursuant to this Act may, notwithstanding the provisions of subsection (d)(5)(A) and the references thereto in subsections (d)(1) and (d)(3), apply to service performed by employees of such instrumentality in any policeman's or fireman's position covered by a retirement system, but only upon compliance, to the extent practicable, with the requirements of subsection (d)(3). For the purpose of the preceding sentence, a retirement system, which covers positions of policemen or firemen or both, and other positions, shall, if the instrumentality concerned so desires, be deemed to be a separate retirement system with respect to the positions of such policemen or firemen, or both, as the case may be.

#### ***Delegation of Functions***

(h) The Commissioner of Social Security is authorized, pursuant to agreement with the head of any Federal agency, to delegate any of the Commissioner's functions under this section to any officer or employee of such agency and otherwise to utilize the services and facilities of such agency in carrying out such functions, and payment therefore shall be in advance or by way of reimbursement, as may be provided in such agreement.

#### ***Wisconsin Retirement Fund***

(i)(1) Notwithstanding paragraph (1) of subsection (d), the agreement with the State of Wisconsin may, subject to the provisions of this subsection, be modified so as to apply to service performed by employees in positions covered by the Wisconsin retirement fund or any successor system.

(2) All employees in positions covered by the Wisconsin retirement fund at any time on or after January 1, 1951, shall, for the purposes of subsection (c) only, be deemed to be a separate coverage group; except that there shall be excluded from such separate coverage group all employees in positions to which the agreement applies without regard to this subsection.



(3) The modification pursuant to this subsection shall exclude (in the case of employees in the coverage group established by paragraph (2) of this subsection) service performed by any individual during any period before he is included under the Wisconsin retirement fund.

(4) The modification pursuant to this subsection shall, if the State of Wisconsin requests it, exclude (in the case of employees in the coverage group established by paragraph (2) of this subsection) all service performed in policemen's positions, all service performed in firemen's positions, or both.

***Certain Positions No Longer Covered By Retirement Systems***

(j) Notwithstanding subsection (d), an agreement with any State entered into under this section prior to the date of the enactment of this subsection may, prior to January 1, 1958, be modified pursuant to subsection (c)(4) so as to apply to services performed by employees, as members of any coverage group to which such agreement already applies (and to which such agreement applied on such date of enactment), in positions (1) to which such agreement does not already apply, (2) which were covered by a retirement system on the date such agreement was made applicable to such coverage group, and (3) which, by reason of action by such State or political subdivision thereof, as may be appropriate, taken prior to the date of the enactment of this subsection, are no longer covered by a retirement system on the date such agreement is made applicable to such services.

***Certain Employees of the State of Utah***

(k) Notwithstanding the provisions of subsection (d), the agreement with the State of Utah entered into pursuant to this section may be modified pursuant to subsection (c)(4) so as to apply to services performed for any of the following, the employees performing services for each of which shall constitute a separate coverage group: Weber Junior College, Carbon Junior College, Dixie Junior College, Central Utah Vocational School, Salt Lake Area Vocational School, Center for the Adult Blind, Union High School (Roosevelt, Utah), Utah High School Activities Association, State Industrial School, State Training School, State Board of Education, and Utah School Employees Retirement Board. Any modification agreed to prior to January 1, 1955, may be made effective with respect to services performed by employees as members of any of such coverage groups after an effective date specified therein, except that in no case may any such date be earlier than December 31, 1950. Coverage provided for in this subsection shall not be affected by a subsequent change in the name of a group.

***Policemen and Firemen in Certain States***

(l) Any agreement with a State entered into pursuant to this section may, notwithstanding the provisions of subsection (d)(5)(A) and the references thereto in subsections (d)(1) and (d)(3), be modified pursuant to subsection (c)(4) to apply to service performed by employees of such State or any political subdivision thereof in any policeman's or fireman's position covered by a retirement system in effect on or after the date of the enactment of this subsection, but only upon compliance with the requirements of subsection (d)(3). For the purposes of the preceding sentence, a retirement system which covers positions of policemen or firemen, or both, and other positions shall, if the State concerned so desires, be deemed to be a separate retirement system with respect to the positions of such policemen or firemen, or both, as the case may be.

*Positions Compensated Solely on a Fee Basis*

(m)(1) Notwithstanding any other provision in this section, an agreement entered into under this section may be made applicable to service performed after 1967 in any class or classes of positions compensated solely on a fee basis to which such agreement did not apply prior to 1968 only if the State specifically requests that its agreement be made applicable to such service in such class or classes of positions.

(2) Notwithstanding any other provision in this section, an agreement entered into under this section may be modified, at the option of the State, at any time after 1967, so as to exclude services performed in any class or classes of positions compensation for which is solely on a fee basis.

(3) Any modification made under this subsection shall be effective with respect to services performed after the last day of the calendar year in which the modification is mailed or delivered by other means to the Commissioner of Social Security.

(4) If any class or classes of positions have been excluded from coverage under the State agreement by a modification agreed to under this subsection, the Commissioner of Social Security and the State may not thereafter modify such agreement so as to again make the agreement applicable with respect to such class or classes of positions.

(n)(1) The Commissioner of Social Security shall, at the request of any State, enter into or modify an agreement with such State under this section for the purpose of extending the provisions of title XVIII, and sections 226 and 226A, to services performed by employees of such State or any political subdivision thereof who are described in paragraph (2).

(2) This subsection shall apply only with respect to employees--

(A) whose services are not treated as employment as that term applies under section [210\(p\)](#) by reason of paragraph (3) of such section; and

(B) who are not otherwise covered under the State's agreement under this section.

(3) For purposes of sections 226 and 226A of this Act, services covered under an agreement pursuant to this subsection shall be treated as "medicare qualified government employment".

(4) Except as otherwise provided in this subsection, the provisions of this section shall apply with respect to services covered under the agreement pursuant to this subsection.

## Amended Section 530 of the Revenue Act of 1978

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### *(a) Termination of Certain Employment Tax Liability.*

#### **(1) In general.**

- If -

**(A)** for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and

**(B)** in the case of periods after December 31, 1978, all federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee,

then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

#### **(2) Statutory standards providing one method of satisfying the requirements of paragraph (1).**

- For purposes of paragraph (1), a taxpayer shall in any case be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual for such period was in reasonable reliance on any of the following:

**(A)** judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

**(B)** a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or

**(C)** long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

**(3) Consistency required in the case of prior tax treatment.**

- Paragraph (1) shall not apply with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, if the taxpayer (or a predecessor) has treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for any period beginning after December 31, 1977.

**(4) Refund or credit of overpayment.**

- If refund or credit of any overpayment of an employment tax resulting from the application of paragraph (1) is not barred on the date of the enactment of this Act (Nov. 6, 1978) by any law or rule of law, the period for filing a claim for refund or credit of such overpayment (to the extent attributable to the application of paragraph (1)) shall not expire before the date 1 year after the date of the enactment of this Act (Nov. 6, 1978).

***(b) Prohibition Against Regulations and Rulings on Employment Status.***

- No regulation or Revenue Ruling shall be published on or after the date of the enactment of this Act (Nov. 6, 1978) and before the effective date of any law hereafter enacted clarifying the employment status of individuals for purposes of the employment taxes by the Department of the Treasury (including the Internal Revenue Service) with respect to the employment status of any individual for purposes of the employment taxes.

***(c) Definitions.***

- For purposes of this section -

**(1) Employment tax.** - The term 'employment tax' means any tax imposed by subtitle C of the Internal Revenue Code of 1986 (formerly I.R.C. 1954, section 3101 et seq. of this title).

**(2) Employment status.** - The term 'employment status' means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee).

***(d) Exception.***

- This section shall not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer

programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

***(e) Special Rules For Application of Section.***

**(1) NOTICE OF AVAILABILITY OF SECTION**

- An officer or employee of the Internal Revenue Service shall, before or at the commencement of any audit inquiry relating to the employment status of one or more individuals who perform services for the taxpayer, provide the taxpayer with a written notice of the provisions of this section.

**(2) RULES RELATING TO STATUTORY STANDARDS**

- For purposes of subsection (a)(2) -

**(A)** a taxpayer may not rely on an audit commenced after December 31, 1996, for purposes of subparagraph (B) thereof unless such audit included an examination for employment tax purposes of whether the individual involved (or any individual holding a position substantially similar to the position held by the individual involved) should be treated as an employee of the taxpayer,

**(B)** in no event shall the significant segment requirement of subparagraph (C) thereof be construed to require a reasonable showing of the practice of more than 25 percent of the industry (determined by not taking into account the taxpayer), and

**(C)** in applying the long-standing recognized practice requirement of subparagraph (C) thereof-

**(i)** such requirement shall not be construed as requiring the practice to have continued for more than 10 years, and

**(ii)** a practice shall not fail to be treated as long-standing merely because such practice began after 1978.

(3) AVAILABILITY OF SAFE HARBORS

- Nothing in this section shall be construed to provide that subsection (a) only applies where the individual involved is otherwise an employee of the taxpayer.

(4) BURDEN OF PROOF-

**(A) IN GENERAL**

- If-

(i) a taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee for purposes of this section, and

(ii) the taxpayer has fully cooperated with reasonable requests from the Secretary of the Treasury or his delegate,

then the burden of proof with respect to such treatment shall be on the Secretary.

**(B) EXCEPTION FOR OTHER REASONABLE BASIS**

- In the case of any issue involving whether the taxpayer had a reasonable basis not to treat an individual as an employee for purposes of this section, subparagraph (A) shall only apply for purposes of determining whether the taxpayer meets the requirements of subparagraph (A), (B), or (C) of subsection (a)(2).

(5) PRESERVATION OF PRIOR PERIOD SAFE HARBOR

- If -

(A) an individual would (but for the treatment referred to in subparagraph (B)) be deemed not to be an employee of the taxpayer under subsection (a) for any prior period, and

(B) such individual is treated by the taxpayer as an employee for employment tax purposes for any subsequent period,

then, for purposes of applying such taxes for such prior period with respect to the taxpayer, the individual shall be deemed not to be an employee.

(6) SUBSTANTIALLY SIMILAR POSITION

- For purposes of this section, the determination as to whether an individual holds a position substantially similar to a position held by another individual shall include consideration of the relationship between the taxpayer and such individuals.

## **Revenue Procedure 85-18**

### **SECTION 1. PURPOSE**

The purpose of this revenue procedure is to amplify and supersede Rev. Proc. 81-43, 1981-2 C.B. 616, which provides instructions for implementing the provisions of section 530 of the Revenue Act of 1978, 1978-3 (Vol. 1) C.B. xi, 119 (the Act), relating to the employment tax status of independent contractors and employees.

### **SEC. 2. BACKGROUND**

.01 Rev. Proc. 81-43 is superseded to reflect changes made to section 530 of the Act by section 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982, 1982-2 C.B. 462, 536, which extends the provisions of section 530 indefinitely.

Section 530(a)(1) of the Act, as amended, provides that if, for purposes of the employment taxes under subtitle C of the Internal Revenue Code, a taxpayer did not treat an individual as an employee for any period, then the individual will be deemed not to be an employee for that period, unless the taxpayer had no reasonable basis for not treating the individual as an employee. For any period after December 31, 1978, the relief applies only if (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee, and (2) the treatment is consistent with the treatment for periods beginning after December 31, 1977.

.02 A new section 3.02 titled "Filing of Returns" has been added stating that relief under section 530(a)(1) of the Act will not be granted if a Form 1099 has not been timely filed for each worker for any period after December 31, 1978.

.03 Section 3.05 (relating to refunds, credits, and abatement) is clarified to state that it does not apply to periods in which a taxpayer "treated" an individual as an employee.

### **SEC. 3. APPLICATION**

#### **.01 "Safe Haven" Rules**

There are several alternative standards that constitute "safe havens" in determining whether a taxpayer has a "reasonable basis" for not treating an individual as an employee. Reasonable reliance on any one of the following "safe havens" is sufficient:

(A) judicial precedent or published rulings, whether or not relating to the particular industry or business in which the taxpayer is engaged, or technical advice, a letter ruling, or a determination letter pertaining to the taxpayer; or

(B) a past Internal Revenue Service audit (not necessarily for employment tax purposes) of the taxpayer, if the audit entailed to assessment attributable to the taxpayer's employment tax treatment of individuals holding positions substantially similar to the position held by the individual whose status is at issue (a taxpayer does not meet this test if, in the conduct of a prior audit, an assessment attributable to the taxpayer's treatment of the individual was offset by other claims asserted by the taxpayer); or

(C) long-standing recognized practice of a significant segment of the industry in which the individual was engaged (the practice need not be uniform throughout an entire industry).

A taxpayer who fails to meet any of the three "safe havens" may nevertheless be entitled to relief if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the individual as an employee. In H.R. Rep. No. 95-1748, 95th



Cong., 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633, it is indicated that "reasonable basis" should be construed liberally in favor of the taxpayer.

#### .02 Filing of Returns.

For any period after December 31, 1978, the relief under section 530(a)(1) will not apply, even if the taxpayer has met the "safe haven" rules of paragraph 3.01 of this revenue procedure, if the appropriate Form 1099 has not been timely filed with respect to the workers involved. See Rev. Rul. 81-224, 1981-2 C.B. 197.

#### .03 Interpreting the Word "Treat"

In determining whether a taxpayer did not "treat" an individual as an employee for any period within the meaning of section 530(a)(1) of the Act, the following guidelines should be followed:

(A) The withholding of income tax or the Federal Insurance Contributions Act (FICA) tax from an individual's wages is "treatment" of the individual as an employee, whether or not the tax is paid over to the Government.

(B) Except as provided in paragraph (C) and (E) below, the filing of an employment tax return (including Forms 940 (Employer's Annual Federal Unemployment Tax Return), 941 (Employer's Quarterly Federal Tax Return), 942 (Employer's Quarterly Tax Return for Household Employees), 943 (Employer's Annual Tax Return for Agricultural Employees), and W-2 (Wage and Tax Statement)) for a period with respect to an individual, whether or not tax was withheld from the individual, is "treatment" of the individual as an employee for that period.

(C) The Filing of a delinquent or amended employment tax return for a particular tax period with respect to an individual as a result of Service compliance procedures is not "treatment" of the individual as an employee for that period. For this purpose, Collection or Examination activities constitute compliance procedures. For example, if the Service determines as a result of an audit that a taxpayer's workers are common law employees, that determination is not "treatment" of the workers as employees for the period under audit. However, if the taxpayer withholds employment taxes or files employment tax returns with respect to those workers for the periods following the period under audit, the action is "treatment" of the workers as employees for those later periods.

(D) Internal Revenue Service Center notices that merely advise the taxpayer that no return has been filed and request information from the taxpayer are not compliance procedures.

(E) A return prepared by the Service under section 6020(b) of the Code is not "treatment" of an individual as an employee; nor is the signing of an audit Form 2504 (Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment).

#### .04 Consistency in prior periods

The relief under section 530(a)(1) of the Act, as amended, does not apply to the employment tax treatment of any individual for any period ending after December 31, 1978, if the taxpayer (or a predecessor) treated any individual holding a substantially similar position as an employee for employment tax purposes for any period beginning after December 31, 1977. However, relief will not be denied under the consistency provision for any periods prior to the period in which the individuals were treated as employees. For example, a taxpayer did not treat an individual as an employee in 1978 and 1979. In 1980, the taxpayer began treating individuals holding substantially similar

positions as employees. This subsequent treatment does not prevent the taxpayer from receiving relief under section 530(a)(1) for 1978 and 1979. The application of the consistency rule prevents taxpayers from changing the way they treat workers solely to take advantage of the relief provisions. The application of this provision to predecessors is intended to prevent evasion of this rule, for example, by reincorporations.

#### .05 Refunds, Credits, and Abatements

Relief under section 530(a)(1) of the Act is available to taxpayers who are under audit by the Service or who are involved in administrative (including Appellate) or judicial processes with respect to assessments based on employment status reclassifications. Relief also is extended to any claim for a refund or credit of any overpayment of an employment tax resulting from the termination of liability under section 530(a)(1), provided the claim is not barred on the date of enactment of this provision (November 6, 1978) by any law or rule of law.

Taxpayers who have entered into final closing agreements under section 7121 of the Code or compromises under section 7122 with respect to employment status controversies are ineligible for relief under the Act, unless they have not completely paid their liability. Thus, for example, a taxpayer who has agreed to or compromised a liability for an amount which is to be paid in installments, but who still has one or more installments to pay, is relieved of liability for such outstanding installments. Taxpayers who settled employment status controversies administratively with the Service on any basis other than section 7121 or 7122 of the Code or who unsuccessfully litigated such cases also are eligible for relief, provided their claims are not barred by the statute of limitations or by the application of the doctrine of *res judicata*. However, unpaid judgments will be abated if section 530(a)(1) of the Act applies. Thus, an unsuccessful litigant in an employment status case who fulfills the Act's requirements can avoid collection of any unpaid employment tax liabilities, regardless of the doctrine of *res judicata*.

The application of the doctrine of *res judicata* will prevent a refund based on section 530(a)(1) of the Act if a taxpayer paid a judgment in an action relating to the same issue as to the same taxpayer. Thus, if the specific matter was judicially decided and the judgment paid, relief under section 530(a)(1) is not available.

This subsection will not apply to those periods in which a taxpayer "treated" an individual as an employee within the meaning of subsection .03 of this section.

#### .06 Handling of Claims

Relief under section 530(a)(1) of the Act applies to the taxes imposed on an employer by sections 3111 or 3301 of the Code. It also applies to an employer's liability under section 3102 and 3403 to withhold and pay the taxes imposed by sections 3101 and 3402. Therefore, an unpaid assessment of those taxes against an employer who qualifies for relief under section 530(a)(1) of the Act should be abated. Timely claims for refund of such taxes paid by a taxpayer who qualifies for relief will be honored.

#### .07 Interest and Penalties

If a taxpayer is relieved of liability under section 530(a)(1) of the Act, any liability for interest or penalties attributable to that liability is forgiven automatically. This relief from interest and penalties applies whether charged directly against the taxpayer or personally against a corporate taxpayer's officers.

#### .08 Status of Workers

Section 530 of the Act does not change in any way the status, liabilities, and rights of the worker whose status is at issue. Section 530(a)(1) terminates the liability of the employer for the employment taxes but has no effect on the workers. It does not convert individuals from the status of employee to the status of self-employed.

Section 31.3102-1(c) of the regulations provides, with respect to the collection and payment of the employee's share of the FICA tax, that "until collected from him [by [\*10] the employer] the employee is also liable for the employee tax with respect to all wages received by him." Therefore, if an employer's liability under section 3102 of the Code for the employee's share of the tax imposed by section 3101 is terminated under section 530(a)(1) of the Act, the employee remains liable for that tax. Employees who incorrectly paid the self-employment tax (section 1401 of the Code) may file a claim for refund; however, the amount of the self-employment tax refund will be offset by the amount of the employee's share of the tax imposed on the employee as a result of the application of section 31.3102-1(c) of the regulations.

#### .09 Definition of Employee

For purposes of section 530(a) of the Act, the term employee means employees under sections 3121(d), 3306(i), and 3401(c) of the Code.

#### SEC. 4.EFFECT ON OTHER DOCUMENTS

Rev. Proc. 81-43 is amplified and superseded.

**Internal Revenue Service  
Revenue Ruling 86-88**

**FICA; HOSPITAL INSURANCE; EXTENSION TO STATE AND POLITICAL  
SUBDIVISION EMPLOYEES**

This revenue ruling provides guidelines concerning the applicability of the Medicare tax to employees of states and political subdivisions.

For purposes of this revenue ruling, the term 'state' includes the Commonwealth of Puerto Rico, the Virgin Islands, and the District of Columbia.

For purposes of this revenue ruling, the term 'political subdivision' has the same meaning that it has under section 218(b)(2) of the Social Security Act, 42 U.S.C. section 418(b)(2). Thus, 'political subdivision' ordinarily includes a county, city, town, village, or school district. In many states, depending upon the manner in which such entities are created under state law, 'political subdivision' includes a sanitation, utility, reclamation, improvement, drainage, irrigation, flood control, or similar district.

For purposes of this revenue ruling, the term 'state employer' of a state includes the state and any agency or instrumentality of that state that is a separate employer for purposes of withholding, paying, and reporting the federal income taxes of employees. The term 'political subdivision employer' of a political subdivision includes the political subdivision and any agency or instrumentality of that political subdivision that is a separate employer for purposes of withholding, reporting, and paying the federal income taxes of employees.

**SERVICES SUBJECT TO THE MEDICARE TAX**

Q1. What services are subject to the Medicare tax under the Act?

A1. As a general rule, services performed for a state employer or political subdivision employer by an employee hired by the state employer or political

subdivision employer after March 31, 1986, are subject to the Medicare tax. The following services, however, are NOT subject to the Medicare tax even though the services are performed by an employee hired after March 31, 1986:

(1) services covered by an agreement between the state and the Secretary of Health and Human Services entered into pursuant to section 218 of the Social Security Act, 42 U.S.C. section 418 (218 agreement) providing for social security coverage including Medicare,

(2) services excluded from the definition of employment under any provision of section 3121(b) of the Code other than section 3121(b)(7),

(3) services performed by an individual who is employed by a state employer

(except for a District of Columbia employer) or a political subdivision employer to relieve the individual of unemployment,

(4) services performed in a hospital, home, or other institution by a patient or inmate thereof as an employee of a state employer or a political subdivision employer,

(5) services performed by an individual as an employee of a state employer or a political subdivision employer serving on a temporary basis in case of fire, storm, snow, earthquake, flood, or other similar emergency, or

(6) services performed by any individual as an employee included under section 5351(2) of title 5, United States Code (relating to certain interns, student nurses, and other student employees of the District of Columbia government), other than as a medical or dental intern or a medical or dental resident in training.

#### THE CONTINUING EMPLOYMENT EXCEPTION

Q2. If an employee was hired before April 1, 1986, by a state employer or a political subdivision employer and services are performed for the state employer or political subdivision employer by that employee after March 31,

1986, are those services subject to the Medicare tax?

A2. Services are not subject to the tax if they are performed after March 31,

1986, for a state employer or political subdivision employer by an employee who was hired by the state employer or the political subdivision employer before April 1, 1986, and if the employee meets the following requirements:

(i) the employee was performing regular and substantial services for remuneration for the state employer or political subdivision employer before April 1, 1986,

(ii) the employee was a bona fide employee of that employer on March 31, 1986,

(iii) the employment relationship with that employer was not entered into for purposes of avoiding the Medicare tax, and

(iv) the employment relationship of the employee with that employer has not been terminated after March 31, 1986 (other than as provided in the rules described in Q&A8 below, which concern employees who transfer from one state employer, or one political subdivision employer, to another).

Section 3121(u)(2)(C) of the Code.

For purposes of this revenue ruling, this exception to the Medicare tax is called the 'continuing employment exception.'

Q3. An employee signed an employment contract before April 1, 1986, but did not begin to perform services until after March 31, 1986. Does the employee qualify for the continuing employment exception?

A3. No. The employee does not qualify for the continuing employment exception because the employee was not performing regular and substantial services for remuneration before April 1, 1986. Section 3121(u)(2)(C)(ii)(I) of the Code.

Q4. Before April 1, 1986, an individual was performing services for remuneration as a substitute teacher on an 'as needed' basis for a state employer or a political subdivision employer, and the individual continued performing those services on that basis after March 31, 1986. Does the individual qualify for the continuing employment exception?

A4. No. The individual does not qualify for the continuing employment exception. Even though the services performed may have been substantial, the services were not regular because they were performed on an 'as needed' basis. Section 3121(u)(2)(C)(ii)(I) of the Code.

Q5. A was a state employee performing regular and substantial services for remuneration prior to April 1, 1986. A's employment relationship with the state employer was terminated after March 31, 1986. but A was later rehired by the state employer. Does the continuing employment exception apply to A?

A5. No. Section 3121(u)(2)(C)(iii) of the Code.

Q6. How is termination of employment defined for purposes of determining whether the Medicare tax is applicable?

A6. The question of whether an employment relationship has terminated is a question of fact that must be determined on the basis of all the relevant facts and circumstances. Great weight, however, will be given to the personnel rules of the state employer or political subdivision employer to determine whether an employment relationship has been terminated.

Q7. An employee who was hired before April 1, 1986, by a state employer transferred after March 31, 1986, to another state employer of that state. The transfer was made without a termination of the employee's overall employment relationship with that state. Does the employee qualify for the continuing employment exception?

A7. Yes. An employee hired before April 1, 1986, by a state employer who transfers after March 31, 1986, to another state employer of that state may qualify for the continuing employment exception, provided the transfer was made without a termination of the employee's overall employment relationship with that state. The same rule applies to an employee hired before April 1, 1986, by a political subdivision employer, who transfers after March 31, 1986, to another political subdivision employer of that political subdivision.

On the other hand, 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 state employer to a political subdivision employer or from a political subdivision employer to a state employer. Likewise, an employee does not qualify for the exception if the employee transfers from a political subdivision employer in one political subdivision to a political subdivision employer in a different political subdivision, or from a state

employer in one state to a state employer in a different state. Section 3121(u)(2)(D) of the Code.

Different rules, however, control whether a transfer affects an employee's status for purposes of the Medicare tax wage base. In the case of an employee who is subject to the Medicare tax, even if the employee transfers from one state employer to another state employer of that state or from one political subdivision employer to another political subdivision employer of that political subdivision, a new Medicare tax wage base applies to wages received from the second employer. Thus, the rules that determine whether there is a new Medicare tax wage base are the same as those applicable to employees of private employers.

#### SERVICES EXCLUDED FROM EMPLOYMENT

Q8. What services are excluded from the definition of employment?

A8. See sections 3121(b)(1)-(6), (8)-(20) of the Code for a list of services that are excluded from the definition of employment for purposes of the social security taxes, including the Medicare portion of the taxes.

Q9. A 218 agreement may contain terms optionally excluding from social security coverage certain types of employment. 42 U.S.C. section 418(c)(3). If employment is optionally excluded from coverage under the terms of a 218 agreement, is that employment subject to the Medicare tax if services are performed by an individual otherwise subject to the Medicare tax under the rules of Q&A1 and Q&A2?

A9. Yes. The optionally excluded services are subject to the Medicare tax if they are performed by an individual otherwise subject to the tax under the rules of Q&A1 and Q&A2 above.

Q10. A student is hired by a school, college, or university after March 31, 1986, to perform services for the school, college, or university. The student is in a group optionally excluded from coverage under the terms of an applicable 218 agreement. Are the services performed by the student subject to the Medicare tax?

A10. Services performed by a student employed by a school, college, or university are not subject to the Medicare tax if the student is enrolled and regularly attending classes at the school, college, or university. Section

3121(b)(10) of the Code. Services of a student that are subject to contributions under a 218 agreement continue to be subject to such contributions.

#### DEFINITION OF WAGES

Q11. Is the definition of wages for Medicare tax purposes the same as the definition of wages for making social security contributions under 218 agreements?

A11. No, not in all cases. The term 'wages' for purposes of paying Medicare tax is defined by section 3121(a) of the Code. The term 'wages' for purposes of making

contributions under a 218 agreement is defined by section 209 of the Social Security Act. 42 U.S.C. section 409. Questions concerning the definition of wages (and employment) for purposes of paying Medicare tax should be directed to the Service. Questions concerning the definition of wages (and employment) for purposes of making 218 contributions should be directed to the Social Security Administration (SSA).

#### RULES FOR REPORTING AND PAYMENT OF MEDICARE TAX

Q12. Is the Medicare tax reported and paid to the Internal Revenue Service or to the SSA?

A12. The Medicare tax is reported and paid to the Service (1) by a state employer of a state if on April 7, 1986, NO employee of any state employer of that state was covered under a 218 agreement, and (2) by a political subdivision employer of a political subdivision if on April 7, 1986, NO employee of any political subdivision employer of that political subdivision was covered under a 218 agreement.

The Medicare tax is reported to the State Social Security Administrator (1) by a state employer of a state if on April 7, 1986, ANY employee of any state employer of that state was covered under a 218 agreement, and (2) by a political subdivision employer of a political subdivision if on April 7, 1986, ANY employee of any political subdivision employer of that political subdivision was covered under a 218 agreement.

Q13. A 218 agreement was in effect with state X on or before April 7, 1986. The agreement provided for coverage of employees of a political subdivision employer of political subdivision A but not for coverage of any employee of any political subdivision employer of political subdivision B. After April 7, 1986, a modification of the 218 agreement was executed providing for coverage of some, but not all, employees of a political subdivision employer of political subdivision B. The effective date of the new coverage was April 1, 1986. When that political subdivision employer of political subdivision B reports and pays the Medicare tax on wages for services performed by those of its employees who are not subject to the modification, is the tax reported and paid to the State Social Security Administrator or to the Internal Revenue Service?

A13. The tax is reported and paid to the Internal Revenue Service. Modifying a 218 agreement after April 7, 1986, to extend coverage on a retroactive basis does not change the agency to which the employer must report and pay the Medicare tax for services performed by employees who are subject to the Medicare tax.

Q14. How is the Medicare tax reported and paid to the Internal Revenue Service?

A14. Taxable wages must be reported on line 6 of Form 941E, Quarterly Return of Withheld Federal Income Tax and Hospital Insurance (Medicare) Tax. The reporting, depositing, and paying of the Medicare tax are subject to the same rules applicable to private employers. These rules are similar to those applicable to income tax withholding.

Q15. How is the Medicare tax reported and paid to the SSA?



A15. The Medicare tax is reported and paid to the SSA just as contributions under a 218 agreement are reported and paid to the SSA.

Q16. Will all penalties for failure to pay the Medicare tax and failure to make timely deposits of that tax be assessed against state and political subdivision employers?

A16. The Service will waive penalties for failure to pay and for failure to make timely deposits of the Medicare tax with respect to services performed through the fourth quarter of 1986, so long as all payments due for April through December of 1986 are paid by February 2, 1987. If all payments due for April through December 1986 are not paid by February 2, 1987, this automatic waiver of penalties is not applicable, even with respect to amounts paid by February 2, 1987. Penalties may be waived, however, if the employer shows reasonable cause for failure to pay and failure to make timely deposits of the tax. See sections 6651 and 6656 of the Code. A state employer or political subdivision employer should not report any Medicare tax wages on line 6 of Form

941E for the second or third quarter unless appropriate deposits and/or payments are made for that quarter.

Q17. If a state employer or a political subdivision employer has federal employees on the state or political subdivision payroll, how should that employer report the full social security tax or the Medicare portion of the social security tax, whichever is applicable?

A17. The state employer or political subdivision employer should use Form 941E to report the full social security taxes and or the Medicare portion of the taxes. For those federal employees subject to the FULL social security taxes, the tax must be included with the withheld federal income tax on line 3 of Form 941E, with an attached supporting statement showing the amount of wages subject to the social security taxes, the amount of the taxes withheld, and the employer's share of the taxes. For those federal employees subject ONLY to the Medicare portion of the social security taxes, the Medicare tax must be reported on line 6 of Form 941E.

Q18. If a state employer or a political subdivision employer must report and pay the Medicare tax to the Service as explained in Q&A12, how should the employer transmit Copy A of Forms W-2 for newly hired employees who are subject to the Medicare tax?

A18. For newly hired employees subject to the Medicare tax. the employer should transmit Copy A of Forms W-2 with a Form W-3, Transmittal of Income and Tax Statements, and should check the 'Medicare Fed. emp.' checkbox in Box 2 on the Form W-3. This checkbox will be changed to 'Medicare government employee' on the 1987 Form W-3 to reflect the extension of the Medicare tax to state and political subdivision employees. For employees not subject to the Medicare tax, the employers should follow the current practice of transmitting Copy A of Forms W-2 with a Form W-3, checking the '941/941r' checkbox in Box 2 on the Form W-3.

Q19. If a state employer or a political subdivision employer must report and pay the Medicare tax to the State Social Security Administrator as explained in Q&A12, how

should the employer transmit Copy A of Forms W-2 for newly hired employees subject to the Medicare tax?

A19. For newly hired employees subject to the Medicare tax, the employer should transmit Copy A of Forms W-2 with a Form W-3 S&L, Transmittal of Income and Tax Statements for State and Local Governmental Employers, and should check the 'Medicare Government Employee' checkbox on the Form W-3 S&L IN ADDITION TO the 'Section 218' checkbox. For those employees covered under a 218 agreement, the state employer or the political subdivision employer should follow the current practice of transmitting the Forms W-2 with a Form W-3 S&L, checking the 'Section 218' checkbox in Box 2 on the Form W- 3 S&L. If the employer also has employees who are not covered under the 218 agreement and who were hired before April 1, 1986, then for those employees, the employer should transmit Forms W-2 with a Form W-3 and should check the ' 941/941u ' box on the Form W-3.

**Revenue Ruling 88-36**

**FICA, HOSPITAL INSURANCE; STATE AND POLITICAL SUBDIVISION EMPLOYEES**

**SECTION 3121. - DEFINITIONS**

FICA, hospital insurance; state and political subdivision employees. Guidance is provided, in question and answer form, concerning the application of the hospital insurance (medicare) tax portion of the Federal Insurance Contributions Act (FICA) by section 3121(u) of the Code, to wages for services performed by state and political subdivision employees hired after March 31, 1986. Rev. Rul. 86-88 supplemented.

The Service has issued Rev. Rul. 88-36, supplementing Rev. Rul. 86-88, 1986-2 C.B. 172, in question and answer format, which provides guidelines concerning the 1985 amendment to section 3121(u), which extended Medicare (the hospital portion of FICA) to wages for services rendered by state and political subdivision employees hired after March 31, 1986. The ruling addresses such areas as the types of services which are subject to the medicare tax and the continuing employment exception. In general, an individual, who was employed by a state or political subdivision before March 31, 1986 and who was performing regular and substantial services for remuneration, will not be subject to the tax on services performed after that date. This rule applies only if the employment was not terminated after April 1.

This revenue ruling supplements Rev. Rul. 86-88, 1986-2 C.B. 172, which provides guidelines, in question and answer form, concerning the 1985 amendment of section 3121(u) of the Internal Revenue Code. In general, the amendment extends the hospital insurance (medicare) tax portion of the Federal Insurance Contributions Act (FICA) to wages for services rendered by state and political subdivision employees hired after March 31, 1986.

In this revenue ruling, the terms 'state,' 'political subdivision,' 'state employer,' 'political subdivision employer,' and 'continuing employment exception' have the same meanings as in Rev. Rul. 86-88.

**SERVICES SUBJECT TO THE MEDICARE TAX**

Q1. If an individual receiving social security retirement insurance benefits was hired as an employee of a state or political subdivision after March 31, 1986, are the services performed by the individual for the state or political subdivision subject to the medicare tax?

A1. Yes. The fact that an employee is receiving social security retirement insurance benefits does not affect the employee's liability for the medicare tax.

Q2. Are services performed by an election official or election worker for a state employer or political subdivision employer subject to the medicare tax?

A2. Yes, unless the remuneration paid in a calendar year for such service is less than \$100. Section 3121(u)(2)(B)(ii)(V) of the Code, added by section 1895(b)(18)(A) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 852. This amendment is effective for services rendered after March 31, 1986.

Q3. A township has a small number of regularly employed fire fighters. To assist these fire fighters, certain residents of the township have volunteered their services in cases of emergency. The township alerts these residents to emergencies by sounding a siren. The township keeps a record of the residents who respond to the emergency calls and periodically pays each such resident a nominal amount for each emergency for which the resident performed services. Are the payments made to the residents by the township subject to the medicare tax?

A3. No. The services are considered to be performed by an employee of a state or political subdivision on a temporary basis in case of fire, storm, snow, earthquake, flood, or other similar emergency and thus are not subject to the medicare tax. See Section 3121(u)(2)(B)(ii)(III) of the Code.

#### THE CONTINUING EMPLOYMENT EXCEPTION

Q4. An individual was hired in September 1984 as a part-time cook by a state hospital to perform two hours of paid service each Sunday preparing the evening meal. The individual is not a patient or inmate of the hospital and has worked two hours each week as an employee of the hospital continuously since September 1984. Are the individual's services performed after March 31, 1986, subject to the medicare tax?

A4. No. The continuing employment exception applies here if the individual was performing regular and substantial services for remuneration for the state employer or political subdivision employer before April 1, 1986. Whether this requirement is met is a question of fact. On these facts, the individual's services are determined to be regular and substantial, and the exception applies.

Q5. In November 1982, an individual was elected to a state public office for a four-year term beginning in January 1983, making the individual an employee of the state. In November 1986, the individual was re-elected. Are the individual's services performed in the second term that begins in January 1987 subject to the medicare tax?

A5. No. The continuing employment exception applies here if the employment relationship has not been terminated after March 31, 1986. The individual was re-elected before the first term expired, so there was no break in the employment relationship.

Q6. B, a school district employee, performed regular and substantial services for remuneration for a political subdivision employer during the school year beginning in September 1985 and ending in May 1986. In May 1986, the school district notified B that B's employment would be terminated as of the end of May 1986 because the school district might not receive sufficient funding. B continued to be covered under the school district's health insurance program through August 1986 on the same basis as before May

1986. Sufficient funding was provided, and in September 1986 B began working on the same basis as before. Are B's services performed after August 31, 1986, subject to the medicare tax?

A6. No. In fact, B's employment with the school district was continuous because the school district received sufficient funding. The school district's personnel policies indicate that the employment relationship continued because B retained health insurance coverage. See Q&A6 of Rev. Rul. 86-88.

Q7. C, a professor at a state university, performed regular and substantial services for remuneration for the university from September 1985 to June 1986. C was granted a leave of absence for the 1986-1987 school year, with the right to return to the same position at the end of the leave. In September 1987, C returned from the leave and resumed the same position with the university. Are C's services performed after returning from the leave of absence subject to the medicare tax?

A7. No. The leave of absence was granted by the university and did not terminate the employment relationship. The university's personnel policies indicate that the employment relationship continued because C was given the right to return to the same position. See Q&A6 of Rev. Rul. 86-88.

Q8. D taught a two-hour photography course twice a week at a local community college in the spring semester, which began on March 1, 1986. D then signed a three-year agreement with the college that he would teach the same course every spring. When D returned in the spring of 1987, were his services subject to the medicare tax?

A8. No. D was performing regular and substantial services for remuneration prior to April 1, 1986. The employment relationship was not terminated, as D had a commitment to return to the same position each spring.

Q9. Each summer, a Township Parks Department advertises for workers to cut grass. E was hired by the township in May 1985 to cut grass during that summer. E stopped performing services for the township at the end of that summer. In May 1986, E was again hired by the township to cut grass. Are E's services performed when E returned in May 1986 subject to the medicare tax?

A9. Yes. E's employment relationship was terminated after April 1, 1986, as E had no commitment to perform services for the township each summer.

Q10. A part-time police officer has been paid on a weekly basis since March 10, 1986, to be 'on call' for a set schedule of hours each week. When the officer is 'on call,' he must stay at his residence and be available to provide assistance in the case of an emergency or to handle any police business that may arise. Are the services performed by the officer after April 1, 1986 subject to the medicare tax?

A10. No. Although the officer responds to calls on an 'as needed' basis, he has a set schedule of hours during which he is performing the service of being available to respond to such calls. Based on the above facts, the officer was performing regular and substantial

services for remuneration prior to April 1, 1986 and thus, qualifies for the continuing employment exception to the medicare tax.

## **Revenue Procedure 91-40**

### **SECTION 1. PURPOSE**

This revenue procedure sets forth rules relating to the minimum retirement benefit requirement prescribed under section 31.3121(b)(7)-2 of the Employment Tax Regulations.

### **SECTION 2. BACKGROUND**

Section 3121(b)(7)(F), added to the Internal Revenue Code by section 11332(b) of the Omnibus Budget

Reconciliation Act of 1990, Public Law No. 101-508, 104 Stat. 1388, generally expands the definition of employment, for purposes of the Federal Insurance Contributions Act (FICA), to include service as an employee for a state or local government entity unless the employee is a "member of a retirement system" of such entity. Section 3121(b)(7)(F) is effective with respect to service performed after July 1, 1991. Thus, wages for services performed after July 1, 1991, received by an employee of a state or local government entity who is not a member of a retirement system of such entity will generally be subject to FICA taxes, and will also be taken into account in determining the employee's eligibility for Social Security and Medicare benefits. Under section 31.3121(b)(7)-2(e) of the regulations, a retirement system generally includes any pension, annuity, retirement or similar fund or system within the meaning of section 218 of the Social Security Act that is maintained by a state, political subdivision or instrumentality thereof to provide retirement benefits to its employees who are participants. However, the definition of retirement system is limited in order to carry out the purposes of section 3121(b)(7)(F) of the Code and the corresponding provisions of the Social Security Act. Under the regulations, in order for service in the employ of a state or local government entity to qualify for the exception from employment under section 3121(b)(7), the employee must be a member of a retirement system that provides certain minimum retirement benefits to that employee. To meet this minimum retirement benefit requirement with respect to an employee, section 31.3121(b)(7)-2(e)(2)(i) of the regulations generally requires that a retirement system provide benefits to the employee that are comparable to those provided in the Old-Age portion of the Old-Age, Survivor, Disability Insurance program under Social Security. Section 31.3121(b)(7)-2(e)(2)(vi) of the regulations provides that the Commissioner may, through guidance of general applicability, promulgate additional testing methods to determine whether, a retirement system meets the minimum retirement benefit requirement. This revenue procedure is an exercise of this authority. It outlines a set of safe harbor formulas for defined benefit retirement systems. Benefits calculated under one of these formulas are deemed to meet the minimum retirement benefit requirement. In addition, procedures are set out by which an employer may determine whether retirement benefits calculated under other formulas meet the minimum retirement benefit requirement of the regulations with respect to an employee.

## SECTION 3. DEFINED BENEFIT RETIREMENT SYSTEM SAFE HARBOR FORMULAS

### .01 Final and highest average pay formulas.

- (1) Periods of 36 months or less. A defined benefit retirement system that calculates benefits by reference to a participant's average compensation meets the minimum retirement benefit requirement with respect to an employee if it makes available to the employee a single life annuity payable beginning no later than age 65 that is at least 1.5 percent of average compensation for each year (or fraction thereof) of credited service. For this purpose, average compensation may be defined as the average of the employee's compensation over the 36 (or fewer) consecutive or non-consecutive months that provides the highest such average, the average of the employee's compensation for his or her last 36 (or fewer) months of service with the employer, or the average of the employee's compensation for his or her high consecutive or nonconsecutive or final 3 (or fewer) calendar or plan years of service.
- (2) Periods of more than 36 months. A defined benefit retirement system that calculates benefits by reference to a participant's average compensation over a period of more than 36 months meets the minimum benefit requirement in the same manner as a retirement system described in section 3.01(l) except that the 1.5 percent factor is replaced with a higher factor in accordance with the following table:

Averaging period	Factor
37-48 months	1.55 percent
49-60 months	1.60 percent
61-120 months	1.75 percent
Over 120 months	2.00 percent

### .02 Formulas using fractional accrual rule.

A defined benefit retirement system that calculates benefits based on a pro rata accrual towards a projected normal retirement benefit may meet the minimum retirement benefit requirement in the same manner as provided in section 3.01(l) provided the projected normal retirement benefit under the plan formula is greater than or equal to the benefit described in such section.

### .03 Additional requirements for defined benefit plan formulas to meet safe harbors.

#### (1) Calculation of compensation.

(a) To meet the requirements of any of the defined benefit safe harbor formulas for plan years beginning after July 1, 1991, a retirement system must calculate benefits based on a definition of compensation that meets the requirements of section 31.3121(b)(7)-

2(e)(2)(iii)(B) of the regulations.

(b) In the event that the definition of compensation under the retirement system is less inclusive than the definition otherwise permitted under this section, the applicable benefit percentage in the safe harbor formula of section 3.01 must be increased to account for the lower compensation base. The benefit percentage for employees in a retirement system whose benefits are computed using this definition must be multiplied by the ratio of (i) aggregate compensation (defined as under section 3.03(l)(a) and assuming that compensation considered in determining retirement benefits is limited to the contribution

base described in section 3121(x)(1)) of these employees to (ii) aggregate compensation (as defined under the plan) of these employees. This ratio may be determined based upon the compensation during the immediately preceding plan year. In the case of a retirement system sponsored by more than one employer, this ratio must be calculated separately with respect to the employees of each employer whose benefits are computed using this definition. The rule in this section 3.03(l)(b) is illustrated by the following example: Example. A defined benefit retirement system maintained by a political subdivision provides a retirement benefit equal to 2.5 percent of a participant's average compensation during his or her last calendar year of service. The compensation used for this purpose satisfies section 3.03(l)(a), except that it caps the compensation taken into account at \$30,000. Assume that the ratio under section 3.03(t)(b) is 150 percent. This figure is derived by comparing the total compensation of employees in the plan (using the plan definition but capping compensation at the FICA contribution base (rather than at \$30,000)) to the total compensation (using only the plan definition of compensation) of employees in the plan. The retirement system meets the requirements of 3.03(l) because the plan benefit percentage of 2.5 percent is more than 150 percent of the applicable safe harbor benefit percentage of 1.5 percent.

(2) Credited service.

(a) In order to meet the requirements of any of the defined benefit safe harbor formulas, a formula must generally include in credited service the employee's entire period of actual service with the employer since commencing participation in the retirement system, plus any past service credited under the retirement system. A formula may, however, exclude any periods of actual service for the employer that are treated as employment under section 3121(b) of the Code, provided that during such periods the employee did not participate in the retirement system. A retirement system subject to paragraph (f)(2)(i)(B) of section 31.3121(b)(7)-2 of the regulations (relating to the treatment of benefits accrued in plan years beginning prior to January 1, 1993) may also limit service consistent with the rules contained in that paragraph.

(b) A formula may limit the maximum period of service that is credited for accrual purposes under this rule. If this limit is less than 30 years in the case of formulas described in section 3.01(l) or (2), or 35 years in the case of formulas described in section 3.02, however, the benefit formula must be increased by the ratio of 30 (or 35) years to such lower limit.

(c) Except as provided in section 3.03(4) with respect to part-time and other classes of employees, a formula may limit the periods of actual service actually credited for accrual purposes under this rule to whole years or similar periods, provided the periods are reasonable.

(d) The rules in this subsection are illustrated by the following example:

Example. In 1995, an employee is a participant in a retirement system with 5 years of credited service. Assume that the retirement system provides benefits under a formula described in section 3.01. In January 1996, the employee moves to a position that is not covered by the retirement system. Assume that service in the new position constitutes covered employment under section 3121(b) of the Code for purposes of the FICA (e.g., because a section 218 voluntary agreement is in effect with regard to such position). In January 1998, the employee returns to the old position and recommences participation



under the retirement system. The employee must be treated as being in the employee's sixth year of credited service in determining whether the benefit under the retirement system meets the minimum retirement benefit requirement. This is because the retirement system may generally disregard the service of an employee that constitutes employment under section 3121(b) for purposes of the FICA.

(3) Treatment of prior distributions from the retirement system.

In determining whether the requirements of any of the defined benefit safe harbor formulas are met, prior distributions may continue to be considered as part of the benefit accrued under the retirement system unless they were distributed by the employer without any election by the employee. In addition, if a retirement system gives a former employee credit for benefit determination purposes for periods of prior service with respect to which a prior distribution was made only if the employee contributes to the system an amount equal to all or a portion of the prior distribution (with or without interest), and this option is provided on reasonable terms, such prior service is not required to be taken into account in determining whether the requirements of any of the defined benefit safe harbors are met until the required contribution is actually made. If prior service is not taken into account under this rule, the prior distribution may not be taken into account either. The rules of this paragraph is illustrated by the following example:

Example. An employee retires under the early retirement option under a retirement system maintained by a state government. The employee elects to receive a single sum distribution representing the entire accrued benefit under the plan. Subsequently, the employee is rehired by the same employer. The plan does not provide for any recontribution of the prior distribution. Whether the employee is a member of the retirement system from which the employee received the distribution is determined without regard to the single sum distribution. That is, a single life annuity that is the actuarial equivalent of the single sum may be treated as part of the accrued benefit under the plan. Similarly, all periods of service credited under the plan during the employee's previous service must be considered.

(4) Credited service for part-time, seasonal, and temporary employees.

To meet the requirements of any of the defined benefit safe harbor formulas with respect to a part-time, seasonal or temporary employee for plan years beginning after December 31, 1992, a safe harbor formula may not permit double proration of the employee's benefits under the retirement system. See 29 CFR §2530.204-2(d) for a description of double proration of benefit accruals. Under this rule, the benefit under the retirement system may be prorated either on the basis of full-time service or on the basis of full-time compensation, but may not be prorated based on both service and compensation. In addition, a safe harbor formula may not subject the crediting of service used in calculating the benefit of any part-time, seasonal or temporary employee to any conditions, such as a requirement that the employee attain a minimum age, perform a minimum period of service, be credited with a minimum number of hours of service, make an election in order to participate, or be present at the end of the plan year. The requirements of this section 3.03(4) will be deemed met with respect to an employee, however, if the requirements of section 31.3121(b)(7)-2(d)(2)(ii) of the regulations relating to amounts distributable upon certain events are met with respect to such employee. See section 31.3121(b)(7)-2(d)(2)(iii) of the regulations for the definitions of part-time, seasonal, and temporary employee for this purpose.

.04 Examples of application of safe harbor formulas.

The application of the defined benefit safe harbors are illustrated in the following examples:

Example 1. An employee has been a participant in a state retirement system for 9 years and several months at the beginning of a plan year of the system. The employee has only 9 years of credited service under the system at the beginning of the plan year, however, because the retirement system calculates service for accrual purposes on the basis of whole years of actual service. Under the retirement system, each participant is credited with a retirement benefit based upon the participant's highest average compensation over 36 consecutive months times his or her years of service (as so determined). Assume the retirement system imposes no other conditions on the accrual of benefits and meets the service crediting requirements of section 3.03(2). If at all times during the plan year prior to being credited with a tenth year of service the employee has a total accrued benefit of at least 13.5 percent of his or her highest average compensation (1.5 percent times 9 years), and at all times during the plan year after being credited with the tenth year of service the employee has a total accrued benefit of at least 15 percent of his or her highest average compensation (1.5 percent times 10 years), and the retirement otherwise meets the requirements of this revenue procedure and the regulations, the employee will be treated as a qualified participant throughout the plan year. This analysis applies without regard to whether the participant actually accrues a benefit in the plan year or is credited with an additional year of service for accrual purposes (e.g., if future accruals under the plan have been frozen or if the participant has obtained the maximum level of benefits under the plan).

Example 2. Assume the same facts as in Example 1, except that the plan grants 1 month of credited service for every whole month of actual service, and that the employee had 111 months of service (9 years and 3 months) at the beginning of the plan year. If at all times during the first month of the plan year prior to being credited with the 112th month of service the employee has a total accrued benefit of at least 13.875 percent of his highest average compensation (1.5 percent times 111 months, divided by 12), and at all times during the first month of the plan year after being credited with the 112th month of service the employee has a total accrued benefit of at least 14 percent of his highest average compensation (1.5 percent times 112 months, divided by 12), and the retirement system otherwise meets the requirements of this revenue procedure and section 31.3121(b)(7)-2(e) of the regulations, the participant is a qualified participant in the plan within the meaning of section 31.3121(b)(7)-2(d)(1) for the entire first month of the plan year.

Example 3. Assume the same facts as in Example 1, except that, instead of crediting only whole years of participation for accrual purposes, the retirement system credits only service during plan years in which a participant has at least 1,000 hours of service. Thus, as in Example 1, the participant has 9 years of credited service at the beginning of the plan year. If at all times during the plan year prior to meeting the 1,000-hour requirement the employee has a total accrued benefit of at least 13.5 percent of his or her highest average compensation (1.5 percent times 9 years), and at all times during the plan year after meeting the 1,000-hour requirement the employee has a total accrued benefit of at least 15 percent of his or her highest average compensation (1.5 percent times 10 years),

the employee will be treated as a qualified participant in the retirement system within the meaning of section 31.3121(b)(7)-2(d)(1) of the regulations throughout the plan year.

#### **SECTION 4. DEFINED BENEFIT RETIREMENT SYSTEMS WITH BENEFIT FORMULAS NOT DESCRIBED IN THE SAFE HARBORS OF SECTION 3**

##### **.01 In general.**

A defined benefit retirement system that calculates benefits under a formula that does not meet one of the safe harbor formulas described in section 3 of this revenue procedure meets the minimum retirement benefit requirement with respect to an employee if the employee's accrued benefit as of the date of the determination is at least as great as the accrued benefit the employee would have if his or her accrued benefit had been calculated under the safe harbor formula in section 3.01(1). In determining whether this requirement is satisfied, the additional requirements set forth in section 3.03 must be taken into account. The rules in this paragraph are illustrated by the following example: Example. A defined benefit plan maintained by a political subdivision and described in section 457(b) of the Code provides only for single sum distributions and thus does not meet the requirements of any of the defined benefit safe harbor formulas. The plan may still meet the minimum retirement benefit requirement with respect to an employee if it provides a single sum with respect to such employee that is the actuarial equivalent (using reasonable actuarial assumptions) of a single life annuity meeting the requirements of section 3.01(1).

##### **.02 Treatment of past service credit.**

In determining whether an employee's accrued benefit under a defined benefit retirement system that calculates benefits under a formula that does not meet one of the defined benefit safe harbor formulas is at least as great as the accrued benefit the employee would have if his or her accrued benefit had been calculated under the safe harbor formula in section 3.01(1), a retirement system may ignore periods of service by an employee with the employer prior to his or her commencement of participation in the retirement system, notwithstanding the additional rules relating to credited service in section 3.03(2). If such periods of service are ignored, however, any accrued benefits attributable to such period of service must also be ignored. The rule in this paragraph is illustrated by the following example:

Example: An employee begins to participate in a retirement system in the employee's fifth year of service. The retirement system provides credit for all past service with the employer. Assume the retirement system does not provide benefits under a formula that meets the requirements of any of the safe harbors. The employee must be treated as being in the employee's fifth year of credited service if benefits attributable to the past service are to be taken into account in comparing the benefit under the retirement system to the benefit the employee would have under the safe harbor formula of section 3.01(1) to determine whether the minimum retirement benefit requirement is met.

#### **SECTION 5. EMPLOYEES WITH MULTIPLE POSITIONS OR WHO PARTICIPATE IN CERTAIN RETIREMENT SYSTEMS**

See section 31.3121(b)(7)-2(e)(2)(iv) and (v) of the regulations for rules to be used in determining the service, compensation and benefits taken into account for purposes of this revenue procedure in the case of employees who are employed in more than one

position with the employer, and employees who are participants in retirement systems maintained by more than one employer, respectively.

**SECTION 6. EFFECTIVE DATE**

This revenue procedure is effective with respect to service performed after July 1, 1991.



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