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.

November 2008 Revision

Introduction

The *Federal-State Reference Guide* provides state and local government employers a comprehensive reference source for guidance on social security and Medicare coverage and Federal Insurance Contributions Act (FICA) tax withholding issues. This guide is a cooperative effort of the Social Security Administration (SSA), the Internal Revenue Service (IRS), and the National Conference of State Social Security Administrators (NCSSSA). The *Guide* was first published in July 1995 with special assistance from the State of Colorado, which spearheaded the effort. Topics addressed in this publication include determining worker status, public retirement systems, social security and Medicare coverage and benefits, Section 218 Agreements, employment tax laws and other tax issues.

Beginning with the 2005 edition, the *Federal-State Reference Guide* has been produced annually, primarily as a web-based document. However, the most recent version can be printed by accessing the IRS website at www.irs.gov/govts. This website also contains information about other related tax topics, upcoming events, the *FSLG Newsletter*, and how to contact the IRS. All IRS forms and publications referred to in this publication can be ordered free through the IRS at (800) 829-3676. Most can be downloaded through the IRS website at www.irs.gov. For general or account-related questions, the Customer Account Service 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, some special provisions that apply to tribal governments are addressed in later chapters. If you have questions about Indian Tribal governments, please visit the office of Indian Tribal Governments (ITG) website at www.irs.gov/tribes or telephone your local IRS ITG office. This website also contains Publication 4268, *Employment Tax Desk Guide*, for further information which specifically addresses employment tax issues for tribal governments.

All SSA forms and publications can be downloaded from SSA's website at www.ssa.gov. You can also go directly to SSA page for state and local government employers at www.ssa.gov/slge. Here you can find contact information for Social Security local offices, regional specialists and State Social Security Administrators. To talk to a Social Security representative call 1-800-772-1213 (TTY 1-800-325-0778).

The *Federal-State Reference Guide* is 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 or benefit obligations. 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.

Contents

Chapter 1

Social Security and Government Employers

Although federal tax requirements generally apply on the same basis to public as to private employers, there is a unique history to social security and Medicare coverage for state and local government employees that involves special provisions for the application of these taxes, as well as withholding and reporting requirements.

Historical Overview — Social Security and Government Employers

State and local government employees were excluded from social security coverage from 1935 (the date of the original Social Security Act) until 1950 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 Act. In 1939, the Old-Age, Survivors, and Disability Income program was created, and the funding mechanism for the social security program was officially established in the Internal Revenue Code as the Federal Insurance Contributions Act (FICA). The IRS is responsible for the collection of this tax.

All 50 states, Puerto Rico, the Virgin Islands, and approximately 60 interstate instrumentalities have Section 218 Agreements with SSA. Because of the voluntary nature of Section 218 Agreements, the extent of social security coverage varies from state to state. At the state level, most public 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 state and local government employees work at the local level. The majority of uncovered local government public employees are police officers, firefighters and teachers. It is estimated that more than 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

January 1, 1951	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.
January 1, 1955	Beginning this date, states could extend social security coverage to employees (other than police officers and firefighters) covered under a public retirement system.
July 1, 1966	Beginning this date, **e**mployees covered for social security under a Section 218 Agreement are automatically covered for Medicare beginning July 1, 1966.
April 20, 1983	Beginning this date, coverage under a Section 218 Agreement cannot be terminated unless the governmental entity is legally dissolved.
April 1, 1986	Employees hired on or after this date are mandatorily covered for Medicare only, 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.
January 1, 1987	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. Since that date, public employers pay Federal Insurance Contributions Act (FICA) taxes directly to the Internal Revenue Service (IRS) in the same manner as private employers.
July 2, 1991	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.
August 15, 1994	The Social Security Independence and Program Improvements Act of 1994 established the SSA as an independent agency, effective March 31, 1995. This act also increased the FICA exclusion amount for election workers from $100 to any amount less than the threshold amount mandated by law in a calendar year. (To verify the current year amount, see the SSA website.) States were authorized to amend their Section 218 Agreements to increase the FICA exclusion amount for election workers to a statutorily mandated threshold. It 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.)
October 21, 1998	Public Law 105-277 provided a 3-month period for states to modify their Section 218 Agreements to exclude from coverage services performed by students. This provision was effective July 1, 2000, for states that exercised the option to take this exclusion.
March 2, 2004	Social Security Protection Act of 2004 (Public Law 108-203) enacted, including provisions: 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 (see Chapter 11); and allowing Kentucky and Louisiana the option to provide a divided retirement system.

Social Security Coverage (Section 218 and Non-Section 218)

Social security coverage can vary widely, even 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). For mandatory coverage questions, contact an IRS FSLG Specialist (see www.irs.gov/govts for a directory).You can also visit the SSA State and Local Government Employers website at 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:

Applicable Section 218 Agreement:

1. When did the state voluntarily enter into a Section 218 Agreement to elect voluntary social security coverage for a particular political subdivision? What optional exclusions and what coverage groups were listed in that Agreement or later modification? Does the political subdivision have more than one modification?
2. 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?
3. Has the state elected to provide Medicare HI-only for a particular entity?

Non-Section 218 Coverage (Public Retirement Systems):

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 (effective July 2, 1991).

   * Throughout this publication, the term "public retirement system" refers to a retirement system of 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, the retirement system does not need to meet the minimum benefit standards for qualified plans 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 4, **Social Security 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.

<u>Step 2</u>: 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, **Public Retirement System**.) 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 next step to determine Medicare coverage for any employee hired prior to April 1, 1986.

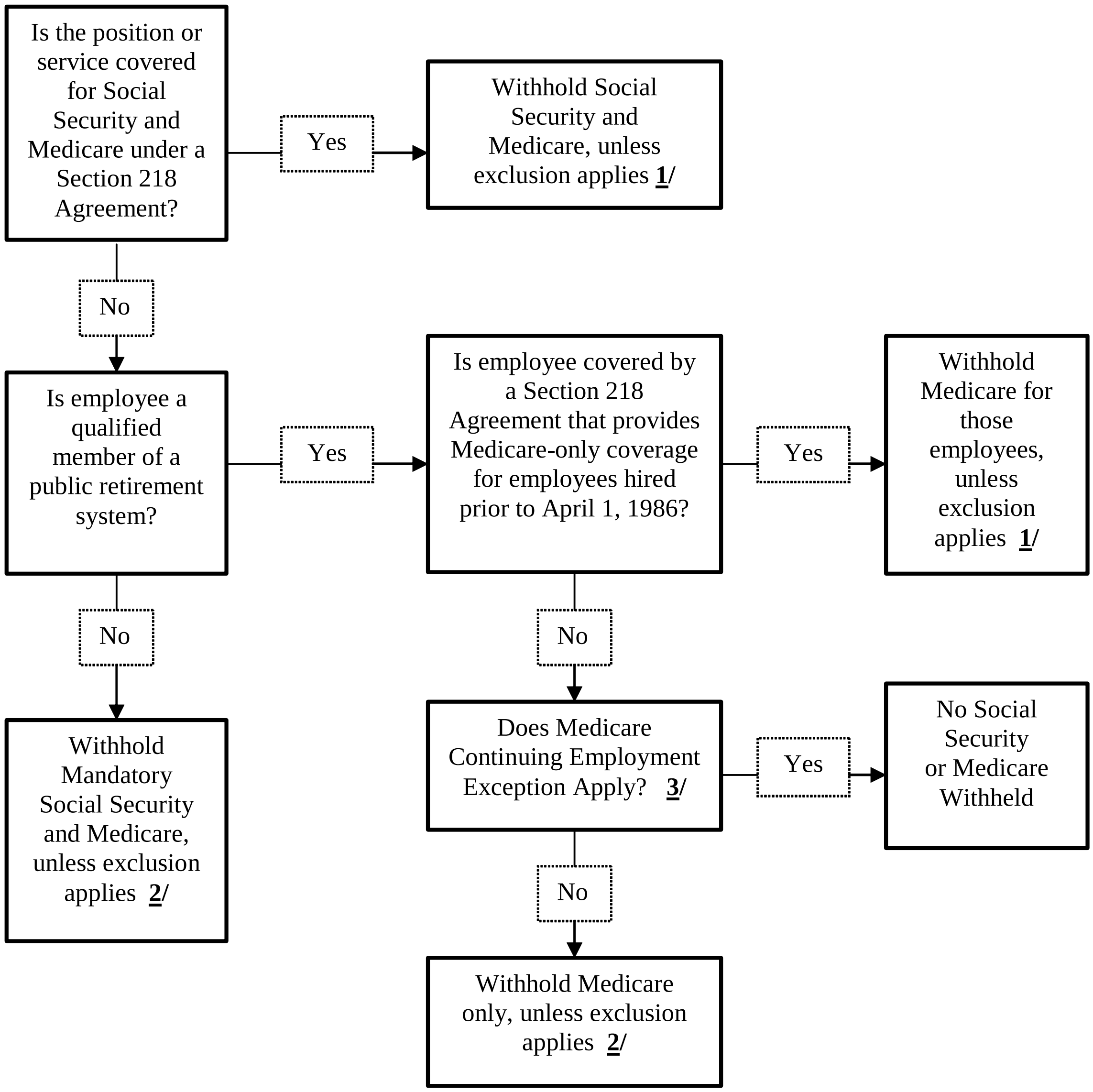
<u>Step 3</u>: Determine whether the retirement system has a Section 218 Agreement that provides Medicare only coverage for employees hired prior to April 1, 1986. If "yes," the employee is covered for Medicare only. If "no," proceed to next step.

<u>Step 4</u>: Determine whether the Medicare continuing employment exception applies to the employee. (Chapter 5, **Social Security and Medicare Coverage**.) If "yes," the employee is exempt from mandatory Medicare. If "no," the employee is subject to mandatory Medicare, unless an exclusion applies.

The flowchart on the next page illustrates the above steps.

***Note**: **Section 218 coverage is based on the position an employee occupies.** 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. **Mandatory coverage is based on the employee.** The employer must look at the employee and 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



<u>1</u>/ <u>Section 218 Mandatory and Optional Exclusions</u> (see Chapter 5)
<u>2</u>/ <u>Mandatory Exclusions from FICA</u> (see Chapter 5)
<u>3</u>/ <u>Medicare Continuing Employment Exception</u> (see Chapter 5)

NOTE: This chart is meant as a guide only and is not a substitute for discussing difficult 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 **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 tax issues. See Chapter 10, **Internal Revenue Service**.

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 9, **Social Security Administration**.

State Social Security Administrators are responsible for administering and maintaining the Section 218 Agreement that governs voluntary social security and Medicare coverage by state and local government employers in each state. The state administrator will also prepare Section 218 modifications to include additional coverage groups, correct errors in other modifications, identify additional political subdivisions that join a covered retirement system, or obtain Medicare coverage for public employees whose employment relationship with a public employer has been continuous since March 31, 1986.
The state administrator acts as a liaison between state and local government employers and federal agencies, including SSA and IRS. Depending on the organization of the state government, the state administrators may have other responsibilities with regard to employee retirement or other areas. See Chapter 8, **State Social Security Administrator.**

The following chapters detail the responsibilities of state and local employers with respect to employment taxes and social security coverage. Because there are unique laws that pertain to governmental employers, the next chapter addresses the definition of a government entity.

Chapter 2

Government Entities

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.

State Government

Different definitions of a "state" apply for different legal purposes. 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 providing distribution. Some of these services include:

- Health care
- Public assistance for persons in need
- Protection of natural resources

- Improvement in living and working conditions

Local Government

Local governments include 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 jurisdiction and 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 generally provide services as needed by the local area (such as building a bridge) or protective services (such as police and fire departments).

Local governments receive financial aid from state and federal governments in providing these services according to need. Some of the services which local governments take primary responsibility for providing include:

- Conducting and coordinating elections
- Protecting public health and 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 taxes for local and state governments
- Keeping official records, such as marriage, birth and death

Indian Tribes

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.

Instrumentalities

An instrumentality is an organization created by or pursuant to state statute, operated for public purposes, and expressly declared by statute to be an instrumentality. Generally, an instrumentality performs governmental functions, but does not have the full powers of a government, such as authority for police, tax, 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 concerning the status of an instrumentality for benefits purposes should be directed to the Parallel Social Security Office (see Chapter 9).

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.

If an interstate instrumentality covers 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 on the basis of the desires of the members, in addition to being able to conduct a majority vote referendum. 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.

The IRS addressed the question of whether an organization is wholly-owned by one or more states or political subdivisions in Revenue Ruling 57-128. 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 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 of 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. This 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 made 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.*

Chapter 3

Wages and Employment Taxes

This chapter briefly covers the forms of compensation that are included in employee wages, and the tax withholding that applies to these items. 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 covered by social security (section 3121).

Taxes under the Federal Insurance Contributions Act (FICA) 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. The state or local entity must withhold and pay over the employee's part of the taxes and must pay the employer's part.

In addition, employers are generally required under section 3402 to withhold income tax from wages.

Section 3301 imposes the Federal Unemployment Tax (FUTA) on employers. "Employer" for this purpose is defined in section 3306. However, government entities are generally exempted from this tax by section 3306(c)(7).

Workers are subject to social security, Medicare, or income tax withholding only if they are employees of the organization paying them. The determination of whether workers are employees can be complex and is the subject of Chapter 4.

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. Some 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, or paid on a percentage basis.

The social security wage base establishes the maximum amount of wages subject to the social security tax per year. For 2009, this amount is $106,800. The amount is adjusted each year. (Since 1994, there has been no wage base limit for Medicare tax.)

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. The state should withhold and pay social security tax only up to the wage base for that employee. An employee who transfers from a state agency to a political subdivision, 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.

Statutory Exceptions to Social Security and Medicare Coverage

Government employment not covered by a retirement system 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 include services performed by:

3121(b)(7)(F)(i) – individuals 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 workers, for amounts below a designated threshold

3121(b)(7)(F)(v) – an 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.

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 at the time of payment. The fair market value may be based on the prevailing value of the items in the locality or upon a reasonable value established for other purposes. Special rules may apply to noncash fringe benefits, discussed below.

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, e.g., 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. Social security and Medicare tax and income tax withholding apply in the year of payment at the rates in effect for that period.

The period for which back pay is credited as wages for social security purposes is different if the back pay is awarded under a statute. 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 of the payment of back pay under a statute. 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.

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." See IRC section 62(c) and section 1.62-2 of the Income Tax Regulations. There are three requirements for a system to be treated as an accountable plan:

1) The expenses must be 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 in excess of expenses within a reasonable period of time.

The use of per diem rates at or below the federal rate for travel expenses can reduce and simply 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.

Fringe Benefits

Generally, fringe benefits must be included in an employee's gross income and are subject to social security and Medicare as well as income taxes. Examples of fringe benefits include vehicles for personal use, meals, tickets to entertainment or sporting events, etc. Some fringe benefits are nontaxable based on specific provisions of the Internal Revenue Code. Some common situations are discussed below.

The IRS office of Federal, State and Local Governments (FSLG) has created a Taxable Fringe Benefits Guide designed specifically for government employers. For a more comprehensive discussion of fringe benefits, you can see and download this publication at www.irs.gov/govts.

Employer-Provided Vehicles

If an employer provides an employee with unrestricted use of a vehicle, the employee receives a noncash fringe benefit and the value is required to be included in income. The value of the vehicle 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 use of a vehicle:

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

These rules are discussed in IRS Publication 15-B, and in the FSLG Taxable Fringe Benefit Guide, available at www.irs.gov/govts.

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. See IRC section 132(a)(3).

Under certain circumstances, the value of a "qualified nonpersonal use vehicle" can be excluded from income as a working condition fringe. 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 or fire vehicle, a flatbed truck, a school bus, ambulance, etc. 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.

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 it is made under a written plan or is available to all classes of employees. A health retirement 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 Plans

Cafeteria plans, including flexible spending arrangements, are benefit plans under which employees can choose from among cash and certain qualified benefits. 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 purposes if the benefits are excludable from gross income under a specific section of the Internal Revenue Code (other than scholarship and fellowship grants under section 117 and employee fringe benefits under section 132).

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. 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. However, adoption benefits and group-term life insurance that exceeds $50,000 of coverage are subject to social security and Medicare taxes, but not to income tax withholding, even when provided as qualified benefits in a cafeteria plan.

If an employee elects to receive cash instead of any qualified benefit, it is treated as wages subject to all employment taxes. See IRS Publication 15-B for further details.

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 under a salary reduction election are considered paid by the employer; therefore, the employee is not entitled to exclude 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** 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 lodging as a condition of employment. See IRS Publication 15-B for more information.

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 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 worker's 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.

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. On Form W-2, the employer should show the payment 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. If the payment is made after the year of death, report it in box 3 of Form 1099-MISC, Miscellaneous Income, as a payment to the estate or beneficiary. Use the name and taxpayer identification number (TIN) of the estate or beneficiary on Form 1099-MISC. See Revenue Ruling 86-109, 1986-2 C.B.196.

See the Instructions for Forms W-2 and W-3 for more information.

Retirement Plans

Many public employees are covered by some form of retirement plan, apart from social security. These plans vary greatly, but in general provide for deferred income, placed in trust for retirement. These plans may involve employee or employer contributions, or both. Under certain circumstances, contributions are tax deferred 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, either under IRC sections 403(b) or 457, discussed below.

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 "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 social security coverage under section 218.

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 ($16,500 in 2009). 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 general information on 403(b) plans, see Publication 571.

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)

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 ($16,500 in 2009). 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 Section VI of Notice 2003-20 in the Appendix and the irs.gov Employee Plans site.

Section 457(f)

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

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 keeps track of 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. EINs should be used on all employment tax returns, information returns 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 one municipality annexes another, or when school districts are combined, the EIN of the annexed area or abolished district should no longer be used, as it is no longer a separate entity. When an unincorporated area is incorporated, it becomes a separate entity and must obtain its own EIN. To obtain a new EIN, complete a Form SS-4.

Check the EIN for accuracy and completeness on each tax document submitted. When an incorrect EIN is used, tax payments can be credited to the wrong account.

Note: *EINs beginning with the digits 69 are SSA-assigned employer identification to report earnings for tax years prior to 1987, but 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.*

Federal Income Tax Withholding

Employers are 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 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.

Each employee should be provided with a Form W-4 to claim the appropriate number of withholding allowances and identify marital status. The signed Form W-4 must be kept on file for each employee. If an employee does not complete a Form W-4, the employer is required to withhold tax as if the employee were a single person claiming no withholding allowances. If not enough tax is withheld, the employee may be subject to penalties.

Employers are no longer required to submit certain Forms W-4 to the IRS with Form 941. The IRS may contact you with instructions regarding withholding for a particular employee. See Publication 15 for more information.

There are two common ways to determine the amount of federal income tax to be withheld: the wage bracket method and the percentage method. Tables for both methods are found in IRS Publication 15. Alternative methods of withholding are explained in IRS Publication 15-A, including methods for annualized wages, average estimated wages, cumulative wages, and part-year employment.

Generally, the wage bracket method is the easiest to use. However, for amounts of pay or pay periods not included in the tables, the percentage method may be needed. Any method may be used if it achieves approximately the same withholding.

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 distributions of these amounts when they are withdrawn from the plan.

Withholding on Section 457 Plans

Amounts deferred 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 Section IV of Notice 2003-20.

Withholding on Supplemental Wages

Supplemental wages are compensation paid to an employee in addition to the employee's regular wages (e.g., severance pay, awards, back pay, payments for non-deductible moving expenses, etc.). Supplemental wages are subject to social security and Medicare and income tax withholding. Under final regulations effective January 2007, overtime pay and reported tips may be treated as regular or supplemental wages, at the employer's option. The option may be elected separately with respect to each employee.

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

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

If the employer withheld income tax from regular wages, one of the following methods for the supplemental wages can be used:

1) ***Optional Method*** - Withhold at a flat 25% rate. To use this method, you must have paid regular wages to the employee during the same year that regular wages were paid or the previous year. In addition, the supplemental wages must have been stated separately or not paid concurrently with regular wages. Disregard, for this purpose, the number of allowances claimed on Form W-4.

2) ***Aggregate Method*** - Add the supplemental and regular wages for the most recent payroll period this year. Then figure the income tax withholding as if

the total were a single payment. Subtract the tax already withheld from the regular wages. Withhold the remaining tax from the supplemental wages.

Special rules apply for employees whose total supplemental wages exceed $1 million during a calendar year. See Regulation 31.3401(g)-1 for more information.

If the employer did not withhold income tax from the employee's regular wages, method 2 above should be used.

New Withholding Requirement for Governments Beginning in 2011

Internal Revenue Code section 3402(t) requires that after December 31, 2010, all payments by governmental entities for property or services are subject to 3% income tax withholding, with some exceptions. Notice 2008-38 provides more information on these requirements.

Payments made to other governmental or tax-exempt entities, income assistance payments, 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 an information return after the end of the tax year, similar to backup withholding or withholding on wages.

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

Final Regulations have not yet been issued on this provision. 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.

Exception to FUTA for Indian Tribal Members

As of December 21, 2000, Indian tribes are excluded from FUTA on the same basis as state and local governments when they participate in the Federal-State Unemployment Compensation (UC) program.

As a condition of participation in the UC program, services performed in the employ of tribes generally are no longer subject to the Federal Unemployment Tax Act (FUTA), if they participate in state unemployment tax.

If an Indian tribe fails to make required payments to the state's unemployment fund or payments of penalty or interest, then the tribe will become liable for the FUTA tax and the state may remove tribal services from state UC coverage.

In the event a tribe does not meet the requirements of the UC program, the IRS will be notified. Once the IRS is notified, the tribe will become liable for filing Form 940, *Employer's Annual Federal Unemployment Tax Return)* with the IRS.

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.

Advance Earned Income Credit

The Earned Income Credit (EIC) is a tax credit for workers who have earned income below specific thresholds. Eligible employees can choose to collect part of the earned income credit during the year from their employers with their paychecks, or they can claim the entire amount on their tax returns when they file for the year.

Form W-5

Eligible employees who want to receive advance EIC payments during the year with their pay must complete Form W-5, Earned Income Credit Advance Payment Certificate. A state entity is required to make advance EIC payments to eligible employees who complete a Form W-5. See Publication 15.

On Form W-5, an employee states that he or she expects to be eligible for the EIC and shows whether he or she has a certificate in effect with any current employer. The employee also shows whether he or she is married, and, if married, whether his or her spouse has a certificate in effect with an employer. An employee may have only one certificate in effect with a current employer at one time. If an employee is married and his or her spouse also works, each spouse should file a separate Form W-5. Form W-5 remains in effect until the end of the calendar year unless the employee revokes the certificate or files another one. Eligible employees must file a new certificate each year.

An advance EIC payment is not wages and is not subject to withholding of income tax or social security and Medicare taxes. An advance EIC payment does not change the amount of income tax or social security and Medicare taxes withheld from the employee's wages. Add the EIC payment to the employee's net pay for the pay period. When the Form W-2 is completed for that year, show the total advance EIC payments in box 9, "Advance EIC Payment," of Form W-2. Do not include this amount in the "Wages" box.

Advance EIC payments become a credit against the employer's Form 941 tax liability. Show the total payments made to employees on the advance EIC line of Form 941, discussed below. Subtract this amount from the total taxes. (See the instructions for Form 941.)

Required Notice to Employees

State and local entities are required to notify employees who have no income tax withheld that they may be eligible for a tax refund because of the EIC. Employers are encouraged to notify employees eligible for EIC. Eligible employees may get a refund of the amount of EIC that exceeds any tax they owe. For further information on eligible employees, how to figure advance EIC payments, and notification requirements, refer to IRS Publication 15.

Forms 941 and 944

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 is an annual version of the form, filed by employers with the smallest payrolls.

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 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 are:

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 (line 6a) may differ from total wages. A common reason is that earnings that exceed the annual wage base are not subject to the OASDI portion of social security tax. However, there are no limits on the earnings subject to Medicare tax (line 7). 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. The first quarter return covering January through March is due by April 30th. 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 on the return.

Form 944

Certain taxpayers with small payrolls are required to report their employment taxes on an annual basis. The IRS will notify these taxpayers early in the calendar year of their changed requirement. Instead of the quarterly Form 941, they can file an annual Form 944, Employer's Annual Employment Tax Return. The deposit requirements, discussed below, remain the same as for quarterly filers. For more information on eligibility, see Publication 15 or the Instructions for Form 944.

Some 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

Prior to 2009, employers corrected amounts previously reported 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 for the quarter in which the error was discovered. Beginning January 1, 2009, Form 941c is obsolete. 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.

Depositing Taxes

Employers deposit federal employment taxes by using the Electronic Federal Tax Payment System (EFTPS) or by mailing or delivering a check, money order, or cash to an authorized financial institution. Some employers are required to use EFTPS. See information on electronic deposit requirements below.

Two additional alternatives 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 2000-38**.**

Electronic Deposit Requirement

In order to determine whether your entity is required to use EFTPS to deposit taxes, you must "look back" to the total tax deposits (such as social security and Medicare taxes and excise taxes) in the second prior years. When an entity's total depository taxes exceeds $200,000 a year, it is required to make deposits using EFTPS for deposits made after December 31 of the following year. For example, if your entity's total deposit of depositary taxes in 2007 exceeded $200,000, then you must make all deposits through EFTPS for deposits made after December 31, 2008. Once an entity is required to deposit through EFTPS, it must continue to use EFTPS in all succeeding years regardless of the amount of deposits it makes. Employers who are not required to make electronic deposits may voluntarily participate in EFTPS. For information on EFTPS, see IRS Publication 966, or call toll free 1-800-945-8400 or 1-800-555-4477. (These numbers are for EFTPS information only.)

When to Deposit

There are two schedules—monthly or semiweekly—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 (not reduced by any advance EIC payments) reported on Forms 941 (line 11) 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.

Summary of Federal Tax Deposit (FTD) Rules

If the employer is a…	And the payroll date is…	Then a deposit must be made:
Monthly schedule depositor *($50,000 or less during the lookback period)*	Any time during the month	On or before the 15th of the month
Semiweekly schedule depositor *(More than $50,000 during the lookback period)*	Saturday, Sunday, Monday, Tuesday	On or before the following Friday
	Wednesday, Thursday, Friday	On or before the following Wednesday

<u>Special Rules:</u>

$2,500 Rule: Taxes less than $2,500 in a quarter do not have to be deposited if paid with a timely filed return.

$100,000 Next Day Rule: $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.

Accuracy of Deposits Rule: An employer who inadvertently under-deposits will not be penalized if the shortfall is 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 Publication 15, for details.

Deposits on Banking Days Only: 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.

Special Rules for Non-banking Days: 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.

Deposit Requirements for Nonpayroll (Form 945) Tax Liabilities

The deposit rules 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 deposits for employment tax liabilities with any other deposits, including those made on Form 945, Annual Return of Withheld Federal Income Tax. 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 Deposit System (EFTPS), see IRS Publication 966.

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.

Penalties, figured as a percentage of the amount due, apply in the following cases:

Deposit	**Rate**
1-5 days late	2%
6-15 days late	5%
More than 15 days late, but paid by the 10th day after notice and demand. Notice and demand date is the assessment date (23C date).	10%
Taxes still unpaid after the 10th day following notice and demand for payment	15%
Failure to deposit	10%
Amounts subject to electronic deposit but not deposited by EFTPS	10%

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 a like return for the return period in which the error was ascertained (e.g., quarter ended March 31 is due April 30). In addition, additional tax due as a result of an IRS examination or ruling may qualify for an interest-free adjustment.

Penalties

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.

IRC	**Penalty assessed for:**	**Penalty Rates:**
Section 6651(a)(1)	Failure to file a tax return (failure to timely file)	5% of the tax due per month up to 25%

Section 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%
Section 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%
Section 6652(b)	Failure to file certain information returns and registration statements, etc. (failure to file information returns not covered under other sections)	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
Section 6656	Failure to make deposit of taxes on the date prescribed (failure by any person to deposit in a government depository)	The penalty for failure to make deposit of taxes is assessed when there is a failure to timely deposit, in the prescribed manner, the correct amount of taxes a) 1-5 days late = 2% b) 6-15 days late = 5% c) More than 15 days, but paid by the 10th day after notice and demand (notice and demand date is the assessment date (23C date) = 10% d) Taxes still unpaid after the 10th day following notice and demand, or unpaid as of the date on which notice and demand for immediate payment is given =15%
Section 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

***Information Reporting Penalties* -** The following are the most commonly assessed penalties as they relate to information reporting:
;

IRC	Penalty assessed for:	Penalty Rates – In General:
Section 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 $50 for each failure to a maximum of $250,000 per calendar year
Section 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 $50 for each failure, not to exceed $100,000 per calendar year
Section 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

Chapter 4

Determining Worker Status

It is critical for any entity paying compensation to know whether the workers are employees. 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 tax (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 in matching shares by the employer and employee. State and local governments generally pay the FICA tax on employees covered under Section 218 Agreements and on employees not covered by a public retirement system, and generally pay the Medicare portion on all other employees hired after March 31, 1986. State and local governments do not pay 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 is not required to withhold and pay employment taxes on behalf of the worker.

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

Common-Law Standard

For employment tax purposes, an employee is defined as by IRC 3121(d)(2) as “any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee”. The common-law rule for determining whether a worker is an employee is 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 in the charts below, with special emphasis on those affecting government employers.

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 when he or she is engaged. Many times, when workers perform their tasks satisfactorily, the entity does not appear to exercise much control. The 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 behavior control.

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. A state statute requires that animal control officers receive state-sponsored training. A statute requires 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 stationary 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 be employees, however. 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, 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 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 performance, 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, because employees generally receive a salary 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 the corporate formalities, 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 illustrative of 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. (Employment Tax Regulation §31.3121(d)-1(a)(3)) The following items may reflect the intent of the parties:

- Filing a Form W-2 indicates the employer's belief that the worker is an employee.
- 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.

Discharge or Termination	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. Today, however, business practices and legal standards governing worker termination have changed. 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. Today 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.
Termination of Contracts	A worker’s ability to terminate work at will was traditionally 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, 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 workers protection for liability for terminating the relationship does not necessarily indicate employee status. However, the government’s ability to refuse payment for unsatisfactory work continues to be indicative of independent contractor status.
Non-performance of Employees	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.
Permanency	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. 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 most worker classification cases, some facts will support independent contractor status and others will support employee status. This is because 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.

The following discussion addresses some special situations involving governmental employees.

Workers Covered Under Section 218 Agreements

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). To determine whether these taxes should be withheld, the first question for a government entity 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 public retirement system coverage 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. 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.

Public Officials

A public official has authority to exercise the power of the government and does so as an agent and employee of the government. The U.S. Supreme Court has held on this basis that public officials are employees. 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. *Metcalf & Eddy v. Mitchell*, 269 U.S. 514 (1926).

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

The IRC does not define the term “public official,” but Regulation §1.1402(c)-2(b), which indicates 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 is 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 following specific examples are given of positions that constitute “public office”:

- Mayor
- Member of a legislature or elected representative
- 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

For employment tax purposes, the primary legal basis for defining 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.” In other words, an officer, employee, or elected official of a state or local government is an employee for income tax withholding purposes. 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.

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 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 prosecuting 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 classify the individual as a common-law employee.

Elected Officials

Elected officials 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 not to reelect them. 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, elected officials are employees for income tax withholding purposes under section 3401(c).

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 than 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

When a worker, regardless of being termed a "volunteer," receives compensation, and there is an employer-employee relationship, that compensation is wages subject to FICA tax (unless an exclusion applies). 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*, they are taxable. An accountable plan is one that is designed to reimburse only actual, substantiated business expenses. An accountable plan must (1) require workers to substantiate incurred business expenses, (2) provide advances or reimbursements only for reasonably expected business expenses, and (3) require that any amounts received that exceed substantiated expenses must be returned within a reasonable period. 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 social security and Medicare.

The services of volunteers are generally not eligible for the exclusion from FICA for emergency workers, discussed in the next chapter. IRC §3121(b)(7)(F)(iii) provides that services performed by employees on a temporary basis in the case of fires, storm, snow, earthquake, floor 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 is only for temporary workers who respond to unforeseen emergencies, such as hurricanes or floods.

Exclusion for Volunteer Firefighters and Emergency Responders

Beginning in 2008, and through 2010, qualified emergency response organizations may exclude certain amounts from income, social security and Medicare wages amounts paid to any firefighter or emergency responder. This includes:

1) Up to $30 for each month in which any services were performed during the year, from reimbursements, expense allowances, or any type of compensation. The maximum exclusion is $30 x 12 months. or $360 per year.

2) Any tax reduction or abatement provided based on service to a volunteer fire or emergency response organization.

No deduction may be taken by these individuals on their income tax returns for amounts that were excluded under these provisions.

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.

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

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. Then, 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. Copies of any statutory provisions relating to the relationship should be reviewed. 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 an employee of the governmental entity. If there is no 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 have made determinations of employee status for worker's compensation, minimum wage, or other purposes. Different standards may apply to determine worker classification for federal employment tax purposes. Characterizations 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 employee or be interpreted to achieve different policy objectives.

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 IRS Form 1099-MISC, Miscellaneous Income. Independent contractors are required to provide a taxpayer identification number (TIN) to the entity that pays them. IRS Form W-9, Request for Taxpayer Identification Number, contains the required certification and can be used for this purpose.

The following table indicates responsibilities for payers of independent contractors:

1099 Filing Information	- By January 31 of the following year, send a copy of Form 1099-MISC to independent contractors (and other required service providers) who were paid $600 or more during the year. - By February 28th, send Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, with Copies A of all paper Forms 1099-MISC. File Forms 1096 and 1099-MISC with the IRS. - If you are required to file fewer than 250 information returns, you can file them on paper forms. If you are required to file 250 or more information returns, they must be filed electronically. General instructions for all information returns can be found in one booklet, General Instructions for Forms 1099, 1098, 5498, and W-2G. Also refer to IRS Publication 15, *Employer's Tax Guide*. Both publications are revised annually. -The IRS operates a centralized call site to answer questions about information reporting. If you have questions about reporting, you may call (304) 263-8700.
Taxpayer Identification Numbers (TINs)	-TINs are used to associate and verify amounts that are reported to the IRS with corresponding amounts on tax returns. Therefore, it is important that the proper TIN be sent to the IRS. -A TIN can be either a social security number (SSN) or an employer identification number (EIN). -Electronic IRS Form W-9 can be submitted to the requester if the established system meets IRS requirements.
Backup Withholding	-In some circumstances you are responsible for backup withholding. The withholding rate after 2002 is 28%. Backup withholding is required in the following situations: a payee does not provide the payer with a TIN; IRS tells the payer that the TIN is incorrect; and IRS notifies the payer that backup withholding is required. -Use IRS Form 945, Annual Return of Withheld Income Tax, to report the withheld amounts. Form 945 is due January 31st. See instructions for Form 945 and Publication 15 for more information.
Payments to Corporations and Attorneys	- Generally, information reporting is not required for payments to corporations. There are some exceptions which frequently apply to government entities: • Medical and health care payments to a corporation in the amount of $600 or more to each physician or other provider are reportable on Form 1099-MISC. • Attorney fees of $600 or more to a corporation are reportable on Form 1099-MISC. There is no exemption from reporting legal payments to corporations.

***Note**: Keep copies of information returns you filed with IRS for at least 3 years from the due date of the returns. Keep copies of information returns for 4 years if backup withholding was imposed.*

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 the years examined.*

Workers who were incorrectly treated as independent contractors may have treated themselves as self-employed, filing Schedule C and paying self-employment tax (SECA) rather than paying social security and Medicare taxes. Workers who have been determined to be employees may need to file amended returns to correct errors. Employers who 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 instance, 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 must be separate. If the services or compensation are interrelated, then the individual is not acting in two separate and distinct capacities.

Section 530

If the IRS conducts an audit of a government entity involving a worker classification issue, Section 530 of the Revenue Act of 1978 (Section 530) can provide relief from federal employment tax obligations for individuals that meet the common-law tests, if certain requirements are met.

The purpose of Section 530 is to allow employers who misclassified employees as independent contractors to continue to treat those workers as independent contractors, provided the employer had a reasonable basis for the classification and has acted consistently on that basis. To qualify for Section 530 treatment, the employer has to fulfill two conditions: (1) having filed all information returns consistent with the worker being an independent contractor; and (2) not having treated the worker, or any other worker in a substantially similar position, as an employee. Section 530 terminates liability for the employer's employment taxes, including social security and Medicare, income tax withholding and any penalties attributable to the liability. See Revenue Procedure 85-18.

At the time Section 530 was enacted, only employees of state and local governments who were covered by Section 218 Agreements were subject to social security withholding from their wages. Section 530, by its terms, does not apply to controversies between the SSA and states concerning coverage under Section 218 Agreements. ***Section 530 relief is not available for any workers covered under a Section 218 Agreement.*** However, state and local government employees now may be subject to mandatory social security and Medicare outside the scope of Section 218 Agreements. The IRS position is that government employers, whose workers are subject to mandatory social security and/or Medicare taxes, may be eligible for Section 530 treatment. See IRC section 3121(b)(7)(F).

IRS Must Consider Section 530

It is not necessary for the government entity to claim Section 530 treatment for it to be applicable. IRS personnel must provide the taxpayer a plain language summary of Section 530 at the beginning of an examination involving worker classification. Additionally, the government entity need not concede or agree that the workers are employees in order to get Section 530 treatment. The IRS will consider Section 530 as the first step in any case involving worker classification. A government may want to consider this possibility.

Section 530 Tests

The first step in any IRS audit involving worker classification issues is to determine whether the entity meets the requirements of Section 530. This is done before any determination of worker classification. If the entity is entitled to treatment under Section 530, it will not have any employment tax liability with respect to the workers at issue.

The government entity must meet the following consistency and reasonable basis requirements to qualify for treatment under Section 530:

Consistency Test	- The entity must have treated the worker, and all workers in substantially similar positions, consistently as independent contractors. This test is comprised of two parts, and both must be satisfied: 1) It must have filed all required Forms 1099 for the worker (***reporting consistency***); 2) It must have always treated this worker, and all workers in substantially similar positions, as independent contractors (***substantive consistency***).

Reasonable Basis Test	- A government entity that satisfied the consistency tests must also have had a reasonable basis for classifying the worker(s) as independent contractors. It can establish it had a reasonable basis by showing that it relied on: judicial precedent or published rulings; a prior IRS audit; an established, longstanding practice in the industry, or another reasonable basis. These criteria for reasonable basis are often called safe havens. An entity, that can establish consistent treatment (reporting consistency and substantive consistency) and also qualify for a safe haven, is allowed to continue treating the worker(s) as independent contractors. There are no judicial precedents dealing with Section 530 as applied to governments.

These tests are discussed in greater detail below.

Consistency Tests

Reporting Consistency: Filing Information Returns

- Timely filing is required of all Forms 1099 with respect to the worker for the period. The provision applies only for the period. See Revenue Procedure 85-18, Section 3.03(b). Therefore, if a government entity in a subsequent year files all required Forms 1099, then it may qualify for Section 530 treatment for the subsequent period.
- If a government entity is not required to file Forms 1099, Section 530 treatment will not be denied on the basis that the returns were not filed. Revenue Ruling 81-224, 1981-2 C.B. 197, addresses specific questions about timely filing of Forms 1099. It provides that:
  - Employers that do not file timely Forms 1099 may not obtain treatment under Section 530 for that worker for that year.
  - Employers that mistakenly, in good faith, file the wrong type of Form 1099 do not lose eligibility for Section 530.

Substantive Consistency: Substantially Similar Position

- The entity must never have treated the worker in question, or any worker in a substantially similar position, as an employee.
- A position is substantially similar if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities are substantially similar. The determination of whether workers hold substantially similar positions requires consideration of the relationship between the employing entity and the individuals. This includes, but is not limited to, the degree of supervision and control.
- The determination of what is substantially similar work rests on analysis of the facts. The day-to-day services that the worker performs and the method by which they are performed are relevant in determining whether two positions should be treated as substantially similar.
- Comparison of job functions is important. Workers with significantly different, though overlapping, job functions are not substantially similar.

Defining Treatment - What is meant by treatment that is consistent (or inconsistent) with independent contractor status?

1. The withholding of federal income tax or social security and Medicare tax from a worker's wages is treatment of the worker as an employee, whether or not the tax is paid to the government.
2. Filing any of Forms 940, 941, 943, 944 or W-2 with respect to a worker, whether or not tax was withheld from the worker, is treatment of the worker as an employee for that period. Revenue Procedure 85-18.
3. The filing of a delinquent or amended employment tax return for a particular tax period is not treatment as an employee if the filing was a result of IRS compliance procedures. However, filing returns for periods after the period under audit is treatment of the workers as employees for those later periods, regardless of the time at which the return was filed.
4. Neither the preparation of a return by the IRS when no return was filed, nor the signing of IRS Form 2504, *Agreement To Assessment and Collection of Additional Tax and Acceptance of Overassessment*, constitutes employee treatment.

Treatment for State Purposes - Only federal tax treatment as an employee is relevant to Section 530. Thus, if a government entity treats workers as employees for state withholding tax purposes, that does not constitute treatment for purposes of Section 530. However, if the government entity uses a federal form, such as Form W-2, to report state tax withholding, the filing of the federal form is treatment for purposes of Section 530.

Changing Treatment of Workers - If the government entity begins to treat misclassified workers as employees, relief is available under Section 530 for the prior years when it treated them as independent contractors, provided it satisfied all the requirements of Section 530. See Revenue Procedure 85-18, Section 3.04.

Dual Status - Some workers perform services in more than one capacity. For example, a bookkeeper might be separately engaged to design and print educational materials. The fact that the bookkeeper is treated as an employee with respect to bookkeeping services does not preclude application of Section 530 if it is determined that the individual is an employee, and not an independent contractor, with respect to the design and printing of educational materials.

Reasonable Basis Tests

Judicial Precedent, Published Ruling Safe Haven

One reasonable basis for independent contractor treatment is reliance on judicial precedent or published rulings. Reliance on judicial precedent means reliance on a court case published before the decision was made to treat the worker as an independent contractor. Reasonable basis may also be established by reliance on a technical advice memorandum, private letter ruling, or determination letter issued to that particular entity. Published rulings are IRS Revenue Rulings intended for use by all employers. Rulings by state administrative agencies, including agencies that regulate employment, and rulings by federal agencies other than the IRS cannot be relied on as a reasonable basis.

Prior Audit Safe Haven

Another reasonable basis for independent contractor treatment is reliance on a prior IRS audit. This may be any audit prior to 1997; however, taxpayers may not rely on an audit begun after December 31, 1996, unless the audit included an examination of employee status for employment tax purposes. The prior audit safe haven does not apply if the relationship between the government entity and the workers is substantially different from that which existed at the time of the audit. A government entity will be able to claim that it was subject to a prior audit if the IRS previously inspected its books and records. Mere inquiries or correspondence from an IRS Customer Service Center will not constitute an audit.

Audits conducted by agencies other than IRS will not qualify a government entity for relief based upon the prior audit safe haven.

Industry Practice Safe Haven

Another reasonable basis for independent contractor treatment is reasonable reliance on a long-standing recognized practice of a significant segment of the industry in which the taxpayer is engaged. The practice need not be uniform throughout the entire industry. *Note: The industry-practice safe haven was designed with private businesses in mind, and there is no specific guidance on how this standard applies to governmental entities.*

Other Reasonable Basis Safe Haven

Another reasonable basis for treatment of workers as employees may include reliance on the advice of an attorney or accountant.

The Pension Protection Act of 2006 amended section 530 to establish that for an individual providing services as a test proctor or room supervisor by assisting in the administration of college entrance or placements examinations, the **substantive consistency** requirement does not apply to services performed after December 31, 2006 (and remuneration paid with respect to such services). This provision applies if the individual (1) is performing the services for a tax-exempt organization, and (2) is not otherwise treated as an employee of such organization for purposes of employment taxes. If the requirements are satisfied, the IRS is prohibited from challenging the treatment of such individuals as independent contractors for employment tax purposes, even if the organization previously treated such individuals as employees.

Tax Consequences for Workers

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 eligible for income tax withholding and will have to make estimated tax payments.

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

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. As a supplement to the social security coverage information provided in this publication, refer to the Social Security Administration's "State and Local Government Employers" website.

For social security coverage purposes, state and local government employees fall under one of three categories:

1) 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) Mandatory social security coverage. The employees are required to be covered, as 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) No social security coverage. The employees are covered by a qualifying public retirement system, and are therefore exempt from social security. They are not covered by a section 218 Agreement. (Public retirement systems are discussed in chapter 6.)

Different employees with the same entity may be subject to different rules, depending on whether the positions they occupy are covered by a Section 218 Agreement. Each of the three categories of employees is discussed below.

1 - 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 to:

- Provide social security and Medicare coverage for non-retirement system coverage groups and retirement system groups.

- Provide 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 officials and election workers who earn less than the threshold amount mandated by law for a calendar year.
- Provide Medicare 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 is provided by modifications. Each modification, like the original Agreement, is binding upon all parties. The initiative for securing coverage lies with the state.

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 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 **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 coverage groups** (non-retirement system groups); 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

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 a public retirement system (Section 218(d)(4) of the Act). A group covered by a retirement system may be provided social security and Medicare coverage under an Agreement only after a referendum is held. 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

Coverage Referendum for Employees under Retirement Systems

If a group of employees is covered by a retirement system, social security coverage may be extended by a Section 218 Agreement, using either a majority or divided vote referendum.

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, rather than a majority of the eligible employees voting, must favor 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:

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, California, Connecticut, Florida, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Massachusetts, Minnesota, Nevada, New Jersey, New Mexico, New York, North Dakota, Pennsylvania, Rhode Island, Tennessee, Texas, Vermont, Washington and Wisconsin. It must be remembered that these "divided vote" states are not limited to holding divided vote referendums; they are also permitted to hold majority vote referendums if they so desire.

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. Most states prefer procedure (1). 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 Rules

An entity with a Section 218 Agreement may terminate its existence as a governmental unit, or be merged or consolidated into another entity . In these situations, 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 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 exists 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) – 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 would be 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 would 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.

Social Security 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 only **optional exclusions** under Section 218(c)(3), (5) and (8) and, therefore, may be covered under a voluntary Section 218 Agreement if so chosen. 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 voluntary (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 Social Security Administration determines the employer under the common-law rules, discussed in Chapter 3. ***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.)

- **Services performed by transportation system employees who are covered for Social Security under Section 210(k) of the Social Security Act**.

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 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.

Beginning July 2, 1991, most services that were optionally excluded under a Section 218 Agreement are covered by the mandatory social security provisions unless: 1) the employee is covered under a qualifying public retirement system or 2) the services are excluded from mandatory social security coverage under Section 210 of the Act (e.g., election worker services, student services; see **Exclusions from Mandatory Social Security Coverage** below). The following are positions and services which may be optionally excluded:

- **All services in any class or classes of elective positions.** These are positions filled by an election. 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 the Section 218 Agreement provisions may be different from the "part-time" definition under the mandatory social security provisions.*(See note below)

- **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 **Fee-Based Public Officials** below.

- **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 on **Election Officials and Election Workers**, later.

Note: *Effective July 1, 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. Likewise, Section 2023 of Public Law 105-277 enacted October 21, 1998, 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 (that is, under a Section 218 Agreement).

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 - Mandatory Social Security Coverage

Section 11332 of 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.

Exclusions from Mandatory Social Security Coverage

The following are exclusions from mandatory social security coverage as 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 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. This is true 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 Social Security Administration determines the employer under the common-law rules, discussed in Chapter 3. ***Note:*** *Services performed by patients or inmates as part of the rehabilitative or therapeutic program of the institution are not usually performed as 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 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 alien was admitted to the U.S.**

- **Services in positions compensated solely by fees that are subject to SECA (Self-Employment Contributions Act), unless a 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 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.**

- **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 a Section 218 Agreement covers certain agricultural services.**

Note: Coverage under a Section 218 Agreement supersedes all other considerations. 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.

States may continue to enter into voluntary Section 218 Agreements to extend coverage to employees who are mandatorily covered for social security and to members of a public retirement system.

If an employee is mandatorily covered for social security and becomes a member of a public retirement system that is covered for social security under a Section 218

Agreement, the employee is covered from that point forward for social security under that 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 per calendar year beginning January 1, 2009, 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, this 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, 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 threshold under mandatory social security for calendar years prior to 2009 are as follows:

2008	$1,400
2006 and 2007	$1,300
2002 through 2005	$1,200
2000 and 2001	$1,100
1995-1999	$1,000
1978-1994	$ 100

For 1968 through1977, the threshold was $50 per calendar quarter.

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. IRS Revenue Ruling 2000-6 provides reporting instructions for election officials and election workers.

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, stating 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 exclusion is taken, none of the compensation received, 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

Police officer and firefighter positions are generally defined under state statutes and court decisions. For social security purposes, the terms do not include services in positions that, although connected with police and firefighting functions, but 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	

All states may use the majority vote referendum procedure. Some states are also authorized under the Act to use the divided retirement system referendum. (Interstate instrumentalities may use the majority or divided retirement system referendum procedures.)

If the police officers and firefighters are covered under the same retirement system, their positions may be considered separate retirement systems for referendum and coverage purposes, or combined with each other, or with other positions, or both.

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 issues, contact the IRS or SSA. (See IRS Publications 515, 519 and 901 for additional information.)

3 - No Social Security Coverage

The final category of workers include 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. Qualifying public retirement systems are the subject of the next chapter.

Identifying Workers in the Coverage Group

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 federal law is applied and other issues to which state law is applied. 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)
What is the identity of the employer?
Are 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. See Chapter 8.

Identity of the Employer for Social Security Coverage and Taxation Purposes

Sometimes it is not clear which of two or more entities, organizations, or individuals is a worker's employer. In some cases, individuals ("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.

State Entities and Reporting Officials

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.)

The reporting officials should be familiar with Form 941 filing requirements, federal tax deposit requirements, and information return requirements, and are responsible for maintaining appropriate records.

The IRS has the responsibility for investigating incorrect reports and failures in reporting as well as assisting local officials in the proper preparation of tax reports. The SSA Employer Services Liaison Officer has the responsibility for responding to questions regarding the preparation of wage reports. (See Chapter 7.)

Indian Tribal Governments

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). Generally, Indian tribal governments should follow general rules that apply to nongovernmental entities for employment tax. Publications 15, *Employer's Tax Guide*, and 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.

1. 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).

2. 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 1959-354, 1959-2 C.B. 24.

3. 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.

Mandatory Medicare Coverage

The employer and employee Medicare tax supports a Federal health insurance program for individuals 65 and older and those with certain disabilities. Medicare benefits are discussed in Chapter 11. 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. 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 10.

Employees who have been in continuous employment with the employer since March 3l, 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. (See Revenue Ruling 86-88 and Revenue Ruling 88-36 in the Appendix.)

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 list of state administrators at ncsssa.org.) The same rules that are discussed earlier in this chapter apply.

Chapter 6

Social Security and Public Retirement Systems

With the passage of the 1950 Social Security Amendments, states began to participate in the Social Security program on a “voluntary” basis by entering into Section 218 Agreements with SSA. 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. Under this provision, states can provide these mandatorily covered employees with membership in a public retirement system as an alternative to mandatory social security coverage.

This chapter provides information about the requirements for a public retirement system as an alternative to the social security retirement system.

Mandatory Social Security and Public Retirement Systems

Mandatory social security coverage only applies if 1) the employee’s position is not covered by a Section 218 Agreement, and 2) the employee is not a qualified participant in a public retirement system. If mandatory coverage would apply, an employer can provide an alternative retirement system as long as it meets the requirements of IRC Section 3121(b)(7)(F).

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. A public retirement system may exclude part-time employees. If an employee excluded from 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.

This chapter explains the meaning of the terms “qualified participant” and “public retirement system,” as they are defined in IRC section 3121(b)(7)(F) and Regulation 31.3121(b)(7)-2 of the Employment Tax Regulations. The term “employer” is used only 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.

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. 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 a minimum level of benefits under that system. The minimum benefit requirements for a public retirement system are contained in the regulations section 31.3121(b)(7)-2(e) and in Revenue Procedure 91-40.*

Public Retirement System – Minimum Benefit Requirement

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. In other words, a retirement system must provide a minimum retirement benefit.

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 position unless the employee is a member of a public retirement system with respect to that position. See Section 31.3121(b)(7)-2(e)(1).

Types of Retirement Systems

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. This plan could be established under IRC sections 401(a), 403(b) or 457, for example. 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 credit employees 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. The definition of compensation must generally be no less inclusive than the definition of the employee's base pay.

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 one or more 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 ($106,800 in 2009) may also be disregarded.

> **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 2008, an employee contributes to the plan at a rate of 7.5 percent of base pay. Assume that the employee 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. If the pro rata allocation available on a given day would have to meet the minimum retirement benefit requirement with respect to compensation from the beginning of the plan year through that day, employees are treated as qualified participants 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 is 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, and it is not certain that any allocations will be made. 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 remains 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, on that day, the employee is (or ever has been) an actual participant in the retirement system and, 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 be 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. 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 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 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 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 Employee

A part-time employee, for purposes of mandatory social security and Medicare tax, is any employee who normally works 20 hours or less per week. 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. See Regulation 31.3121(b)(7)-2(d)(2)(iii).

> **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).

Note: *The definition of "part-time" under mandatory social security should not be confused with a definition of "part-time" provided under a Section 218 Agreement. 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.*

> **Example:** A city provided social security coverage to some of its employees under a Section 218 Agreement, but excluded services performed in part-time positions. Part-time positions are defined by the Section 218 Agreement 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.

Seasonal Employee

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 Employee

For purposes of a public retirement system, 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, since the individual is a qualified participant in the retirement plan with respect to the full-time position, it is not necessary to pay social security and Medicare tax with respect to the part-time position. See Section 31.3121(b)(7)-2(c)(2).

Whether an employee is a member of a retirement system is determined on an entity-by-entity rather than a position-by-position basis. If an employee is a member of a retirement system with respect to service the employee performs in a full-time position, the employee is generally treated as a member of a retirement system with respect to all service performed for the same employer in any other positions. See Regulation 31.3121(b)(7)-2(c)(2).

Caution: In some cases, 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 employment under Section 3121(b)(7), 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)-(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 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 (the employers) 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(c)(2).

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.

Example. An employee is a qualified participant in a retirement plan of a city on the last day of the plan year, May 31, 2005. If the alternative

> lookback rule is used, no liability for social security tax exists for the employee for calendar year 2006. 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). See Regulation 31.3121(b)(7)-2(d)(4)(i). 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.

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. 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. In addition, all retirees hired after March 31, 1986, are covered for Medicare.

> **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).

Chapter 7

Wage Reporting

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.

The information submitted to IRS is compared to the Form W-2 information sent to SSA. As SSA processes employer wage reports, it maintains a record of total wages processed for each employer. These totals are then compared with IRS employment tax records filed by the employer on Form 941, 943 or 944. Employers whose reports to IRS and to SSA do not match are contacted for an explanation. IRS contacts employers who reported more wages to SSA than to IRS, and SSA contacts employers who reported a higher amount to IRS. The employer must resolve any discrepancies identified in these records. Failure to resolve these discrepancies may result in IRS assessing penalties for filing incorrect reports.

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.

Note: *Government entities are responsible for reporting payments on information returns. Payments for nonemployee compensation are covered in Section 4. Governments must file Form 1099-G, Certain Government Payments, for certain payments, including tax refunds and grants. See the Instructions for Form 1099-G for more information.*

Medicare Qualified Government Employment (MQGE)

Employers must file a separate Form W-2 for each employee subject to Medicare-only withholding. MQGE Forms W-2 are filed separately from Forms W-2 having full FICA wages, 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.*

Employees Covered for MQGE and FICA

Because of employment 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 the employee is in a continuous employment relationship with the same employer (same EIN) for the year, 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 each withholding category, i.e., one 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 worker's compensation is less than a statutorily established amount ($1,500 for calendar year 2009), it is generally not subject to social security and Medicare tax. See IRC section 3121(b)(7)(F)(iv) and 3121(u)(2)(B)(ii)(V). However, under a state's 218 Agreement an election worker's 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 compensation is 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 worker's 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.

Worker's Compensation

Amounts received by police, 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 worker's compensation act or a statute in the nature of a worker's 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.

Worker's 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 worker's compensation act, however, may be subject to employment taxes and reporting.

How SSA Processes Wage Reports

All wage reports (Form W-2 information) 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 penalty assessments.

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

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 (Circular E), for a discussion of requirements for new hires.

Verification Services Available from Social Security

SSA offers free verification of employee names and social security numbers to employers to allow employers to ensure they have a correct name and SSN. This can be done by telephone or paper submission. The instructions are in SSA Publication 20-004, Employee Verification Service (EVS). This is available from any ESLO or it can also be downloaded from the SSA website.

Up to 5 Names/SSNs – Call the SSA toll-free number for employers at 1-800-772-6270, or the general number at 1-800-772-1213. Both numbers are available from 7:00 a.m. to 7:00 p.m., Eastern Time.

Up to 50 Names/SSNs – Submit to your local Social Security office. Your local office will provide you with format and submission instructions. Some offices accept faxed listings. Check your local telephone listings or visit the SSA website to find the office nearest you.

More Than 50 Names/SSNs – A simple registration process is required for verification requests of more than 50 names. **Paper listings should contain no more than 300 names and SSNs for verifications.**

Larger verification requests are ideal for verifying an entire payroll database, or if you hire more than 50 workers at a time.

See the SSA employer page for more information on the Employee Verification Service.

Note: *As of 10/01/07, SSA no longer accepts magnetic media submissions for EVS. SSA will only accept paper and telephone submissions.*

The Social Security Number Verification Service (SSNVS) is a free, internet-based service 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 website.

Verifying Employment Eligibility

Under the **Immigration and Nationality Ac**t, 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 M-274, *Handbook for Employer*s, complete with Form I-9 and answers to questions, is 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 website at www.uscis.gov, call (202) 375-5283, or mail questions to:

U.S. Citizenship and Immigration Service
Office of Employer and Labor Relations
425 I Street NW
Washington DC 20536

A free on-line computer verification service is available that allows instant verification of name, SSN, and work eligibility via a personal computer and modem. Contact the USCIS Business Liaison Office at 1-800-357-2099 for information and free software for this service.

Correcting Wage Reports

Once information has 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 MMREF-2, Magnetic Media Reporting and Electronic Filing of Forms W-2c, available on SSA's website or from any Employer Service Liaison Officer (ESLO). A list of the ESLOs is also available at this site. See "Failure to File Form W-2c and/or Form W-3c with SSA" below when adjusting prior year earnings on Form 941 and/or Form 941c.

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.*

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 incorrect wage base for social security, or applying 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 will (1) be unable to read the form, or (2) 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

Major reporting problems. 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 in case there is a problem with the submission.

Unreadable reports. Reports must meet the requirements set out in MMREF-1, Magnetic Media Reporting and Electronic Filing, 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.

Note: For information on the most recent MMREF-1 formats, visit the SSA website.

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 otherwise unnecessary and costly reconciliations between SSA, the IRS and the employer.

Social Security and Medicare Tax Rates and Limits

Social Security and Medicare Tax				
Social Security (OASDI) Tax Information	**2006**	**2007**	**2008**	**2009**
Employee Rate	6.20%	6.20%	6.20%	6.20%
Employer Rate	6.20%	6.20%	6.20%	6.20%
Maximum Wages*	$94,200	$97,500	$102,000	$106,800
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			
*The wage base subject to social security for the next calendar year is calculated and announced by SSA in October. *Note: For years before 2006, visit SSA's website at* http://www.socialsecurity.gov/OACT/COLA/cbb.html *to* obtain the wage base information.				

Chapter 8

State Social Security Administrators

Each state designates, by statute, a state official 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, and Social Security Regulations 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 ("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 secured 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 to resolve 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. Interaction with non-section 218 entities is appropriate and necessary, but the degree of involvement varies from state to state.

The State Social Security Administrator (State Administrator) is the principal state official responsible for these functions. As such, the 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 Social Security Administrator and staff possess a wealth of knowledge 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. The law requires that each state provide a central point of contact to handle these complex matters.

National Conference of State Social Security Administrators (NCSSSA)

The ever-changing and complex social security coverage statutes, withholding requirements, reporting obligations and associated employment tax regulations require constant monitoring and interpretation. For more than 50 years the National Conference of State Social Security Administrators (NCSSSA) has provided an effective network of communication for federal, state, and local governments concerning social security coverage and federal employment tax policy.

With the enactment of Section 218 to the 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 the particular 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 NCSSSA was established to provide a unified state perspective at the federal level to provide an on-going medium for problem solving and to maintain an open forum for the development of new policy.

Since its formation in 1952, the NCSSSA has worked closely with SSA and IRS to address social security (and later Medicare) coverage and employment tax issues raised by state and local employers and State Social Security Administrators throughout the United States. The NCSSSA works with the federal officials to ensure that legislative and regulatory changes address state and local concerns. The NCSSSA 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.

Audits and Reviews of Public Employers

When the IRS or SSA conducts an audit or review of a public employer, it may contact the State Administrator for that state to clarify the employer's status, including:

- Whether the employees are covered under a Section 218 Agreement; and,
- If so, the specific exclusions (mandatory **and** optional) that are applicable to that entity that which must be taken into account during the audit or review, including any that are unique to individual employees (for example, whether any employees are subject to the Medicare continuing employment exemption).

For further information about the NCSSSA, contact your State Social Security Administrator. (See the list at NCSSSA's website, www.ncsssa.org.)

Chapter 9

Social Security Administration

The Social Security Administration (SSA) is the primary income security agency for Americans. It administers the federal Old-Age, Survivors and Disability Insurance (OASDI) program and the Supplemental Security Income (SSI) program. The OASDI program is the largest income-maintenance program in the United States. The 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.

In addition to the OASDI and SSI programs, SSA provides service delivery support to other programs, particularly Medicare, the Black Lung Program, Railroad Retirement, Medicaid, and Supplemental Nutrition Assistance Program (food stamps).

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, **Social Security and Medicare Coverage**, for more information.)

Black Lung Program

The Black Lung program pays monthly cash benefits to coal mine workers and their dependents and survivors. SSA is responsible for administering Part B of the Black Lung program under title IV of the federal Coal Mine Health and Safety Act.

Railroad Retirement

SSA provides services in connection with entitlement to benefits from the Railroad Retirement Board (RRB). In most instances, SSA takes the applications and determines benefit payments by giving credit for wages earned with railroad (RR) employment. Depending on the number of RR credits earned, a separate application for benefits may need to be filed with the RRB to obtain a benefit based on those RR earnings. In survivor cases, either the RRB or the SSA will pay the benefits, depending on the worker’s status at death.

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.

Supplemental Nutritional Assistance Program

SSA assists the Department of Agriculture by providing information about the food stamp program and taking food stamp applications for qualified OASI, DI and SSI claimants.

Social Security Number

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 forward these amounts, along with the employer tax, to the IRS on a regular schedule. By the end of February (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. In turn, 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 earning 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.

Organization

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

All components within SSA's central office, which is located in Baltimore, Maryland, 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 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.

SSA Responsibilities

Public employers should first consult with the State Social Security Administrator on coverage issues. If additional assistance is needed regarding coverage, the appropriate Parallel Social Security Office should be contacted. (See list at the end of this chapter.) Public employers who have questions regarding electronic filing should contact the appropriate Employer Services Liaison Officer (ESLO) listed at the SSA website.

For additional contact information, see the SLGE page at the SSA site. Questions related to tax liability should be directed to the IRS.

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.

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.

Note: *Listings of the Regional Social Security Offices and the Parallel Social Security Offices (discussed above) are located at the end of this chapter.*

<u>Central Office</u>

The Office of Income Security Programs (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.

Office of Income Security Programs (OISP)

This office plans, develops, evaluates, and issues operational policies and procedures concerning coverage and wage questions related to Sections 210 and 218 of the Social Security Act. As lead component for all state and local matters, OISP administers the Social Security Act and interprets its provisions. OISP:

- Interprets laws and regulations relating to state and local coverage and wages;
- Coordinates national coverage and wage policy with the Internal Revenue Service and other federal and state agencies;
- Coordinates coverage and wages issues for which no policy has been established or in which present policy may require a change that may have national impact;
- Issues policies and develops procedures and instructions on coverage, wages, and reporting;
- Administers the policy for decisions involving pre-1987 reporting and wage corrections;
- Maintains and updates the State and Local Coverage Handbook (SLCH) for SSA and the State Social Security Administrators; and
- Makes decisions regarding 218(s) and (t) cases for pre-1987 periods.

<u>Office of Communications (OCOMM)</u>

This office maintains liaison with all levels of government—federal, state and local (county and municipal). OCOMM has oversight responsibility for both the Agency's interaction and relationships with government entities with a focus on public information and public affairs. Basically, in regard to state and local activities, OCOMM:

- Coordinates the broad informational effort to explain social security programs to state and local employees and employers;
- Produces comprehensive publicity materials to explain the protection which social security coverage provides;
- Maintains contact with national organizations representing governmental and government employee interest;
- Represents SSA in negotiations with federal, state and local government agencies on major program issues concerning public affairs and public information, i.e., the interface between federal and state income maintenance programs, or the

implications of proposed changes in SSA administered programs for state and local governments;

- Seeks to ensure that the interests of state and local governments and other federal agencies are represented in SSA's policy and decision making process; and
- Has lead role in NCSSSA/SSA Government Communications Workgroup to develop strategy for reaching state and local audiences, as well as to improve communications in general among the states, regions, and Central Office as well as other federal agencies in state and local matters.

Office of Central Operations (OCO)

This office processes all wage and correction reports (including those from state and local governments), reconciles Annual Wage Reports with IRS Form 941 tax returns, and corresponds with those employers showing reporting discrepancies.

Office of Legislation and Congressional Affairs (OLCA)

- Conducts program evaluation and legislative planning activities including those related to state and local coverage issues;
- Monitors legislation that affects SSA programs and reviewing regulations resulting from legislation;
- Prepares testimony and background material for use by SSA officials in connection with congressional hearings and other contacts with the Congress.

Office of Financial Policy and Operations

- Resolves unpaid Section 218 pre-1987 contribution liability.

Regional Social Security Offices

Direct inquiries regarding state and local coverage questions only to State and Local Coverage Specialist. For all other inquiries, go to www.socialsecurity.gov/reach.htm.

Boston:
Social Security Administration
Room 1900
JFK Federal Building
Boston, Massachusetts 02203

Dallas:
Social Security Administration
1301 Young St. Ste. 130
Dallas, Texas 75202-5433

New York:
Social Security Administration
Federal Building, Suite 4060
26 Federal Plaza
New York, New York 10278

Kansas City:
Social Security Administration
601 East 12th Street, Room 436
Kansas City, Missouri 64106

Philadelphia:
Social Security Administration
P.O. Box 8788
300 Spring Garden St.
Philadelphia, Pennsylvania 19101

Denver:
Social Security Administration
1961 Stout Street
Room 1052 Federal Office Bldg.
Denver, Colorado 80294-3538

Atlanta:
Social Security Administration
61 Forsyth Street, SW
Suite 22T64 – RSIPT
Atlanta, GA 30303

San Francisco:
Social Security Administration
P.O. Box 4206
Richmond, California 94804

Chicago:
Social Security Administration
600 West Madison Street
10th Floor, Chicago, IL 60601

Seattle:
Social Security Administration
701 Fifth Avenue
Suite 2900 M/S 303A
Seattle, Washington 98104-7075

Parallel Social Security Office Contacts

Region 1:

Connecticut
960 Main Street, Second Floor, Hartford, CT 06103

Maine
*(mailing address)*PO Box 1075 Augusta, ME 04332-1075
(office address) North Park Professional Building, 330 Civic Center Dr., Augusta, ME 04330

Massachusetts
1st floor, 10 Causeway Street, Rm 148, Boston, MA 02222

New Hampshire
Suite 100, 70 Commercial Street, Concord, NH 03301

Rhode Island
380 Westminister Mall, Room 318, Providence, RI 02903

Vermont
33 School St, Montpelier, VT 05602

Region 2:

New Jersey
635 S Clinton Avenue, Trenton, NJ 08611

New York
Federal Building, 1 Clinton Avenue, Rm 430, Albany, NY 12207

Puerto Rico
4 Piso SJ SIF Bldg, 1579 Ponce de Leon, Rio Piedras, PR 00926

St. Thomas, Virgin Islands
8000 Nisky Center, 1st Floor, Suite 2, Charlotte Amalie, VI 00802-9911

Region 3:

Delaware
Suite 100, 500 W. Loockerman Street, Dover, DE 19904

Maryland
Suite 200, 1010 Park Avenue, Baltimore, MD 21201

Pennsylvania
555 Walnut Street, Harrisburg, PA 17101

Virginia
1834 W. Cary Street
Richmond, VA 23220

West Virginia
500 Quarrier Street
Suite 300
Charleston, WV 25301

Region 4:

Alabama
2450 President Drive, Montgomery, AL 36120

Florida
2002 Old St. Augustine Road, Suite B12, Tallahassee, FL 32301

Georgia
401 W. Peachtree Street, Suite 2860, Atlanta, GA 30308

Kentucky
140 Flynn Avenue, Frankfort, KY 40601

Mississippi
100 W Capitol Street, Suite 225, McCoy, Federal Building, Jackson, MS 39269

North Carolina
4701 Old Wake Forest Road, Raleigh, NC 27609

South Carolina
Strom Thurmond Federal Building, 1835 Assembly Street, 2nd Floor, Columbia, SC 29202

Tennessee
4527 Nolensville Road, Nashville, TN 37211

Region 5:

Illinois
2715 West Monroe St, Springfield, IL 62704

Indiana
575 N Pennsylvania Street, Room 685, Indianapolis, IN 46204

Michigan
5210 Perry Robinson Circle, Lansing, MI 48911

Minnesota
190 5th Street E Ste 800, St. Paul, MN 55101

Ohio
Federal Building, 200 North High Street, Room 225, Columbus, OH 43215

Wisconsin
6011 Odana Rd, Madison, WI 53719

Region 6:

Arkansas
Federal Building, 700 W Capitol Street, Rm 1433, Little Rock, AR 72201

Louisiana
5455 Bankers Avenue, Baton Rouge, LA 70808

New Mexico
1922 Fifth Street, Santa Fe, NM 87505

Oklahoma
Shephard Mall, 2615 Villa Prom, Oklahoma City, OK 73107

Texas
1029 Camino La Costa San Jacinto Boulevard, Suite 102, Austin, TX 78701

Region 7:

Iowa
Federal Building, 210 Walnut Street, Room 293, Des Moines, IA 50309

Kansas
600 SW Commerce Place, Topeka, KS 66615

Missouri
3523 Amazonas Drive, Jefferson City, MO 65109

Nebraska
100 Centennial Mall N, Room 191, Lincoln, NE 68508

Region 8:

Colorado
1616 Champa Street, 4th Floor, Denver, CO 80202

Montana
Suite 1600, 10 W. 15th Street, Helena, MT 59626

North Dakota
1680 E. Capitol Avenue, Bismarck, ND 58501

South Dakota
Federal Building, 200 4th Street, S.W., Room 105, Huron, SD 57350

Utah
202 West 400 South, Salt Lake City, UT 84101

Wyoming
5353 Yellowstone, 2nd Floor, Room 210, Cheyenne, WY 82009

Region 9:

Arizona
Suite 100, 1122 N. 7th Street, Phoenix, AZ 85006-2781

California
8351 Folsom Boulevard, Sacramento, CA 95826

Hawaii
Federal Office Building, 300 Ala Moana Boulevard, Room 1-114, Honolulu, HI 96850

Nevada

1170 Harvard Way, Reno, NV 89502

Region 10:

Alaska
222 W 8th Avenue, Room 66, Anchorage, AK 99513-7505

Idaho
1249 S. Vinnell Way, Suite 101, Boise, ID 83709-1678

Oregon
11975 SW 2nd Street, Suite 100, Beaverton, OR 97005-2906

Washington
402 Yauger Way SW, Olympia, WA 98502-5068

Chapter 10

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 marks 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.

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.

These operating divisions include:

Wage and Investment, focused on individual taxpayers.

Small Business/Self-Employed, oriented to S-corporations, partnerships, small corporations and sole proprietors.

L*arge and Mid-Size Business*, dealing with all forms of business with assets greater than $5 million.
Tax Exempt and Government Entities, which includes 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 very distinct customer segments: Employee Plans, Exempt Organizations, and Government Entities. Customers range from small local community organizations and municipalities to major universities, large pension funds, state governments, 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.

Government Entities contains three components:

Tax-Exempt Bonds (TEB)

Indian Tribal Governments (ITG)

Federal, State, and Local Government (FSLG)

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 efforts. It also administers and conducts the tax-exempt bond examination program. For more information, visit the Tax Exempt Bond website.

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 unique 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.

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
- The semiannual FSLG Newsletter
- Links to related sites of interest

Chapter 11

Social Security and Medicare Benefits

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 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 federal general 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 2009, one credit is earned for each quarter with $1,090 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.

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 needed to be eligible for social security and Medicare benefits depends on the individual's 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 if they die.

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. 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

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 FRA, then the individual's monthly benefit is reduced by a certain percentage. In 2003, FRA or the age at which full benefits are payable began to increase in gradual steps from 65 to 67. This provision affects people born in 1938 and later.

If you receive social security benefits before you reach FRA, your benefits are further reduced if you continue to work and earn more than an annual exempt amount. The annual exempt amount changes each year. You can earn up to that amount and not experience any additional reduction of your social security benefits. If you are under FRA and earn over the exempt amount, your benefits will be reduced $1 for every $2 in earnings above the exempt amount. In the year you reach FRA your 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. 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.

(Note: Benefits for divorced spouses age 62 or older may be payable if the insured worker 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.

	2005	2006	2007	2008	2009
Earnings required for one credit	**$920**	**$970**	**$1,000**	**$1,050**	**$1,090**
Exempt amount - under full retirement age	**$12,000**	**$12,480**	**$12,960**	**$13,560**	**$14,160**
Exempt amount - year attaining normal/ full retirement age	**$31,80**	**$33,240**	**$34,440**	**$36,120**	**$37,680**

Full retirement age or older **No limits effective January 2000.**

NOTE: *For years after 2004, visit the SSA Automatic Increases web page to obtain new social security benefit amounts. To see a chart of full retirement ages (FRA) see the Retirement Planner page.*

Survivors

For family members to receive benefits upon a worker's death, the worker must have earned one social security credit for each year beginning in 1951 (or since age 21, whichever is later) and a minimum of six credits. Family members may also qualify for benefits if the worker earned six credits in the three years prior to death. The number of credits a person needs for survivors to be eligible for benefits increases each year until the worker reaches age 62, up to a maximum of 40 credits.

Children and the surviving spouse may qualify for monthly benefits up to a maximum level and may also qualify for a one-time death benefit. A surviving spouse's benefit can be affected by his or her age, work history, and the number of other family members who receive benefits on the deceased worker's earnings record. The benefit is permanently reduced if the surviving spouse retires before age 65 and is not caring for a child who receives benefits on the deceased worker's earnings record.

Benefits are paid to widows and widowers at age 60, at age 50 if disabled, or at any age if the widow or widower is caring for the deceased's child. The child must be under age 16 or disabled before age 22 and eligible to receive benefits on the deceased's record.

Unmarried children under the age of 18 (under 19 if in high school) or any age if disabled before age 22 also may qualify for social security benefits on a deceased parent's social security record.

Disability

To qualify for disability benefits, a worker must be fully insured and, except where the individual is disabled because of blindness, must also meet a test of substantial recent work activity. Under this test, a worker aged 31 or older must have at least 20 credits during the period of 40 calendar quarters ending with the quarter in which the disability began. Workers disabled at ages 24 through 30 must have credit in one-half of the calendar quarters elapsing after age 21, and workers under age 24 need 6 credits in the period of 12 quarters ending with the quarter of disability onset.

Benefits to the worker and entitled family members may be reduced if workers' compensation or public disability benefits are also received.

Medicare

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 two parts: Part A (Hospital Insurance) and Part B (Medical Insurance). Part A helps pay for inpatient hospital care, skilled nursing care and other services. Part B helps pay for doctor's fees, outpatient hospital visits and other medical services and supplies. Generally, individuals who are entitled to monthly social security benefits are entitled to Part A coverage at age 65 or the 25th month of disability entitlement, as are individuals who have Medicare-only coverage under a Section 218 Agreement. Others who are not insured for Part A through their own employment may have coverage as the spouse, divorced spouse, or widow(er) of a covered individual if they meet certain other requirements. Individuals age 65 and older, who are not eligible for social security or Medicare-only coverage, can obtain Part A coverage by paying a monthly premium. These individuals can purchase Part B only or both Part A and Part B coverage.

> **Example:** A public school teacher, covered by a state teachers retirement system, whose entire public service was performed at the same board of education, may be exempt from paying both social security and Medicare taxes. This teacher, unless eligible for premium-free Part A as a spouse, would have to purchase Part A coverage by paying substantial premiums.

HI provides protection to disabled beneficiaries who have been entitled to social security disability benefits for at least 24 months (or government employees with Medicare-only coverage who have been disabled for more than 29 months), and to insured workers (and their spouses and children) with chronic kidney disease that requires dialysis or a kidney transplant. Effective July 1, 2000, the 24-month waiting period is waived for disability beneficiaries who have Amyotrophic Lateral Sclerosis. Call 1-800-MEDICARE to speak with a Medicare Customer Representative.

Note: *Although the full retirement age for social security is changing, Medicare eligibility remains at age 65. 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, **Social Security and Medicare Coverage.**

Social Security Statement

SSA sends a statement annually to workers and former workers aged 25 and older that 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) for their entire working lifetimes 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.

Pensions 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 your social security benefit. The Windfall Elimination Provision (WEP) affects the way your social security retirement or disability benefit is computed. The Government Pension Offset (GPO) affects the amount of the social security benefit you receive as a spouse or widow(er). 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.

Windfall Elimination Provision (WEP)

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.

Before 1983, people who worked mainly in a job not covered by social security had their benefits calculated as if they were long-term, low-wage workers. They had the advantage of receiving a social security benefit representing a higher percentage of their earnings, plus a pension from a job where they did not pay social security taxes.

The purpose of the WEP is to remove the unintended advantage that the heavy weighting in the social security benefit formula provides for persons who receive pensions from non-covered employment. The weighting 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.

The basic formula also benefits 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 eliminated 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.

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 same 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, within this GPO provision, a spouse or widow(er) could meet the GPO exemption 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 requires 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 need 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 is covered by both social security and the pension system and the last day occurs 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 exempted from the GPO regardless of when he/she filed for benefits.

The Act does provide a transition for workers whose last day of government employment occurs within 5 years after the date of enactment (March 2, 2004). Any state or local government worker whose last day of government employment occurs after June 30, 2004, and before March 2, 2009, can 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 would be 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 the date of enactment, March 2, 2004. If the 60-month period is reduced, the remaining months of service needed to fulfill the requirement must be 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 begins 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 is before March 2, 2009, Ms. Jones would be exempt from the GPO offset.

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

Defining a Pension for WEP/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. This provision, does not apply if the 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 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, for instance, 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.

Examples:

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.

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.

Chapter 12

Publications, Forms and Other Resources

Publications and Forms — Internal Revenue Service

Actual exhibits are not included in this chapter because forms are revised frequently. A more comprehensive list of IRS publications is available in IRS Publication 17, **Your Federal Income Tax (For Individuals).**

Publication Number	Title
1	Your Rights as a Taxpayer
15	Circular E, Employer's Tax Guide
15-A	Employer's Supplemental Tax Guide
15-B	Employer’s Tax Guide to Fringe Benefits
17	Your Federal Income Tax
51	Circular A, Agricultural Employer's Tax Guide
80	Circular SS, Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands
463	Travel, Entertainment, Gift and Car Expenses
509	Tax Calendars
515	Withholding of Tax on Nonresident Aliens and Foreign Entities
519	U.S. Tax Guide for Aliens
521	Moving Expenses
553	Highlights of 2008 Tax Changes
571	Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations
594	The IRS Collection Process
901	U.S. Tax Treaties
910	IRS Guide to Free Tax Services
915	Social Security Benefits and Equivalent Railroad Retirement Benefits
947	Practice Before the IRS and Power of Attorney

Publication	
957	Reporting Back Pay and Special Wage Payments to the Social Security Administration
1542	Per Diem Rates
1976	Do You Qualify for Relief Under Section 530?
4268	Employment Tax Desk Guide (available only at www.irs.gov/tribes)

Form Number	Title
SS-4	Application for Employer Identification Number
W-2	Wage and Tax Statement
W-2c	Corrected Wage and Tax Statement
W-3	Transmittal of Wage and Tax Statements
W-3c	Transmittal of Corrected Wage and Tax Statements
W-4	Employee's Withholding Allowance Certificate
W-5	Earned Income Credit Advance Payment Certificate
W-9	Request for Taxpayer Identification Number and Certification
941	Employer's Quarterly Federal Tax Return
941X	Adjusted Employer's Quarterly Federal Tax Return
943	Employer's Annual Tax Return For Agricultural Employees
944	Employer's Annual Federal Tax Return
944X	Adjusted Employer's Annual Federal Tax Return
945	Annual Return Of Withheld Federal Income Tax
945-A	Annual Record Of Federal Tax Liability
1042	Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
1042-S	Foreign Person's U.S. Source Income Subject to Withholding
1096	Annual Summary and Transmittal of U.S. Information Returns
1099-MISC	Miscellaneous Income
8233	Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual

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.

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 (1-800-829-1040)

Publications and Forms – Social Security Administration

Publication/Form Number	Title
SS-5	Application for Social Security Card
SSA-7004	Request for Social Security Statement
16-004	Employer's Guide to Filing Timely and Accurate W-2 Wage Reports
20-004	Employee Verification Services
31-011	Software Standards and Edits for Annual Wage Reporting
31-031	Software Specifications and Edit Criteria for Correcting Annual Wage Reports
Publication No. 42-007	Specifications for Filing Forms W-2 Electronically (EFW2)
Publication No. 42-014	Specifications for Filing Forms W-2c Electronically (EFW2)
Form SSA-1945	Statement Concerning Your Employment in a Job Not Covered by Social Security
---	*SSA/IRS Reporter*
	(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.

To request SSA publications:

- Telephone 1-800-772-1213 (toll-free), or TTY 1-800-325-0778
- Download from the SSA employer page.

Other SSA Services

Business Services Online (BSO)

Employers with Internet access can submit their W-2 files using SSA's SSA Business Services Online. This option is fast, free and secure and uses the same W-2 file format as would be sent on disk or tape. 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).

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 www.ssa.gov/reach.htm.

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 online on its web page. 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, 8th Floor, Washington DC 20254.

Key SSA Web Pages

***Employer Reporting Instructions and Information* (www.socialsecurity.gov/employer)**

This SSA website addresses employer reporting and other interests.

***Social Security Online* (www.socialsecurity.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.socialsecurity.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.

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.

Chapter 13

Frequently Asked Questions

The following are some questions that arise often in connection with the topics in this publication. Some are hypothetical situations that reflect common types of questions. After each answer, the primary organization responsible for answering this question is identified. For convenience, the questions are grouped by topic.

(Section 218 and Social Security)

1. **What is a Section 218 Agreement?** A Section 218 Agreement is a written voluntary agreement between a state and the SSA pursuant to the provisions of Section 218 of the Social Security Act to provide 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 needs to execute one, contact your State Social Security Administrator. See list of state administrators under Chapter 8, **State Social Security Administrators,** or on-line at 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 under a public retirement system. This may provide social security coverage and Medicare coverage for:

   - Absolute coverage group (non-retirement system) employees, prior to being covered by a section 218 Agreement. The social security and Medicare coverage continues in addition to retirement system coverage.

   .

   - Employees performing services that are excluded from mandatory coverage provisions, but are optional exclusions under Section 218 Agreements, e.g., student services; services of election officials and election workers who earn less than the threshold amount.

   - Election officials and workers, establishing a threshold amount for coverage lower than the statutory requirement.

- Employees hired before April 1, 1986, who are qualified participants in a public retirement system and meet the continuing employment exception. [STATE]

3. **Why would 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 ineligibles, to cover employees changing to the "Yes" group in a divided retirement system, to cover previously terminated groups, to identify additional political subdivisions that join 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. Why can't our town stop its coverage?** Since April 20, 1983, coverage obtained under a Section 218 Agreement cannot, by law, be terminated. Beginning July 2, 1991, if state and local government employees are not covered for social security under a Section 218 Agreement and are not qualified participants in a public retirement system, they are mandatorily covered under social security. Mandatory social security coverage ceases if the employees subsequently become qualified participants in a public retirement system. [STATE/SSA]

5. **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 August 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]

6. **Are any services excluded from mandatory social security and Medicare coverage under Section 3121(b)(7)(F) of the IRC?** Yes. However, some services excluded under Section 3121(b)(7) of the IRC may be covered by a Section 218 Agreement. See Chapter 5, **Social Security and Medicare Coverage**. [IRS, SSA]

7. **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 a Section 218 Agreement.

8. **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 1) covered under a Section 218

Agreement or 2) not a qualified participant in a public retirement system. Any official elected or appointed after March 31, 1986, is subject to Medicare. [IRS]

9. **Are Indian tribal government employers eligible to enter into Section 218 Agreements?** No, Indian tribal governments are not treated as states for this purpose. See IRC section 7871. [IRS]

10. **What determines whether an organization is a public or a private non-profit employer?** Generally, you should consider the provisions of state and local law when determining whether an organization is a public employer or a private non-profit employer. Obtain a copy of the statute under which the entity was created and the legal document creating the entity. When the status of an entity is unclear, the state may request the Attorney General's opinion concerning whether the entity constitutes a political subdivision under the laws of that state. Some political subdivisions, such as hospitals and libraries, can be both public and nonprofit. Contact the IRS concerning the status of an entity for social security and Medicare purposes. Refer questions concerning the status of an entity for Section 218 purposes to the State Social Security Administrator. Also, see Chapter 2, **Government Entities**, for information on wholly-owned instrumentalities of a state or political subdivision. [IRS]

(Whom To Contact)

11. **I have a question regarding social security and Medicare coverage requirements. 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 is needed, coverage issues should be addressed to SSA. See Chapter 8, **State Social Security Administrators**. [STATE]

12. **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 receiving applications for monthly retirement, disability or survivors benefits. The amount of benefits is based in part on an individual's earnings over his or her working career. Therefore, SSA must know about those earnings. 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 reporting questions. [IRS/SSA]

13. **Where can I obtain a list of governmental employers in my state?** A list of all states and the total number of government employers can be found on the U.S.

Bureau of the Census Governments Integrated Directory website at **www.census.gov.** To identify the specific entities, locate a list of state departments in your state and identify who works with employers. You may start with offices such as the state department of labor and employment or Secretary of State and contact other offices such as the department of local affairs. Determine whether any government types are not included in your existing lists and gather lists from the appropriate sources, such as school districts. [STATE]

(Correcting Errors)

14. **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.You can get Form SSA-7004 from any Social Security office, by calling 1-800-772-1213, or through the SSA website at www.ssa.gov/mystatement. [SSA]

15. **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 and penalties. See Chapter 4, **Determining Worker Status**. [IRS]

16. **What do you do if the status of a worker cannot be determined?** 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, **Determining Worker Status**. [IRS]

17. **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]

(Coverage for Specific Types of Workers)

18. **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 (e.g., 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). [IRS]

19. **Does a college student employed by a university during the summer months qualify for the student social security and Medicare exception 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, "Update: Student FICA Exception", in the June 2005 FSLG Newsletter for further details. [IRS]

20. **How is prison inmate labor treated?** 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 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*. In addition, services performed by inmates as part of the rehabilitative and therapeutic program of the institution are not usually performed as employees. See also the article "Amounts Paid to Inmates" in the January 2006 FSLG Newsletter. [IRS]

21. **Are elected and appointed officials employees?** Elected 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. 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, **Determining Worker Status**. [IRS]

(Mandatory Social Security Coverage)

22. **How is termination of employment defined for purposes of determining whether the Medicare tax is applicable?** All requirements of the continuing

employment exception, as discussed in Section 5, must be met to exempt an employee from the Medicare tax. 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. (Revenue Ruling 86-88.) [IRS]

23. **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]

24. **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. 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. Also, 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. [SSA]

(WEP/GPO Reduction)

25. **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 full benefits from both?** The Windfall Elimination Provision may reduce social security benefits. Additionally, spouses' benefits may be reduced by the Government Pension Offset formula. See Chapter 11, Social Security and Medicare Benefits. [SSA]

(Public Retirement System)

26. **A Section 218 Agreement can cover services of employees who are in a retirement system, but how does the Social Security Administration define a retirement system for this purpose? Is it the same definition that the Internal Revenue Service uses?** A retirement system for retirement system group coverage under an Agreement is 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. See Chapter 6, Public Retirement Systems. [IRS/SSA]

27. **What is a "public retirement system" as defined by the IRS?** A "public retirement system" or 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. Also see Chapter 6 and Question (2) above. A public retirement system is not based on the requirements be a qualified plan within the meaning of the Employees' Retirement Income Security Act of 1974 (ERISA). [IRS]

28. **What does it mean to be a qualified participant in a retirement system?** A member must actually participate in the system. If an employee is eligible but decides not to participate, that individual will be subject to mandatory social security tax, up to the amount of the social security wage base for the year. 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]

29. **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 works 20 hours or less per week. A seasonal employee can work full-time but less than 5 months a year. A temporary employee performs services under a contractual arrangement of two years or less. 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.

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]

30. **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 vested (100 percent). 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]

31. **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 would qualify. Nevertheless, each local government is a separate employer. [IRS]

32. **Is there any waiting period for alternate retirement system coverage in which social security and Medicare taxes do not have to be paid?** Yes. If a full-time employee can be enrolled in the plan by the first day of the second calendar month of service, social security and Medicare taxes do not have to be paid during this interim period. This rule does not apply to part-time, seasonal and temporary employees. [IRS]

33. **Is a retirement system that does not cover all employees a "retirement system" within the meaning of Regulations section 31.3121(b)7-2?** This determination is made on an individual-by-individual basis. Thus, a pension plan that is a retirement system for some employees may not be a retirement system for other employees. [IRS]

34. **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?** 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 applicability of the Medicare tax depends upon whether the continuing employment exception is available. [IRS]

35. **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 taxes on the wages as a bus driver?** No. The teacher 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 would, however, have to pay Medicare tax because the original employment relationship terminated at retirement. [IRS]

(Role of State Administrator)

36. **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, it should contact the State Social Security Administrator. [STATE]

37. **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]

38. **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 the public employer at issue. [SSA]

39. **Whom should I call when I have questions about Annual Wage Reporting?** Call your local Employer Services Liaison Officer. See Chapter 9, or go to the SSA website. [SSA]

40. **What information can IRS share with SSA and under what circumstances?** Section 6103 of the IRC governs the disclosure of tax information by the IRS to other federal and state agencies. SSA can obtain tax information from IRS under

several provisions of section 6103 when necessary to administer the social security laws. Questions concerning what can be disclosed by IRS to SSA should be directed to the local IRS Disclosure Officer. [IRS]

Glossary

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

Agreement - Section 218 Agreement.

Alternative Lookback Rule – A rule that allows an employer to determine whether an employee can be treated as a qualified participant in a retirement plan for purposes of mandatory FICA. 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.

Average Annual Wage - The annual wages paid divided by the average annual days of employment.

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 brought under 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 a worker who is an employee under the common-law test. 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; a corporation, partnership, LLC, 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 with respect to wages for employment.

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 most state and local government employees must be covered for state unemployment insurance purposes.

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.

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 between 65 and 67.

Full Social Security - Full social security includes 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 – A traditional function of government, legislative, executive, judicial: the control and prevention of crime, promoting the general welfare, 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 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 is used to offset 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 tribe, band, community, village or group of Indians or (if applicable) Alaska Natives that is determined by the Secretary of the Treasury, after consultation with the Secretary of the Interior, to exercise governmental functions. IRC section 7701(a)(40). Under IRC section 7871(a), listing purposes for which Indian tribal governments are treated as states, a subdivision of an Indian tribal government shall be treated as a political subdivision of a state if (and only if) the Secretary of the Treasury determines, after consultation with the Secretary of the Interior, that the subdivision has been delegated the right to exercise one or more of the substantial governmental functions of the Indian tribal government.

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 - Those services that are not covered under Sections 210 and 218 of the Social Security Act.

Mandatory Medicare (HI) – Required Medicare tax and coverage to state and local government employees hired or rehired after March 31, 1986.

Mandatory Social Security – Required application of social security tax and coverage to 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 years of age 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 (HI only) 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.

NCSSSA - National Conference of State Social Security Administrators.

Non-Covered Employment - Employment not covered by social security or Medicare 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.

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 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 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 as a political subdivision.

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 paying 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 a "retirement system" is not identical to 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 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.

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.

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.

Social Security Offices - The offices that administer the social security program locally. These servicing offices may request technical assistance from the PSSO as needed.

SSA - Social Security Administration.

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

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

TIN - Taxpayer identification number.

Wage Base - The maximum wage of each worker that is subject to the OASDI portion of social security tax in any calendar year. The social security wage base changes yearly. There is no wage base limit for Medicare beginning in 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 used for 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 websites www.irs.gov, www.ssa.gov, and www.ncsssa.org.

SECTION 218 of The Social Security Act

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 (l) 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

(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. t

(f) Treatment of Test Room Supervisors and Proctors Who Assist in the Administration of College Entrance and Placement Exams.—

(1) IN GENERAL.—In the case of an individual described in paragraph (2) who is providing services as a test proctor or room supervisor by assisting in the administration of college entrance or placement examinations, this section shall be applied to such services performed after December 31, 2006 (and remuneration paid for such services) without regard to subsection (a)(3) thereof.

(2) APPLICABILITY.—An individual is described in this paragraph if the individual—

(A) is providing the services described in subsection (a) to an organization described in section 501(c), and exempt from tax under section 501(a), of the Internal Revenue Code of 1986, and

(B) is not otherwise treated as an employee of such organization for purposes of subtitle C of such Code (relating to employment taxes).”.

26 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 abatements) 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.

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(l). 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 PARTICPATE 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.

Notice 2003-20

I. PURPOSE AND SCOPE

This notice describes the withholding and reporting requirements applicable to eligible deferred compensation plans described in § 457(b) of the Internal Revenue Code ("' 457(b) plans") for periods after December 31, 2001.

Specifically, this notice addresses --

$ income tax withholding and reporting with respect to annual deferrals made to a ' 457(b) plan;

$ income tax withholding and reporting with respect to distributions from a ' 457(b) plan, including changes for a § 457(b) plan established by a state or local government employer enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16;

$ Federal Insurance Contributions Act (FICA) payment and reporting with respect to annual deferrals under a ' 457(b) plan;

$ employer identification numbers (EINs) used in connection with trusts established under § 457(g); and

$ the application of annual reporting requirements to ' 457(b) plan administrators and trustees holding assets of a ' 457(b) plan in accordance with § 457(g).

The rules provided in this notice apply to deferrals and distributions from eligible ' 457(b) plans made after December 31, 2001. This notice addresses only reporting and withholding rules that apply to ' 457(b) plan participants who are or were employees of state and local governments or tax-exempt organizations and does not cover special reporting rules that may apply to § 457(b) plan participants who are or were independent contractors. Notice 2000-38, 2000-2 C.B. 174, applies to ' 457(b) plan distributions made before January 1, 2002, but see Section IX of this notice concerning its effective date provisions.

II. BACKGROUND

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers. State and local governments and tax-exempt organizations are eligible employers. They can establish either eligible plans that meet the requirements of § 457(b) or plans that do not meet the requirements of § 457(b) and that are therefore subject to § 457(f).

EGTRRA made numerous revisions to § 457, most of them effective after December 31, 2001. EGTRRA § 641(a)(1)(D)(i) added new § 3401(a)(12)(E) which provides that remuneration paid to an employee or beneficiary from a § 457(b) plan maintained by a state or local governmental employer (a governmental § 457(b) plan) is no longer treated as wages for purposes of income tax withholding under section 3402(a), but is now subject to income tax withholding under section 3405. This change is effective for distributions made after December 31, 2001. However, EGTRRA did not revise the provision of Chapter 21 of the Internal Revenue Code treating amounts deferred under a § 457(b) plan as subject to FICA taxes. See § 3121(v)(2) and (3). FICA taxes include both the Old Age, Survivors, and Disability Insurance (OASDI) tax and the Hospital Insurance (HI) tax, which are referred to in federal tax forms as social security and Medicare tax, respectively. This notice includes guidance under these new provisions regarding income tax withholding and reporting upon distributions from governmental § 457(b) plans.

Section 1448 of the Small Business Job Protection Act of 1996 ("SBJPA"), Pub. L. 104-188, 1996-3 C.B. 155, 212, amended § 457 by adding § 457(g), which requires that governmental § 457(b) plans hold all plan assets and income in trust, or in custodial accounts or annuity contracts described in § 401(f), for the exclusive benefit of participants and their beneficiaries. Section 457(g) does not apply to a ' 457(b) plan established by a tax-exempt organization that is not a state or local governmental entity. Notice 2000-38 provided guidance in response to inquiries concerning withholding and reporting upon § 457(b) plan distributions in light of this SBJPA amendment and certain changes made by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

This notice updates and supersedes Notice 2000-38 for contributions and distributions made after December 31, 2001.

III. INCOME TAX WITHHOLDING AND REPORTING ON ANNUAL DEFERRALS

As amended by EGTRRA, § 457(a)(1)(A) provides that annual deferrals under a governmental ' 457(b) plan and any income attributable to the amounts so deferred are not includible in a participant’s gross income until that amount is paid to the participant or beneficiary. Section 457(a)(1)(B) retains the pre-EGTRRA rule that annual deferrals under a ' 457(b) plan of a tax-exempt entity and any income attributable to the amounts so deferred are not includible in a participant’s gross income until that amount is paid or made available to the participant or beneficiary. Therefore, annual deferrals under a § 457(b) plan are not subject to income tax withholding at the time of the deferral. However, a participant’s annual deferrals during the taxable year under a ' 457(b) plan are reported on Form W-2, Wage and Tax Statement, in the manner described in the instructions to that form. “Annual deferrals,” as used in this notice, means the amount of compensation deferred under the plan in accordance with § 457(b), and in compliance with the annual maximum deferral limitation under the plan, whether by elective deferral or nonelective employer contribution, during a taxable year. Deferrals in a single employer’s eligible plan or plans in excess of the § 457(b) limitations are not annual deferrals and thus are subject to income tax withholding rules.

IV. INCOME TAX WITHHOLDING AND REPORTING ON GOVERNMENTAL § 457(b) PLAN DISTRIBUTIONS

A. Income Tax Withholding on Governmental § 457(b) Plan Distributions

"Distributions" from a governmental § 457(b) plan to a participant or beneficiary (including an alternate payee) include all amounts that are paid from the governmental § 457(b) plan. See Section V for provisions regarding income tax withholding on distributions from a § 457(b) plan of a non-governmental tax-exempt organization.

EGTRRA revises Chapter 24 of the Code, to provide that, effective after December 31, 2001, distributions to an individual from a governmental ' 457(b) plan are subject to income tax withholding in accordance with the income tax withholding requirements of ' 3405 applicable to distributions from qualified plans, annuities, and individual retirement arrangements (IRAs). Thus, EGTRRA extends the § 3405(c) direct rollover and mandatory 20 percent withholding rules to governmental § 457(b) plan distributions that qualify as eligible rollover distributions as defined under § 402(c)(4).

In addition, EGTRRA provides that the § 3405(a) and (b) elective withholding rules applicable to distributions from qualified plans, § 403(b) annuities, and IRAs that are not eligible rollover distributions are also extended to distributions from governmental § 457(b) plans. Thus, periodic distributions from governmental § 457(b) plans that are not eligible rollover distributions are subject to withholding under § 3405(a) as if the distribution were wages, and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding under § 3405(b) at a 10-percent rate. In either case (periodic or nonperiodic distributions), the recipient may elect not to have withholding apply under § 3405(a) or (b) to a distribution that is not an eligible rollover distribution from a governmental § 457(b) plan. For additional information regarding the provisions of § 3405 and related sections, see § 35.3405-1 of the Employment Taxes and Collection of Income Tax at Source Regulations under the Tax Equity and Fiscal Responsibility Act of 1982, § 31.3405(c)-1 of the Employment Taxes and Collection of Income Tax at Source Regulations, and §§ 1.401(a)(31)-1, 1.402(c)-2, and 1.402(f)-1 of the Income Tax Regulations.

B. Person Responsible for Income Tax Withholding on Distributions

EGTRRA amended § 3405(d) of the Code to make plan administrators of eligible governmental plans, rather than the payor of the designated distribution, generally liable for withholding under § 3405 upon distributions from such plans. However, under § 3405(d)(2)(A), a plan administrator is not liable for withholding if the administrator directs the payor to withhold income tax under § 3405 and provides the payor with the necessary information required by regulations at § 35.3405-1T, E 2 - 5. In that case, the payor is liable for withholding income tax. Subsections C, D, and E of this Section IV provide additional information on the withholding, deposit, and reporting obligations of the plan administrator or payor.

C. Reporting Governmental § 457(b) Plan Distributions on Form 1099-R

Distributions to an individual during a taxable year under a governmental ' 457(b) plan are reported on Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., in the manner described in the instructions to that form. Income tax withheld from governmental § 457(b) plan distributions is reported annually on Form 945, Annual Return of Withheld Federal Income Tax.

D. EINs and Income Tax Deposits for Section 457(g) Trust Accounts

Generally, the income tax withheld on distributions should be reported on the Form 945 of the person responsible for withholding, usually the plan administrator, as described in section IV-B of this notice. The income tax withheld must be aggregated with other amounts reported by that person on Form 945 to determine the frequency of federal tax deposits under § 31.6302-4. This is the same as the first alternative described in Announcement 84-40, 1984-17 IRB 31. Alternatively, the IRS will permit the plan administrator (or payor) of § 457(g) trusts, or custodial accounts or insurance contracts treated as trusts under § 457(g)(3) to use the other two alternatives contained in Announcement 84-40 for the tax administration of such withholdings:

1. The plan administrator or payor may request and use an EIN solely for the purpose of reporting the aggregated withholding from the distributions of every § 457(g) trust, custodial account, or annuity contract under its control, making deposits and filing Form 945 accordingly.
2. The plan administrator or payor may request and use a separate EIN for each § 457(g) trust (or custodial account or insurance contract), making deposits and filing Form 945 accordingly.

The plan administrator or payor exercising any of the above alternatives for depositing and reporting the tax withheld from § 457(g) trust distributions must also follow the same option in filing the related information returns, such as Forms 1099-R and Form 945. That is, the plan administrator or payor must use the same name and EIN on Forms 1099-R as that under which the tax was deposited and the annual Form 945 return filed. The plan administrator or payor must aggregate and deposit all taxes pursuant to § 31.6302-4 under the EIN chosen. The above-described options relate only to trusts, annuity contracts, or custodial accounts established pursuant to § 457(g) for amounts deferred under a governmental § 457(b) plan. For information on the remittance of social security, Medicare, and FUTA taxes by the employer, see section VI-D below.

V. INCOME TAX WITHHOLDING AND REPORTING ON TAX-EXEMPT EMPLOYERS’ § 457(b) PLAN DISTRIBUTIONS

A. Income Tax Withholding on Tax-Exempt Employer’s § 457(b) Plan Distributions

“Distributions” from a § 457(b) plan of a non-governmental tax-exempt entity to a participant include all amounts that are paid or made available under the § 457(b) plan. Distributions to a participant from a tax-exempt employer’s ' 457(b) plan are wages under § 3401(a) that are subject to income tax withholding in accordance with the income tax withholding requirements of § 3402(a). The pension withholding rules of § 3405 do not apply to distributions from a tax-exempt employer's ' 457(b) plan. See ' 35.3405-1T, Q&A-23. See Section IV of this notice for provisions regarding income tax withholding on distributions from a governmental ' 457(b) plan.

Income tax withholding on distributions to a participant under a tax-exempt employer's ' 457(b) plan is calculated in the same manner as withholding on other types of wage payments. For guidance on the use of the flat rate withholding method as a supplement to regular wage withholding in cases where the tax-exempt employer or its agent is paying wages to the participant in addition to the distribution from the ' 457(b) plan, see § 31.3402(g)-1(a) and Rev. Rul. 82-46, 1982-1 CB 158. If an eligible payor uses the flat rate of withholding as an alternative to regular wage withholding on a lump sum payment, § 101(c)(11) of EGTRRA provides that this flat rate became 27 percent in 2002, then becomes 26 percent in 2004, and 25 percent in 2006 and thereafter.

B. Person Responsible for Income Tax Withholding on Distributions

When distributions are made under a tax-exempt employer's ' 457(b) plan, the tax-exempt organization or other person having control of the payment of the distributions, as determined under § 3401(d)(1), is responsible for income tax withholding on the distributions.

C. Reporting Tax-Exempt Employer's § 457(b) Plan Distributions on Form W-2

Distributions to a participant during a taxable year under a tax-exempt employer's ' 457(b) plan are wages and are reported on Form W-2, Wage and Tax Statement, in the manner described in the instructions to that form. See also Rev. Rul. 82-46, supra. Income tax withheld from a tax-exempt employer's § 457(b) plan distributions is deposited in accordance with § 31.6302-1 and reported quarterly on Form 941, Employer=s Quarterly Federal Tax Return.

D. Reporting Death Benefit Payments

Distributions to a beneficiary of a deceased participant under a ' 457(b) plan are reported on Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. See Rev. Rul. 86-109, 1986-2 C.B. 196. No income tax withholding is required for distributions from ' 457(b) plans to beneficiaries. See Rev. Rul. 59-64, 1959-1 C.B. 31. The instructions for Form 1099-R describe how this form is completed for distributions made to a beneficiary from a nonqualified deferred compensation plan, such as a ' 457(b) plan.

VI. FICA AND FUTA TAXES AND REPORTING

A. Scope

The rules described in this Section VI relating to FICA (social security and Medicare) tax apply to employees of state and local governments only if they are subject to social security or Medicare tax under § 3121(u) (relating to Medicare), § 3121(b)(7)(E) (relating to agreements entered into pursuant to section 218 of the Social Security Act), or other provisions of the Code, such as § 3121(b)(7)(F) (relating to state and local government employees who are not members of a state or local retirement system). As previously noted, EGTRRA did not revise the provision of Chapter 21 of the Internal Revenue Code treating § 457(b) plan distributions as "wages" for purposes of subjecting them to social security and Medicare taxes. The FICA rules discussed in this section generally apply to employees of tax-exempt organizations, unless a specific exclusion is applicable. The FICA tax discussed in this section includes the employer's share of the FICA tax imposed under § 3111 as well as the employee's share imposed under § 3101. Any FICA tax imposed on an employee's § 457(b) plan deferrals or distributions must be reported on a Form W-2 for that employee.

The rules described in this Section VI relating to the Federal Unemployment Tax Act (FUTA) do not apply to service for a state or local governmental entity because § 3306(c)(7) provides a FUTA exemption for service performed in the employ of a state or any political subdivision thereof or any instrumentality of any one or more of the foregoing. The rules described in this section relating to FUTA apply to service for a tax-exempt organization other than a tax-exempt organization described in § 501(c)(3). See § 3306(c)(8).

B. Timing of Social Security, Medicare, and FUTA Taxes

Sections 3121(a) (relating to social security and Medicare) and 3306(b) (relating to FUTA) define wages as all remuneration for employment, unless specifically excluded (see section VI-A, above). If social security, Medicare, or FUTA taxes apply, §§ 3121(v)(2) and 3306(r)(2) contain special timing rules that apply in determining when amounts deferred under a nonqualified deferred compensation plan (including employers' contributions) are required to be taken into account. Under these sections, an amount deferred under a nonqualified deferred compensation plan, including a ' 457(b) plan, is required to be taken into account for purposes of social security, Medicare, and FUTA taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount.
Thus, to the extent a ' 457(b) plan provides that annual deferrals are immediately vested, the annual deferrals are subject to social security, Medicare, and FUTA taxes at the time of deferral. However, to the extent the annual deferrals are subject to a substantial risk of forfeiture, the annual deferrals (plus earnings thereon) are generally taken into account for purposes of social security, Medicare, and FUTA at the time such amounts are no longer subject to a substantial risk of forfeiture. For purposes of social security, Medicare, and FUTA taxes, the determination of whether a substantial risk of forfeiture exists is made in accordance with the principles of § 83 and the regulations thereunder. See " 31.3121(v)(2)-1(e)(3) and 31.3306(r)(2)-1.

If amounts deferred under a ' 457(b) plan are properly taken into account as social security, Medicare, and FUTA wages when deferred (or, if later, when they cease to be subject to a substantial risk of forfeiture), the amounts subsequently paid or made available to a participant or beneficiary under the ' 457(b) plan that are attributable to those deferrals generally are not subject to social security, Medicare, or FUTA taxes. See §§ 3121(v)(2)(B) and 3306(r)(2)(B) and " 31.3121(v)(2)-1(a)(2)(iii) and 31.3121(v)(2)-1(d)(2). If an amount deferred for a period is not properly taken into account, distributions attributable to that amount, including income on the amounts deferred, may be wages for FICA purposes when paid or made available. See ' 31.3121(v)(2)-1(d)(1)(ii). Additional special rules apply to ' 457(b) plans in which benefits are not based solely on a participant's account balance. See ' 31.3121(v)(2)-1(e)(4).

C. Examples

The application of social security and Medicare tax is illustrated by the following examples:

Example 1. (i) State R's ' 457(b) plan provides for elective deferrals from current salary, as well as a one percent of salary nonelective contribution for each employee who participates in the plan and who is employed with State R during the plan year. All employees who participate in the plan are covered by an agreement under section 218 of the Social Security Act. All deferrals and contributions, including the state's contribution, are fully and immediately vested.

(ii) Because these contributions are not subject to a substantial risk of forfeiture (and the services to which they relate have already been performed), the elective deferrals are required to be taken into account as wages at the time of the deferral and State R's nonelective contribution is required to be taken into account as wages at the time of the contribution for purposes of the social security and Medicare tax.

Example 2. (i) Assume the same facts as in *Example 1*, except that the plan has three-year vesting for State R's nonelective contribution. Therefore, an employee's rights to the nonelective contributions (and the associated earnings) are subject to a substantial risk of forfeiture until the employee has been employed by State R for three years.

(ii) State R's nonelective contributions (and earnings thereon) are not wages for purposes of the social security and Medicare tax until the employee has completed three years of service. At that time, the aggregate amount of State R's nonelective contributions, plus earnings thereon, is required to be taken into account as wages for purposes of the social security and Medicare tax. Once an individual has met the vesting requirements, future nonelective contributions by State R are required to be taken into account as wages for purposes of the social security and Medicare tax at the time of the contribution. Because the elective deferrals are not subject to a substantial risk of forfeiture (and the services to which they relate have already been performed), the elective deferrals are required to be taken into account as wages at the time of deferral.

D. Deposit and Reporting of Social Security, Medicare and FUTA Taxes

The employer must aggregate and deposit social security and Medicare taxes associated with a ' 457(b) plan (including the employer's share of social security and Medicare taxes under § 3111) with all other social security and Medicare taxes and withheld income taxes paid on behalf of its employees in accordance with ' 31.6302-1 and must report these taxes on Form 941. Employers subject to FUTA must aggregate and deposit FUTA amounts associated with a ' 457(b) plan with all other FUTA amounts paid on behalf of its employees in accordance with ' 31.6302(c)-3 and must report these payments on Form 940.

VII. ANNUAL REPORTING FOR § 457 PLANS

A. § 457(g) Trusts

A trust described in § 457(g) is not required to file Form 990, Return of Organization Exempt From Income Tax, Form 1041, U.S. Income Tax Return for Estates and Trusts, Form 1120, U.S. Corporation Income Tax Return, or Form 5500, Annual Return/Report of Employee Benefits Plans. See, for example, Rev. Proc. 95-48, 1995-2 C.B. 418, which provides that governmental units and affiliates of governmental units that are exempt from federal income tax under § 501(a) are not required to file annual information returns on Form 990, Return of Organization Exempt From Income Tax. A trust described in § 457(g) may be required to file Form 990-T, Exempt Organization Business Income Tax Return. See §§ 1.6012-2(e) and 1.6012-3(a)(5) for the requirements for filing Form 990-T.

B. Section 457(b) Plans of Tax-Exempt Organizations

Annual deferrals and payments to certain participants in a § 457(b) plan of a tax-exempt organization are reported on the organization's Form 990 in the manner described in the instructions to that form.

VIII. OTHER INFORMATION AVAILABLE

Further information regarding the reporting, payment and deposit of employment taxes such as social security, Medicare, FUTA, and withheld income tax can be found in Publication 15, Circular E, Employer's Tax Guide; Publication 15-A, Employer's Supplemental Tax Guide; and Publication 963, Federal-State Reference Guide: Social Security Coverage and FICA Reporting by State and Local Government Employers. These publications will be revised, as appropriate, to reflect the revisions enacted in EGTRRA.

IX. EFFECTIVE DATE

This notice is applicable with respect to deferrals and distributions made after December 31, 2001. However, for deferrals or distributions made after December 31, 2001, and before January 1, 2004, the Internal Revenue Service (IRS) will not assert that there has been a failure to comply with applicable reporting and withholding requirements if the applicable reporting and withholding requirements set forth in Notice 2000-38 have been satisfied. Thus, for example, in any case in which a series of distributions commenced before January 1, 2002 and the distributions are eligible rollover distributions (as defined in § 402(f)(2)(A)) that are payable over a specified period of less than 10 years, the IRS will not assert that there has been a failure to comply with applicable withholding requirements through December 31, 2003, if the applicable withholding requirements set forth in Notice 2000-38 have been satisfied.

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