

# Caught in the IRS Crosshairs ~ Special District Tax Compliance Audits

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In the June 2006, SDA Newsletter, we reported the Internal Revenue Service (“IRS”) had sent shock waves through the firefighting community as a result of the conclusions reached during its “courtesy review” of the Golden Fire Department’s volunteer firefighter program for compliance with the Internal Revenue Code of 1986, as amended (the “Tax Code”). In the ensuing months, many Fire Districts expressed the view that Golden’s situation was unique and it was unlikely the IRS was targeting Fire Districts for tax compliance.

Unfortunately, experience over the last year has shown that is exactly what the IRS is doing. We are aware of two Fire District compliance audits currently being conducted—one in the Denver Metro area; the other in the Colorado Springs area—and there are likely many more of which we are not aware. While there are some tax issues unique to Fire Districts, many of the tax issues apply equally to all Special Districts. There is every reason to believe water and sanitation districts, park and recreation districts, and other forms of Special Districts will come within the IRS’s crosshairs sooner or later. To this end, we wanted to alert all Special Districts to the types of tax issues we are seeing in the field.

## Section 218 Plans

Prior to 1951, Social Security coverage was not available to public employees, and many public employers did not have their own retirement system. At that time, it was believed State sovereignty afforded by the United States Constitution prohibited the Federal Government from mandatorily covering public employees. Amendments to the Social Security Act in 1950 allowed the States, on a voluntary basis, to obtain coverage for public employees who were not covered by a public retirement system through an agreement between the Federal and State governments often referred to as a “Section 218 Agreement,” because it is authorized by Section 218 of the Social Security Act. Compliance criteria are complex because public employees may

be mandatorily excluded or covered, or optionally excluded or covered. There may be questions as to whether the individual is in an employment relationship, whether the remuneration constitutes wages, or whether the public employee is a member of a qualified retirement system offered by the Special District. Adding to the complexity is the fact that the criteria are often phrased in technical terms and widely dispersed throughout various provisions of the Social Security Act, Tax Code, Code of Federal Regulations, and Colorado’s Section 218 Agreement with the Social Security Administration.

If your Special District participates in the State Section 218 Plan with the Social Security Administration, you must ensure the IRS rules relating to Section 218 Plans are being followed. With respect to Special District taxation issues relating to the Social Security Act, under authority of Chapter 21 of the Tax Code, the IRS is responsible for:

- ⊕ Administering the Federal Insurance Contributions Act (“FICA”), including the mandatory Social Security and Medicare provisions concerning services performed by Special District employees;
- ⊕ Assuring that there is proper reporting and collection of Social Security and Medicare taxes by Special Districts under the FICA through examination and other compliance programs; and
- ⊕ Interpreting the FICA provisions applicable to Special Districts through published guidance (e.g., regulations, revenue rulings and procedures) and through non-precedential advice to taxpayers and IRS personnel (e.g., private letter rulings and field advice directives).

The IRS’s primary focus in a Section 218 Agreement compliance examination usually is determining the worker’s status as an employee or an independent contractor. If a worker is incorrectly treated as an independent contractor, the worker will pay both the Special District’s and the employee’s share of employment taxes. For the Special

District, misclassifying a worker can also result in back taxes, penalties and interest. The Colorado Department of Labor and Employment’s website notes that this error has cost some states and their political subdivisions millions of dollars.<sup>1</sup>

## Social Security and/or Medicare Coverage under FICA

There are three ways of providing Social Security and/or Medicare coverage under FICA for Special District employees:<sup>2</sup>

- ⊕ Special Districts may extend FICA coverage to their employees through the Section 218 Agreement (discussed above);
- ⊕ Employees who are not covered for FICA under the Section 218 Agreement, and who were hired after March 31, 1986, are subject to mandatory coverage of the Medicare-only portion of FICA; and
- ⊕ Employees who are not covered under the Section 218 Agreement, and who do not participate in a public employer retirement system, are mandatorily covered by FICA after July 1, 1991.

For Medicare qualified government employees (“MQGE,” also referred to as “Medicare-only”), an IRS Form W-2 is filed separately from Forms W-2 having full-FICA (Social Security and Medicare) wages. MQGE Forms W-2 must be transmitted with a covering Form W-3 with “Medicare Govt. Emp.” checked in box b.

Special District employees may be subject to Medicare-only (MQGE) withholding and full-FICA coverage in the same reporting year. When the employee is in a continuous employment relationship with the same Special District (same EIN) for the year, the Special District has two reporting options:

- ⊕ Prepare a single Form W-2. For both employment positions show the total annual wages in box 1, the total Medicare wages in box 5, and the total Medicare taxes in box 6. For the full-FICA employment, the Social Security wages and taxes are entered in boxes 3 and 4, respectively (SSA prefers using this method); or

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⊕ Prepare a separate Form W-2 for each withholding category -- i.e., one Form W-2 includes wage data for just the MQGE employment; the second Form W-2 includes wage data for just the full-FICA employment.

### “Take Home Vehicles”

The IRS has very specific rules for “take home vehicles” -- i.e., a Special District vehicle provided to an employee/volunteer for “around the clock” use in performing his/her duties. Failure to meet the IRS rules will result in the employee’s personal use of the vehicle, including commuting, to be deemed taxable income. In general, employees/volunteers who drive qualified nonpersonal-use vehicles are exempt from the IRS vehicle fringe reporting requirements. A “qualified nonpersonal-use vehicle” is any vehicle the employee/volunteer is not likely to use more than a minimal amount for personal purposes because of its design. The following conditions for the vehicle type must be met:

- ⊕ Clearly marked fire vehicles, when the employee is required to use the vehicle for commuting and is on call at all times. Personal use (other than commuting), if allowed, must be confined to within the firefighter’s jurisdiction.
- ⊕ Ambulances used for that purpose.
- ⊕ Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds.
- ⊕ Delivery trucks with seating only for the driver, or the driver plus a folding jump seat.
- ⊕ Passenger buses with a capacity of at least 20 passengers and used for that purpose.
- ⊕ Tractors and other special-purpose farm vehicles.
- ⊕ Pick-up trucks. A pick-up truck with a loaded gross vehicle weight of 14,000 pounds, if it has been specially modified so that it is not likely to be used more than minimally for personal purposes. For example, a pick-up truck qualifies if it is clearly marked with

permanently affixed decals, special painting, or other advertising associated with the Special District’s services or function and meets either of the following requirements:

- It is equipped with **at least one** of the following items:
  - A hydraulic lift gate;
  - Permanent tanks or drums;
  - Permanent sideboards or panels that materially raise the level of the sides of the truck bed; or
  - Other heavy equipment (such as an electric generator, welder, boom, or crane used to tow automobiles and other vehicles).
- It is used primarily to transport a particular type of load (other than over the public highways) in a construction, manufacturing, processing, farming, mining, drilling, timbering, or other similar operation for which it was specially designed or significantly modified.

⊕ Vans. A van with a loaded gross vehicle weight of 14,000 pounds or less, if it has been specially modified so that it is not likely to be used more than minimally for personal purposes. For example, a van qualifies if it is clearly marked with permanently affixed decals, special painting, or other advertising associated with the Special District’s services or function and has a seat for the driver only (or the driver and one other person) and either of the following items:

- Permanent shelving that fills most of the cargo area; or
- An open cargo area, and the van always carries merchandise, material, or equipment used in the Special District’s services or function.

### Employees or Independent Contractors

The IRS will closely scrutinize any independent contractor arrangement a Special District may have with an individual. The factors for determining the existence of employment status are found in three substantially similar sections of the Employment Tax Regulations, i.e., Regs. 31.3121(d)-1, 31.3306(i)-1 and 31.3401(c)-1, relating to FICA, the Federal Unemployment Tax Act (“FUTA”) and federal income tax withholding, respectively. Those regulations generally provide that an employer-employee relationship exists when the Special District for whom the services are performed has the right to control and direct the individual

who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. Unless the Special District can demonstrate the “independent contractor” is truly autonomous-- directing and controlling the means and results of his/her work-- the IRS will deem the individual an employee, subjecting the Special District to the withholding and reporting rules for employees.

In determining whether an entity retains the right to control a worker, the IRS generally looks at three main categories: behavioral control; financial control; and the relationship of the parties.<sup>3</sup> The facts considered in each of these categories include whether the Special District provides training or instruction, whether the worker can earn a profit or incur a loss, and whether benefits are provided.<sup>4</sup> All Special Districts must carefully and objectively analyze each independent contractor arrangement to determine whether it meets the IRS’ direction and control tests. The fact that the Special District -- and often the individual-- would prefer to treat the individual as an independent contractor is irrelevant.

### Volunteers

The IRS will subject an individual to the same common law tests of “direction and control” to determine whether he/she is properly classified as a “volunteer” or is actually an employee for tax purposes:

A volunteer is an employee if the entity has the right to direct and control the volunteer’s performance, not only as to the results to be accomplished, but also as to the methods by which the results are accomplished. It is the “right” to control, even if the entity does not exercise the right, that is important. Many factors in an employment relationship have to be considered before a decision can be made as to whether the entity has the right to direct and control.<sup>5</sup>

The IRS has made very clear its position that absent unique circumstances, a volunteer firefighter will be deemed an employee for taxation purposes:

Generally, “volunteer” firefighters are employees of the fire department or district for which they perform services. The usual common-law tests apply in determining their employment status. For example,

the relationship between the firefighter and the fire department will generally indicate that the department provides training and direction in how the work will be performed and provides the equipment to perform the work. ... Payments to those firefighters who are employees under the common-law tests are treated the same as to other government employees....<sup>6</sup>

Many Fire Districts mistakenly believe they are not required to report stipends as long as the total annual stipend to a volunteer is less than \$600. The \$600 “de minimis” rule only applies to independent contractors. There is no rule exempting de minimis payments from taxes if the IRS classifies the individual as an employee.<sup>7</sup>

The IRS Office of Federal, State and Local Governments (“FSLG”) recently has been distributing an informational packet to Fire Districts on IRS rules applicable to emergency services providers. This informational packet includes a document entitled, *Federal Tax Issues for Firefighters*, drafted by Stewart Rouleau, Senior Analyst for FSLG. In this document, Senior Analyst Rouleau makes the point even more emphatically:

It does not matter whether firefighters are termed “volunteers,” are considered employees, or are identified by another name, if the work they do is subject to the will and control of the [Special District], under the common-law rules, they are employees for Federal tax purposes. ... Similarly, it does not matter whether they are paid on a “call” basis, monthly, hourly, etc.; or whether the worker is full-time or part-time. These payments are wages that should be reported on Form W-2, subject to withholding for Federal income tax, social security, and Medicare purposes. ... If a worker is a common-law employee, any amounts they receive, that are not exempt under some special provision, are reported on Form W-2 as wages to the employee. It does not matter what the payments are called.

### Expense Reimbursement

Many Special Districts reimburse their employees/volunteers for expenses incurred in performing their duties. To avoid the expense reimbursements from being deemed taxable income subject to IRS withholding and reporting requirements, the reimbursements must be made under an IRS-compliant “accountable plan.” According to Section 62(c) of the Tax Code, a reimbursement or

other expense allowance arrangement will qualify as an “accountable plan” if it meets the following requirements:

⊕ **Business Connection Requirement.** An arrangement meets the business connection requirement if it provides advances, allowances or reimbursements for certain deductible business expenses paid or incurred by the employee/volunteer in connection with the performance of the services as an employee/volunteer. The arrangement will not meet this requirement if the Special District arranges to pay an amount regardless of whether the employee/volunteer incurs or is reasonably expected to incur deductible business expenses.

⊕ **Substantiation Requirement.** In order to meet the substantiation requirement, the Special District must require the employee/volunteer to substantiate expenses within a reasonable period. To the extent the expenses are covered by Section 274(d) of the Tax Code relating to reimbursements for travel expenses, the employee/volunteer must meet the substantiation requirements of that section. For example, because travel expense deductions are governed by Section 274(d), an employee/volunteer must generally substantiate the amount, time, place and business of the expense. For the convenience of employees/volunteers and employers, the IRS has provided optional simplified methods, known as “deemed substantiation” methods to substantiate the amount of expense governed by Section 274(d). These methods are explained in Rev. Proc. 2000-48. The procedures in that publication are optional; an employee/volunteer can use actual allowable expenses if he/she maintains adequate records.

⊕ **Return of Excess Requirement.** This requirement is met if the arrangement requires the employee/volunteer to return to the Special District, within a reasonable period of time, the amounts in excess of substantiated expenses.

### Pension Plans

The IRS is looking closely at job duties to determine whether a Fire District employee/volunteer is qualified to participate in the pension plan in which the employee/volunteer is enrolled.

### 457(b) Plans

Many Special District employees partici-

pate in nonqualified, or Section 457, deferred compensation plans. These plans do not meet the eligibility requirements for special treatment that applies to qualified tax-deferred benefit plans. Deferrals to an eligible Section 457(b) deferred compensation plan 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.

Amounts deferred to an eligible Section 457(b) plan are not subject to income tax withholding until they are distributed or made available to the participant or beneficiary.

For more information regarding Social Security, Medicare and income tax withholding and reporting on amounts deferred into eligible deferred compensation plans under Section 457(b) see Section IV of IRS Notice 2003-20 (5/19/2003).

### Lodging as Taxable Compensation

In general, lodging furnished by a Special District to an employee/volunteer may be additional compensation and therefore taxable to the employee/volunteer under the broad sweep of Section 61 of the Tax Code. Section 119, however, specifically excludes the value of lodging furnished to an employee/volunteer “for the convenience of the employer” from the gross income of the employee/volunteer if the lodging is furnished “on the business premises of the employer,” and the lodging is required to be accepted by the employee/volunteer “as a condition of employment.” If these conditions are met, the exclusion applies even though lodging is regarded as additional compensation by the parties or by state law, and even though the facilities are furnished for the convenience of the employee/volunteer as well as the convenience of the Special District.

*Convenience of the Employer.* Lodging must be furnished for the convenience of the Special District in order for the value of the benefit to be excluded from the employee/volunteer’s income. In addition, there must be an objective business necessity for providing the amenity to the employee/volunteer. Courts have typically upheld the exclusion in situations where, as a practical matter, the

employee/volunteer could not properly carry out his/her duties if the lodging were not supplied. For example, a construction worker is employed at a remote site in Alaska, where facilities for meals or lodging are inaccessible and poor weather conditions prevail. To complete the construction project, the employer provides meals and lodging at the construction site, and requires the workers to stay there. The exclusion of Section 119 applies to the value of the lodging and the meals, even though the employee is not required to be available for a 24-hour duty.<sup>8</sup>

Generally, the convenience of the employer doctrine, with respect to lodging, has been applied to situations where it is necessary for the employee/volunteer to be available to work for longer than normal work periods to properly perform his duties (or supervise others in the performance of their duties). For example, lodging furnished to firefighters to provide emergency services within very strict and extremely short response criteria would probably qualify.

Where the employer's convenience is not enhanced by the proximity of the employee/volunteer because, for example, extensive duties necessitating his/her presence at unusual times are not required, or the lodging is furnished at the employee/volunteer's preference, the doctrine does not apply. Nor does Section 119 apply where lodging is supplied primarily for the convenience of the employee/volunteer; however, the fact that the lodging serves the convenience of the employee/volunteer is irrelevant so long as it is established that the lodging is furnished for the convenience of the Special District.

*Effective Compensatory Purpose.* If lodging is furnished for the convenience of the Special District, and if it otherwise meets the specific requirements of the statute, its value is not included in income regardless of whether it also represents compensation for services. Thus, the exclusion applies if the lodging is provided in addition to only a nominal monetary compensation, or in lieu of compensation. In determining whether

lodging is furnished for the convenience of the Special District, the provisions of a state statute or employment contract may not be used to determine whether the lodging was intended as compensation.

*Condition of Employment.* The employee/volunteer's acceptance of the benefit must be required as a condition of employment/service, a test closely connected, but in addition to, the convenience of the employer test. The regulations underlying Section 119 define the test of "condition of employment" as "required in order for the employee to properly perform the duties of his employment". Thus, lodging will be regarded as furnished to enable the employee/volunteer to perform the duties of his/her employment/service properly when, for example, the lodging is furnished because the employee/volunteer is required to be available for duty at all times or because the employee/volunteer could not perform the services required unless he/she is furnished such lodging. The employee/volunteer's acceptance of lodging need not be expressly required as a condition of employment/service, so long as the proper performance of the employee/volunteer's duties objectively requires as a practical matter that he/she live on the Special District's premises.

### Uniforms and Work Clothes

Employees/Volunteers can deduct the cost and upkeep of work clothes if the following two requirements are met:

- ⊕ The employee/volunteer must wear them as a condition of employment/service.
- ⊕ The clothes are not suitable for everyday wear.

It is not enough that the employee/volunteer wears distinctive clothing; the clothing must be specifically required by the Special District. Nor is it enough that the employee/volunteer does not, in fact, wear the work clothes away from work; the clothing must not be suitable for taking the place of the employee/volunteer's regular clothing. Examples of workers who may be able to deduct the cost and upkeep of work clothes are: delivery workers; firefighters; health care workers; and transportation workers (air, rail, bus, etc.). In contrast, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible. This is true even if the

reimbursements are made as the result of a union-negotiated contract.

The employee/volunteer can deduct the cost of protective clothing required to perform his/her duties, such as safety shoes or boots, safety glasses, hard hats, and work gloves. Examples of workers who may be required to wear safety items are: carpenters, cement workers, chemical workers, electricians, firefighters, machinists, and truck drivers.

### Closing Comments

The foregoing are just some of the more prominent IRS tax issues that may surface during a Special District tax compliance audit; yet, these issues only scratch the surface of the IRS Tax Code provisions and related regulations that may apply to Special Districts. Special Districts should consult with their legal counsel and a qualified tax attorney to evaluate their tax-compliance status before the IRS comes knocking at their door.

### Endnotes:

- <sup>1</sup> See, <http://pess.cdle.state.co.us>.
- <sup>2</sup> Employer's Guide To Filing Timely And Accurate W-2 Wage Reports, Social Security Administration, Office of Income Security Programs, SSA Pub. No. 16-004 (ICN 361752), May 2007.
- <sup>3</sup> Id.
- <sup>4</sup> Id.
- <sup>5</sup> Public Employer Tax Guide, Internal Revenue Service (July 2007).
- <sup>6</sup> Page 82, Taxable Fringe Benefit Guide, Internal Revenue Service (January 2007).
- <sup>7</sup> Page 82, Taxable Fringe Benefit Guide, Internal Revenue Service (January 2007).
- <sup>8</sup> See, *Van Huff v. Commissioner*, T.C. Memo. 1981-30.

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