State Instrumentalities Can Escape FICA Obligations

By David B. Porter [1]

The Internal Revenue Service ("IRS") has initiated a program to increase its tax audits aimed at federal agencies and state and local governments.[2] At first blush, government taxing government may seem odd, yet even governmental entities are not exempt from some taxes. Indeed, in some cases, these types of taxpayers are considered low hanging fruit to the IRS. The IRS is targeting them for potential employment tax violations. The Tax Exempt and Government Entities (TE/GE) Division of the IRS will be handling this enforcement effort.

This sounds like a blip on the radar, and not a very interesting blip at that. Actually, nothing could be further from the truth. Not only is the IRS targeting government entities and their affiliates for employment tax audits, but also the stakes can be huge. It is widely believed that compensation paid to all employees is subject to Social Security withholding. This is another misconception.

In fact, our law firm recently saved a non-profit tax-exempt foundation millions of dollars in payroll taxes. The foundation was an instrumentality of a state run university. We successfully explored certain provisions that exempted some state employees from Social Security on their compensation. The foundation was under audit for failing to withhold about $10 million in Social Security taxes.

Determining whether Social Security withholding is required on the wages of employees of a state governmental body or a state-related entity can be tricky. The provisions are not simple. This article explores the history of tortured Social Security withholding as it relates to state and non-profit employees.

I. BACKGROUND OF FICA

The first Social Security law was enacted in 1935. In it, Congress implemented an extensive system aimed at providing retirement and unemployment benefits to qualifying individuals who were no longer employed. The Social Security Act also provided certain welfare benefits to those who were unable to work. Retirement and unemployment benefits were financed out of taxes specifically earmarked for these purposes.

The Social Security Act has been amended numerous times in the last seventy years, although the basic mechanism for funding Social Security benefits remains the same. Old-age, survivor, and disability insurance benefits (OASDI) and hospital insurance and Medicare benefits for the aged and disabled (Medicare) are primarily financed from taxes paid by employers and employees under the Federal Insurance Contributions Act (FICA). The combined tax rate for each party is now 7.65%, consisting of a 6.2% component for OASDI, and a 1.45% component for Medicare.

In general, remuneration paid by an employer for services performed by an employee is subject to FICA taxes, unless the payments are specifically excepted from the term "wages," or the services are specifically excepted from the term "employment." Employers collect the employee portion of the tax by deducting the tax from the wages of each employee at the time of payment.[3]

Originally, the collection and verification of taxes under FICA was the responsibility of state governments. Prior to 1951, Social Security coverage was not available to employees of states and their political subdivisions. In 1951, states and their "political subdivisions" (a defined term that turns out to be critical) were able to extend FICA coverage to their employees through voluntary agreements commonly referred to as "Section 218 Agreements."

Section 218 Agreements were made between a state, political subdivision, or instrumentality thereof and the Social Security Administration (SSA). Such an agreement extended OASDI and Medicare coverage to employees of the state, political subdivision, or instrumentality that entered into the agreement. A "political subdivision" includes an instrumentality of the state.[4]

An instrumentality of the state or of a local government may qualify under Internal Revenue Code (the "Code" or "IRC") §501(c)(3) if it is organized as an entity that is separate from the governmental entity, if it is not an integral part of the government, and if it possesses no governmental powers. An affiliate of a government unit includes organizations described in IRC §501(c)(3) that:

- Have a ruling or determination that their income is excludible from gross income (IRC §115);
- That is entitled to receive deductible charitable contributions under IRC §170(c)(1) became contributions are "for the use of" governmental units; and
- That is a wholly owned instrumentation of a state or a political subdivision for employment tax purposes[5].

Hence, tax-exempt organizations that are instrumentalities of a state or a state's political subdivision were excepted from FICA taxes, unless the state, political subdivision or instrumentality *elected* to include its employees under a Section 218 Agreement. It is worth noting that a Section 218 Agreement covers *positions*, not individuals. If a position is covered under the agreement, then any employee filling that position is subject to FICA tax.

II. CHANGE IN FICA COVERAGE FOR IRC §501(C)(3) ORGANIZATIONS

IRC §3121(k) provided an election for religious, charitable and certain other organizations to be covered under the Social Security system. IRC §3121(k)(1)(A) provided that an organization described in IRC §501(c)(3) that is exempt from income tax under IRC §501(a) may file a certificate stating its desires to have the insurance system established by the SSA extended to its employees.

In 1984, Congress again amended the scope of the FICA tax provisions. It repealed IRC §3121(k), requiring Social Security coverage for employees of IRC §501(c)(3) organizations. This change resulted in administrative confusion, to taxpayers—and even to the IRS. In the case my firm recently concluded, these constant and significant changes were part of the problem.

A. Further FICA Developments for IRC §501(c)(3) Organizations

The mandatory Social Security portion of FICA tax for IRC §501(c)(3) organizations became reportable to the IRS in 1984. In contrast, the Social Security portion of FICA tax under a Section 218 Agreement was reportable to the SSA. If an IRC §501(c)(3) organization had previously elected to include its employees under the Social Security insurance system by filing a Section 218 Agreement, payments were still made to the SSA. However, if the IRC §501(c)(3) organization had not previously made such an election, the Social Security portion of FICA taxes were now required to be made to the IRS instead of to the SSA.

In 1986, Congress enacted IRC §3121(u)(2). This provision states that wages paid to any instrumentality employee hired after March 31, 1986, and not covered under a Section 218 Agreement, are subject to the Medicare portion of FICA taxes. IRC §3121(b)(7)(E) provides that the term "employment" (for purposes of FICA) includes service under an agreement entered into pursuant to Section 218 of the Social Security Act. In other words, effective March 31, 1986, an IRC §501(c)(3) organization became *required* to pay the Medicare portion of FICA taxes for employees hired after that date, if the organization was an instrumentality of the state.

In 1987, state governments were relieved from the obligation to collect Social Security contributions from government entities, along with liability for verifying and depositing the amounts owed. Thereafter, the IRS became responsible for ensuring that state and local governmental employers filed returns and paid the appropriate Social Security taxes. As such, FICA payments previously reported to the state Social Security administrator pursuant to a Section 218 Agreement were now reportable to the IRS. That made the IRS the collection agent for all FICA taxes.

Even then, though, the situation was not static—more changes were in store. In 1991, Congress amended the law to provide that wages of any instrumentality employee, not covered under a Section 218 Agreement, and who were not members of a state retirement system, were subject to the Social Security portion of the FICA tax.[6] As stated above, a "political subdivision" includes an instrumentality of the state.[7]

III. THE EMPLOYMENT TAX AUDIT

Recently, my law firm represented a foundation connected to a state university. As mandated by state legislation, the university provided FICA coverage to its employees under a Section 218 Agreement. With the exception of the university's teachers, the university's employees are also members of the California Public Employees Retirement System ("CALPERS"), the famous (or sometimes infamous) state retirement system.

In the early 1960s, the foundation was granted tax-exempt status under IRC §501(c)(3). The foundation's determination letter stated that the exemption was granted to the foundation because its primary purpose was to advance the welfare of the university, to promote and assist its educational services, and to otherwise aid and assist the university in fulfilling its purposes. The foundation accomplished this chiefly by serving as a depository for scholarship and research funds. So far, so good.

In the early 1980s, the foundation changed its status from a state-reimbursed corporation to a non-state reimbursed corporation. One of the major advantages to the foundation on changing its status to a non-state reimbursed corporation was that it would no longer be covered under the university=s Section 218 Agreement for the Social Security portion of FICA tax.

A. No FICA Tax Liability If State Instrumentality Satisfies Test

IRC §§3101, 3111 and 3121 generally subject to FICA taxes all wages paid by employers to employees, unless the payments are specifically excepted from the term "wages," or unless the services are specifically excepted from the term "employment." However, services performed by the workers of a state instrumentality that is not subject to a Section 218 Agreement, and who are members of the state instrumentality=s retirement system are both excepted from the definition of "employment" for purposes of FICA.[8]

B. Are Workers Subject To A Section 218 Agreement?

The Code generally excludes from the term "employment" for purposes of FICA those services performed in the employ of any state, any of its political subdivisions, or any wholly-owned instrumentality of a state or one of its political subdivisions.[9] The State of California provides FICA coverage to its employees under a Section 218 Agreement. Many workers employed by the State of California are also members of CALPERS.

The foundation my firm represented was an instrumentality of the university and was granted §501(c)(3) status. Its primary purposes (as cited in its IRS determination letter) were to advance the welfare of its associated university; to assist it in fulfilling its objectives; to supplement the university's programs and activities in appropriate ways; to promote and assist its educational services; and otherwise to aid and assist the university in fulfilling its purposes and serving the people of the state, especially those in the area of the university's location.

Private letter rulings supported our position. For example, in PLR 9543012, the taxpayer was a medical faculty practice plan incorporated as a professional service corporation under state law, and was associated with a university. The taxpayer received a letter from the IRS recognizing that it was exempt under IRC §501(c)(3), and was not a private foundation. The taxpayer was created to advance the purposes of the medical educational program and related activities of the university, a state university chartered as part of a state university system. The IRS ruled that the taxpayer was an instrumentality of the state or political subdivision.

The foundation my firm represented paralleled the professional service corporation discussed in PLR 9543012. Thus, we believed services performed by the foundation's workers were excluded from the definition of "employment," as long as none of the exceptions of IRC §3121(b)(7) applied. Of course, our foundation never elected to participate in a Section 218 Agreement.

In 1951, states and their "political subdivisions" became able to extend FICA coverage to their employees through voluntary Section 218 Agreements. The Section 218 Agreement was made between a state, political subdivision, or instrumentality and the SSA. The effect of this agreement was to extend OASDI and Medicare coverage to employees of the state, political subdivision, or instrumentality that entered the Agreement. In January 1956, the university related to our foundation had provided FICA coverage to its employees under a Section 218 Agreement.

In the early 1980s, however, the individuals who were employed by our foundation ceased to be employees covered under the university's Section 218 Agreement. That change occurred because the foundation successfully *separated* from the university by changing its status from a state-reimbursed corporation to a non-state reimbursed corporation for financial purposes. There is some precedent for this kind of conversion.

For example, in *Ro Ane v. Mathews*[10], San Francisco teachers contended that they ceased to be covered by Social Security when they elected to terminate their membership in the city and county retirement system (which was covered by a Section 218 Agreement), and became members of the state retirement system (which was not covered). The court held that the teachers continued to be covered by Social Security following their change of retirement systems because, among other things, the teachers continued to hold the same jobs for the same employer after the change of retirement systems (*i.e.*, the teachers continued to meet the SSA definition of membership in a retirement system coverage group). Plus, there was no termination of the Section 218 Agreement in accordance with the provisions of then existing law.

Yet, the court in *Ro Ane* flatly acknowledged Congress's interest in preventing unrestricted movement in and out of the Social Security program. Indeed, the court noted the program's financial detriment that can result to the Social Security program, but noted that there *are* ways to shift in and out of Social Security:

> [A]s the administrative law judge acknowledges in his findings in the instant case, a state can remove its employees from coverage under a Section 218 agreement without suffering consequences under Section 218(g) [the existing termination provision] by reorganizing

> the employer from one political entity to another, *i.e*., from a local to a state agency or from one local agency to another. *Assuming that the former is an employer included in an operative Section 218 agreement and the latter is not, upon the reorganization, the employee group would no longer serve in positions in the retirement system to which the agreement was made applicable and their coverage would therefore cease*.[11]

Ro Ane is thus an important case. Furthermore, two published IRS rulings under former IRC §3121(b)(8) and (k) (which exempted certain IRC §501(c)(3) organizations from FICA taxation prior to 1984) supported the position that the workers who transferred to our foundation the university in 1980 were not covered by the university's Section 218 Agreement following that transfer.

In Rev. Rul. 71-276[12], *M,* a §501(c)(3) hospital was incorporated to take over the operations of three hospitals, *X, Y,* and *Z.* Each of the three hospitals was exempt under IRC §501(c)(3), and each had filed Forms SS-15 and Forms SS-15a (the functional equivalents of a Section 218 Agreement in the exempt organization context) to extend Social Security coverage to their respective employees.

Upon *M's* incorporation, the employees of *X, Y,* and *Z* became employees of *M*. Even though *M* was arguably the continuing or "successor employer" for purposes of IRC §3121(a), the IRS ruled that the employees of *X, Y*, and *Z* would not continue to have Social Security coverage following their transfer to *M*, unless *M itself* filed Form SS-15 and Form SS-15a. The employees of *X, Y*, and *Z* were considered to have terminated their employment with the previous hospitals and to have become employees of *M* upon its incorporation[13].

In our audit, the workers contracted to perform specific grant work obtained by the foundation (an instrumentality of the state), instead of maintaining their status as employees of the university. The university employees were covered under a Section 218 Agreement, the foundation's employees were not. Once the foundation changed its status from a state-reimbursed corporation to a non-state reimbursed corporation, the employees who worked for the foundation ceased to be employees of the university. They therefore also ceased to be covered under the Section 218 Agreement made by the university.

C. Are Workers Members Of A State Maintained Retirement System Comparable To Social Security?

IRC §3121(b)(7) excepts from "employment" services performed in the employ of a state, a political subdivision of a state, or any instrumentality that is wholly owned by a State or political subdivision. For services performed after July 1, 1991, though, IRC §3121(b)(7)(F) generally applies the FICA exemption only to individuals who are members of retirement systems of such states, political subdivisions, or instrumentalities.

Treasury Reg. §31.3121(b)(7)-2(d) explains what constitutes "membership in a retirement system" for purposes of IRC §3121(b)(7)(F). An employee participating in a retirement system of his or her employer must be a qualified participant in the system in order to be considered a member of the retirement system. Generally, an employee will be considered a qualified participant if the employee accrues a benefit or receives an allocation under the retirement system sufficient to satisfy the minimum retirement benefit requirement.[14]

Special rules are provided in the case of part-time, seasonal, and temporary employees. The regulations provide that employees must be fully vested in the retirement benefit provided by the employer in order to be considered a member of the employer's retirement system.[15] If the benefit provided to part-time, seasonal, or temporary employees under an employer's retirement system is not fully vested or non-forfeitable, the services of such employees will be considered employment for FICA purposes. The employee's benefit will be considered nonforfeitable if, on account of separation from service or death, the employee is unconditionally entitled to a single-sum distribution equal to 7.5% of the employee's compensation over the period of covered service, plus interest.

The government employment exception of IRC §3121(b)(7) does not apply to service covered by an agreement under Section 218 of the SSA.[16] Treas. Reg. §31.3121(b)(7)-2(e) provides for the definition of a retirement system:

> "(e) Definition of retirement system. (1) Requirement that system provide retirement-type benefits. For purposes of section 3121(b)(7)(F), a retirement system 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. Whether a plan is maintained to provide retirement benefits with respect to an employee is determined under the facts and circumstances of each case. For example, a plan providing only retiree health insurance or other deferred welfare benefits is not considered a retirement system for this purpose. The legal form of the system is generally not relevant. Thus, for

> example, a retirement system may include a plan described in section 401(a), an annuity plan or contract under section 403 or a plan described in section 457(b) or (f) of the Internal Revenue Code. In addition, the Social Security system is not a retirement system for purposes of section 3121(b)(7)(F) and this section."

The regulations require that the retirement system provide a minimum level of benefits comparable to the benefit provided under the Old-Age portion of the OASDI program of Social Security.[17] Whether the retirement system satisfies this requirement is generally determined on an individual-by-individual basis. Thus, a pension plan that is *not* a retirement system with respect to one employee may nevertheless constitute a retirement system with respect to *other* employees covered by the system. That can cause substantial confusion.

In PLR 9740006, the employer was a governmental instrumentality that provided risk management and self-insurance programs to its members. The taxpayer adopted its plan under IRC §457 for the benefit of its employees. It contributed up to 5% of compensation and the employees contributed 2.5% of compensation for a total of 7.5%. The IRS ruled that the taxpayer's plan satisfied the requirements of IRC §3121(b)(7) and Treas. Reg. §31.3121(b)(7)-2.[18]

California Government Code §19999.2(a) discusses the requirements of IRC §3121(b)(7)(F) and provides that state employees who are not members of the Public Employees' Retirement System must be covered by Social Security, or must be provided benefits through a qualified pension or annuity program. This statute goes on to authorize the development of a retirement program under the State's Deferred Compensation Plan, the Savings Plan, or any other acceptable defined contribution plan in which state employees can defer compensation at 7.5% wages, as the term "wages" is defined for Social Security purposes.

Our foundation workers were covered by the foundation=s retirement system. It provided retirement-type benefits at least equivalent to those provided by Social Security through fixed-dollar annuities issued by the Teachers Insurance and Annuity Association (TIAA), and by variable annuities offered by its companion organization, the College Retirement Equities Fund (CREF). TIAA was founded in 1918 and manages combined assets in excess of $300 billion. Contributions are based on a percentage of the participant=s regular salary.

The regulations state that, "A defined contribution plan maintained by a state, political subdivision or instrumentality thereof meets the requirements of paragraph (e)(2)(i) of this section with respect to an employee if and only if allocations to the employee's account (not including earnings) for a period are at least 7.5% of the employee=s compensation for service for the State, political subdivision or instrumentality during the period. Matching contributions by the employer may be taken into account for this purpose."[19]

D. Other Exceptions

There are other exceptions to the applicability of FICA taxes for employees of exempt organizations such as a university or foundation. For example, the student FICA exception may apply to some workers at educational entities. IRC §3121(b)(10) excepts from the definition of employment services performed in the employ of a school, college, or university (whether or not that organization is exempt from income tax), or an affiliated organization described in IRC §509(a)(3), if the service is performed by a student who is enrolled and regularly attending classes at the school, college, or university. Remuneration for services that is excluded from the definition of employment under IRC §3121(b)(10) is not subject to FICA taxes.

Whether an employee has the status of a student is determined on the basis of the employee's relationship with the school, college, or university where the services are being performed. An employee who performs services in the employ of a school, college, or university as an incident to and for the purpose of pursuing a course of study at the school, college, or university has the status of a student in the performance of those services. Yet, this rule too can be tricky, and can require one to bifurcate the fees paid.

For example, employment that is not incident to, and for the purpose of, pursuing a course of study does not qualify for the exception. If the employee does perform services as an incident to, and for the purpose of, pursuing a course of study and, therefore, has the status of a student, the amount of remuneration for services performed by the employee, the type of services performed by the employee, and the place where the services are performed are immaterial for purposes of the student FICA exception.

IV. MAKING AN ARGUMENT

I hope I have demonstrated that there are some grey areas here. Indeed, quite apart from doing everything *perfectly* (which clients rarely do, particularly in a complex and unforgiving area like employment tax details), sometimes arguments are all you need. In our university foundation audit, I do not know if we were really correct, or if we merely made sufficient arguments. After all, there is an adage that it is better to be convincing than correct. (If there is no such adage, there should be). As with most audits and most administrative appeals, the best victory is often a good settlement. Still, I suppose this can be seen as a disadvantage. As with any compromise or settlement, neither side knows how a court would have ruled on the issue. At the same time, some settlements are way too good to pass up.

As fewer and fewer tax controversies reach the courtroom these days, the taxpayer may not need to have the *winning* argument. It may need only to have a *good* argument. If you can settle a $10 million dispute for $500,000, for example, it usually makes sense to do so, especially if defense costs to go to trial will reach $200,000. These victories are not pyrrhic. They are about dollars, cents, and risk.

If the IRS does what it says it intends to do, it will be targeting more state instrumentalities for employment tax audits. That means these issues are going to arise with increasing frequency. With academic and business people alike, the IRS knows how to play hardball. They rarely lob one across the plate.

The good news is that there *are* cases in which state governmental bodies and state related instrumentalities are *not* obligated to pay FICA taxes. Finding out if you can qualify for such relief usually requires an analysis whether the entity is covered by a Section 218 Agreement, and whether the employees of the entity are enrolled in a state maintained retirement plan that provides benefits comparable to Social Security. This information is worth considering, even if you are not currently under audit.

ENDNOTES

1. Dave Porter is an attorney with Wood & Porter, PC in San Francisco (www.woodporter.com). He is a former Chair of the Tax Procedure and Litigation Committee of the State Bar of California Tax Section. You can reach him at porter@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

2. On June 14, 2006, IRS Deputy Commissioner for Services and Enforcement Mark Matthews stated there would be a significant increase in audits of federal agencies and state and local governments for potential employment tax violations. III TAX NOTES 1348 (Jun. 19, 2006).

3. IRC §3102(a).

4. Treas. Reg. §31.3121(j)-1(d)(3).

5. IRC §3121(b)(7) and IRC §3306(c)(7). *See also* Rev. Rul. 74-15, 1974-1 C.B. (126).

6. IRC §3121(b)(7)(E) and (F).

7. Treas. Reg. §1.3121(j)-1(d)(3).

8. IRC §3121. You would think that these determinations would be simple. It turns out they are not. Indeed, when determining if you have a Section 218 Agreement in place can be fuzzy.

9. IRC §3121(b)(7).

10. 476 F. Supp. 1089 (N.D. Cal., 1977).

11. *Id.* at 1100, fn. 13 (emphasis added).

12. Rev. Rul. 71-276, 1971-1 C.B. 289.

13. *See also* Rev. Rul. 77-159, 1977-1 C.B. 302 (similar facts); *Dodge Jones Foundation v. U.S.*, 1980 U.S. Ct. Cl. LEXIS 916 (1980) (no FICA coverage for employees of IRC §501(c)(3) organization, absent filing of a certificate waiving FICA exemption).

14. Treas. Reg. §31.3121(b)(7)-2(e).

15. Treas. Reg. §31.3121(b)(7)-2(e).

16. IRC §3121(b)(7)(E).

17. Treas. Reg. §31.3121(b)(7)-2(e)(2).

18. *See also* PLR 9749012.

19. Treas. Reg. §31.3121(b)(7)-2(e)(2)(iii).