

# Federal, State and Local Governments Newsletter

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# FEDERAL

# STATE



# LOCAL

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**MESSAGE FROM THE EDITOR**  
STEWART ROULEAU, FSLG SENIOR ANALYST

In the March issue of the FSLG Newsletter, Charles Peterson, Director of Government Entities (GE), spoke about Commissioner Mark W. Everson's effort to rebalance compliance and outreach activities. He pointed out some general areas of increased emphasis for GE, including abusive schemes, information returns, and employee fringe benefits.

Listed below are illustrations of common problems we are encountering in some of the areas that we are focusing compliance efforts.

**Travel and Meal Allowances.** A state auditor recently determined that nearly every agency was allowing reimbursements for meals that exceed Federal per diem allowances, and these were not being reported or accounted for as required by Federal tax law or state policy. The report indicated that many state agencies were unaware of requirements to report reimbursements as taxable income on employee Forms W-2.

**Automobile Use.** We recently discovered situations in which municipal policy allows widespread use of government-owned vehicles for commuting or other personal purposes. In many cases, employers are unaware that this creates a taxable fringe benefit.

**Federal Agency Information Reporting.** A recent GAO report determined that for 2000 and 2001, Federal agencies did not file information returns in 152,000 cases in which they were required. These represent \$25 billion in Federal payments to vendors and contractors.

**Consideration for Volunteers.** In this issue, we address this topic in detail in the article "Taxation of Benefits for Volunteers." Many governments have established policies to provide benefits, such as tax abatements, to certain workers considered to be volunteers. In general, compensation in any form that is contingent upon services provided is taxable income, regardless of the worker status as "volunteers." This includes expense allowances that do not meet the accountable plan rules.

Your FSLG Specialist is available to assist you in answering your questions about these and other topics. A directory of Specialists may be found in this publication. More information, including our Fringe Benefits Tax Guide, is available on our web site at [www.irs.gov/govts](http://www.irs.gov/govts).

## TAXATION OF BENEFITS FOR VOLUNTEERS

BY DENISE Y. BOWEN, FSLG TAX LAW SPECIALIST

### Introduction

In recent years, many states and local governments have created laws that provide incentives to emergency response volunteers in the form of relief from certain taxes. For example, in 1999, Connecticut adopted a law enabling local governments to give property tax relief to persons who volunteer their services as emergency responders. Subsequently, a number of municipalities created programs to provide partial property tax abatements or exemptions for residents of the municipality that volunteer their services as emergency medical technicians, ambulance drivers or firefighters. A similar law was also passed in New York authorizing local governments to grant a 10% property tax deduction to certain emergency volunteers with at least 5 years experience.

These state and local law provisions raise questions about the proper tax treatment of these benefits. The Office of Chief Counsel (CC) has concluded in several Chief Counsel Advice (CCA) memoranda that a local property tax abatement provided to volunteers in exchange for services is a taxable event under §61 of the Internal Revenue Code (IRC) as compensation for services (CCA is legal advice prepared by the national office component of the Office of Chief Counsel which is distributed to field employees of the IRS or the Office of Chief Counsel). In response to an inquiry on a similar volunteer case in Massachusetts, a CCA was issued on two occasions concluding that property tax abatements in exchange for volunteer services must be included in compensation for Federal income tax purposes. Shortly thereafter, CC issued another CCA concluding that the partial abatements and exemptions of property taxes under the Connecticut programs are includible in the gross income of the recipients.

The employment tax consequences of receiving property tax abatements or exemptions in exchange for services are significant. Because the workers in question are most likely employees, the amounts that they earn under the program will constitute wages that are subject to income tax withholding and social security and Medicare (FICA) taxes. The amount of wages will be equal to the value of the property tax liability forgiven. An employer is required to withhold and pay both the employer and employee portions of the FICA tax, even though the wages are paid in noncash payments. An employer is also required to deduct and withhold the income tax required to be withheld even though the wages are paid in noncash payments. If the employer pays the employee's FICA tax obligation or the income tax required to be withheld without receiving reimbursement from the employee, the amount of those payments will also constitute additional income to the employee under section §61 and wages for federal employment tax purposes. This article explains the legal basis for the taxability of these abatements and responds to questions that have been raised about possible exceptions from income and FICA taxation.

THERE IS NO APPLICABLE EXCLUSION UNDER WHICH A PROPERTY TAX ABATEMENT CAN BE EXCLUDED FROM A VOLUNTEER'S INCOME.

## I Basis for Taxation

Section 61(a) of the IRC defines gross income as all income from whatever source derived, including compensation for services. Unless an exclusion applies, gross income includes income realized in any form, whether in money, property or services. There is no applicable exclusion under which a property tax abatement can be excluded from a volunteer's income.

FICA taxes are imposed on both the employer and employee with respect to wages paid by employers to employees for employment. Specific exclusions from wages and employment are provided. The wage exclusions do not apply to this set of facts and are not considered for purposes of this article. There are several potentially applicable employment exclusions. However, the following application of the law and the facts concludes that the services performed by volunteers including volunteer firefighters do not meet the requirements for exclusion from either employment or income.

## II Exclusion from Income

The only exclusion to the income recognition rules that requires examination in this case is the administrative exclusion for "general welfare" payments made by governmental entities. However, because property tax abatements constitute compensation for services performed by the volunteers the exception is inapplicable.

The IRS has consistently ruled that federal payments made under statutorily created social benefit programs for the promotion of the general welfare are nontaxable. The general welfare exception applies only to governmental payments out of a welfare fund based upon the recipients' identified need, and not where made as compensation for services. In response to the inquiry in the Connecticut case CC stated:

The services requirement makes the general welfare exception inapplicable to property tax reductions. Similarly, the requirement of services can change all or a portion of a scholarship that is otherwise excludable from income under §117, into taxable income to the scholarship recipient. This same analysis can be applied to the evaluation of whether the property tax abatements or exemptions meet the requirements for exclusion from income.

CC also noted that because volunteers provide services to municipalities and the municipalities benefit from the services, the abatements and exemptions cannot be treated as a rebate.

Whether a volunteer firefighter is an employee or independent contractor will determine whether the employer is required to withhold FICA and Federal income taxes. If the firefighter is an employee, the amounts earned under the program will constitute wages subject to the withholding and payment of FICA and income taxes.

## III Worker Status

When making a worker status determination, the primary inquiry is whether the worker is

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an independent contractor or an employee under the common law standard. Generally, when workers are employees, the entity that employs them must withhold and pay FICA taxes. When a worker is an independent contractor, the government entity may have information reporting responsibilities, but is not required to withhold, report and pay FICA or income taxes on behalf of the worker.

If the relationship of an employer and employee exists, the designation or description of the parties as anything other than that of employer and employee is immaterial. Thus, if an employer-employee relationship exists, the fact that a worker is described as a volunteer is irrelevant.

In general, volunteers performing services for a state or local government will likely be employees under the direction and control of the government entity for which they are employed. Guidance for determining worker status is found in the Employment Tax Regulations (the Regulations) at §§31.3121(d)-1 and 31.3401(c)-1 for FICA and for income tax withholding, respectively. Information is also available in IRS Publications 15-A and 963 and at [www.irs.gov/govts](http://www.irs.gov/govts). If a government entity would like the IRS to make a determination whether a worker (or class of workers) is an employee, it can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

#### **IV Exclusion from Employment**

For purposes of the FICA, § 3121(b)(7) generally excludes from the term “employment” services performed by state and local government employees. Section 3121(b)(7)(F) effective for services performed after July 1, 1991, limits the general exclusion contained in § 3121(b)(7), and excludes from employment only the services of an employee who is a member of a retirement system maintained by a public employer. The rules for determining whether an employee is a “member of a retirement system” are set forth in § 31.3121(b)(7)-2 of the Regulations.

Whether an employee’s services are excepted from employment under § 3121(b)(7) turns on whether the employee is a qualified participant in a retirement system at the time services are performed. Although the concept of a retirement system is very broad, the system must provide a minimum benefit to an employee in order for the employee’s services to be excepted from employment. Determining whether a plan is a retirement system and whether an employee is a qualified participant in can be complex. For additional information see the Regulations § 31.3121(b)(7)-2, Rev. Proc. 91-40 1991-2 C.B. 694 and Publication 963.

Additional requirements under the Regulations apply to determine whether a part-time, seasonal or temporary employee is a “qualified participant” in a retirement system. A part-time employee for purposes of the FICA is defined as any employee who normally works 20 hours or less per week. A seasonal employee is any employee who normally works on a full-time basis less than 5 months in a year. A temporary employee, for this purpose, is any employee that performs services under a contractual arrangement with the employer for 2 years or less.

Part-time, seasonal and temporary employees are considered qualified participants in a retirement system on a given day only if the benefit relied upon to meet the minimum benefit requirement is 100 percent nonforfeitable or fully vested on that day. For example, if a part-time employee is not entitled to any benefits under a retirement system prior to the completion of 10 years of service, the nonforfeitability requirement is not met. Accordingly, those part-time employees are not qualified participants in a retirement system within the meaning of IRC § 3121(b)(7)(F), and therefore their services are not excluded from employment under IRC § 3121(b)(7).

Regardless of whether the employee is a member of a retirement system, wages paid to the employee will be subject to the Medicare portion of the FICA tax, unless the employee is eligible for the continuing employment section. In general IRC § 3121(u) provides that state and local government employees are subject to the Medicare tax unless the employee has been continuously employed with his or her employer since March 31, 1986. Additional information on the Medicare tax and the continuing employment exception can be found in IRS Publication 963, Federal-State Reference Guide, and in three Revenue Rulings, Rev. Rul. 2003-46, 2003-19 I.R.B. 878, Rev. Rul. 86-88, 1986-2 C.B. 172 and Rev. Rul. 88-36, 1988-1 C.B. 343.

Certain volunteers may assert that their services are excluded from employment under the emergency worker exclusion. Section 3121(b)(7)(F)(iii) provides that services performed by employees on a temporary basis in the case of fires, storm, snow, earthquake, flood or other similar emergency are exempt from employment, regardless of whether the employee is a qualified participant in a retirement system. This exclusion applies only to services of an employee who was hired due to an unforeseen emergency to do work in connection with that emergency on a temporary basis, for example, an individual hired to fight a major forest fire. Individuals performing services as volunteer firefighters on a regular but intermittent basis are not considered emergency workers within the meaning of § 3121(b)(7)(F)(iii).

#### **IV Section 530 Relief**

An employer may assert that it is eligible for relief under §530 of the Revenue Act of 1978 (§530). Section 530 provides relief from Federal employment tax obligations if certain requirements are met. For additional information on §530 see Publication 963 and Revenue Procedure 85-18, 1985-1 C.B. 518.

#### **Conclusion**

The performance of services in return for a benefit, including the cash value of all remuneration for services performed by an employee for his employer, is taxable under IRC §61 as compensation for services. Volunteers that receive partial property tax abatements or exemptions ultimately will have a lower property tax liability. The reduction in the property tax liability results in an in-kind payment in recognition of the services performed by the volunteer. If the volunteer is an employee, the normal FICA tax and income tax withholding rules apply to the in-kind payments.

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