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# FICA Wages and the Exemption for State Instrumentalities

*by David B. Porter*

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The IRS has embarked on a program of increased tax audits aimed at federal agencies and state and local governments.[1] Government taxing government may seem odd at first, 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 the enforcement effort.

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

Our law firm recently saved a nonprofit tax-exempt foundation millions of dollars in payroll taxes. The foundation was an instrumentality of a state-run university. We successfully explored 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 Social Security withholding as it relates to state and nonprofit employees.

### Background of FICA

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

The Social Security Act has been amended numerous times in the last 70 years, although the basic mechanism for funding Social Security benefits remains the same. Old-age, survivor, and disability insurance benefits 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. The combined tax rate for each party is now 7.65 percent, consisting of a 6.2 percent component for OASDI and a 1.45 percent 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.[2]

Originally, the collection and verification of taxes under FICA was the responsibility of state governments. Before 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. The agreements extended OASDI and Medicare coverage to employees of the state,

[1]On June 14 Mark Matthews, IRS deputy commissioner for services and enforcement said there would be a significant increase in audits of federal agencies and state and local governments for potential employment tax violations. *Tax Notes*, June 19, 2006, p. 1348.

[2]Internal Revenue Code section 3102(a).

political subdivision, or instrumentality that entered into the agreement. A political subdivision includes an instrumentality of the state.[3]

An instrumentality of the state or of a local government may qualify under IRC section 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 section 501(c)(3) that:

- have a ruling or determination stating their income is excludable from gross income (IRC section 115);
- are entitled to receive deductible charitable contributions under IRC section 170(c)(1) because contributions are for the use of governmental units; and
- are wholly owned instrumentalities of a state or a political subdivision for employment tax purposes.[4]

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, any employee filling that position is subject to FICA tax.

### Change in FICA Coverage for 501(c)(3) Organizations

IRC section 3121(k) provided an election for religious, charitable, and some other organizations to be covered under the Social Security system. IRC section 3121(k)(1)(A) provided that an organization described in IRC section 501(c)(3) which is exempt from income tax under IRC section 501(a) may file a certificate stating its wish 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 section 3121(k), requiring Social Security coverage for employees of IRC section 501(c)(3) organizations. The change resulted in administrative confusion for taxpayers — and to the IRS. In the case my firm recently concluded, that change was part of the problem.

### Further FICA Developments for 501(c)(3) Organizations

The mandatory Social Security portion of FICA tax for IRC section 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 section 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 section 501(c)(3) organization had not previously made that election, the Social Security portion of FICA taxes now had to be made to the IRS instead of the SSA.

In 1986 Congress enacted IRC section 3121(u)(2), stating 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 section 3121(b)(7)(E) provides that the term ''employment'' (for purposes of FICA) includes service under an agreement entered into under section 218 of the Social Security Act. In other words, effective March 31, 1986, IRC section 501(c)(3) organizations were *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 the 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. FICA payments previously reported to the state Social Security administrator under a section 218 agreement were now reportable to the IRS. That made the IRS the collection agent for all FICA taxes.

Even then, 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 not a member of a state retirement system were subject to the Social Security portion of the FICA tax.[5] As stated above, a political subdivision includes an instrumentality of the state.[6]

### 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 teachers, the university's employees are also members of the California Public Employees Retirement System (CALPERS), the famous (or infamous) state retirement system.

In the early 1960s, the foundation was granted tax-exempt status as described under IRC section 501(c)(3). The foundation's determination letter stated that the exemption was granted to the foundation because the foundation's primary purpose was to advance the welfare of the university, to promote and assist its educational services, and to otherwise aid and assist it in fulfilling its purposes. The foundation accomplished that goal 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.

[3]Treas. reg. section 31.3121(j)-1(d)(3).

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

[5]IRC section 3121(b)(7)(E) and (F).

[6]Treas. reg. section 1.3121(j)-1(d)(3).

### No FICA Tax Liability if State Instrumentality Satisfies Test

IRC sections 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 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 excepted from the definition of ''employment'' for purposes of FICA. IRC section 3121(b)(7).[7]

### 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.[8] The state of California provides FICA coverage to its employees under a section 218 agreement. Many workers employed by the state are also members of CALPERS.

The foundation my firm represented was an instrumentality of the university. Its primary purposes, again, 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 in 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.

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 as described under IRC section 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. 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 section 3121(b)(7) applied. Of course, our foundation never elected to participate in a section 218 plan.

In 1951 states and their political subdivisions became able to extend FICA coverage to their employees through voluntary section 218 agreements. 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*,[9] San Francisco teachers argued 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 system because the teachers continued to hold the same jobs for the same employer after the change of retirement systems (that is, the teachers continued to meet the SSA definition of membership in a retirement system coverage group). Also, there was no termination of the section 218 agreement in accordance with the provisions of then-existing law.

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

> As 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.*

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

*Ro Ane* is an important case. Further, two published IRS rulings under former IRC sections 3121(b)(8) and (k) (which exempted some IRC section 501(c)(3) organizations from FICA taxation before 1984) supported the position that the workers who transferred to our foundation from the university in 1980 were not covered by the university's section 218 agreement following that transfer.

In Rev. Rul. 71-276, 1971-1 C.B. 289, *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 501(c)(3), and each had filed forms

[7]You would think these determinations would be simple but it turns out they aren't. Determining if you have a section 218 agreement in place can be difficult.

[8]IRC section 3121(b)(7).

[9]476 F. Supp. 1089 (N.D. Cal., 1977).

SS-15 and SS-15a (the functional equivalents of a section 218 agreement in the exempt organization context) to extend Social Security coverage to their 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 under IRC section 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 forms SS-15 and 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.[10]

In our audit, the workers contracted to perform 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 also ceased to be covered under the section 218 agreement made by the university.

### Are Workers Members of a State Maintained Retirement System That is Comparable to Social Security?

IRC section 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 section 3121(b)(7)(F) generally applies the FICA exemption only to individuals who are members of retirement systems of those states, political subdivisions, or instrumentalities.

Treas. reg. section 31.3121(b)(7)-2(d) explains what constitutes membership in a retirement system under IRC section 3121(b)(7)(F). An employee participating in a retirement system of his or her employer must be a qualified participant in the system 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.[11]

Special rules are provided for part-time, seasonal, and temporary employees. The regulations provide that employees must be fully vested in the retirement benefit provided by the employer to be considered members of the employer's retirement system.[12] If the benefit provided to part-time, seasonal, or temporary employees under an employer's retirement system is not fully vested or is non-forfeitable, the services of those employees will be considered employment for FICA purposes. The employee's benefit will be considered non-forfeitable if, because of separation from service or death, the employee is unconditionally entitled to a single-sum distribution equal to 7.5 percent of the employee's compensation, plus interest, over the period of covered service.

The government employment exception of IRC section 3121(b)(7) does not apply to service covered by a section 218 agreement.[13] Treas. reg. section 31.3121(b)(7)-2(e) provides the definition of a retirement system:

> 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 retirement system must provide a minimum level of benefits comparable to that provided under the old-age portion of the OASDI program of Social Security.[14] Whether the retirement system satisfies that requirement is generally determined individually. Thus, a pension plan that is not a retirement system regarding one employee may still constitute a retirement system regarding other employees covered by the system. That can cause much 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 section 457 for the benefit of its employees. It contributed up to 5 percent of compensation, and the employees contributed 2.5 percent of compensation for a total of 7.5 percent. The IRS ruled that the taxpayer's plan satisfied the requirements of IRC section 3121(b)(7) and Treas. reg. section 31.3121(b)(7)-2.[15]

California Government Code section 19999.2(a) discusses the requirements of IRC section 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. The

[10] *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 section 501(c)(3) organization, absent filing of a certificate waiving FICA exemption).

[11] Treas. reg. section 31.3121(b)(7)-2(e).

[12] Treas. reg. section 31.3121(b)(7)-2(e).

[13] IRC section 3121(b)(7)(E).

[14] Treas. reg. section 31.3121(b)(7)-2(e)(2).

[15] *See also* PLR 9749012.

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 percent of wages, as the term ''wages'' is defined for Social Security purposes.

Our foundation workers were covered by the foundation's retirement system, which 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 TIAA's 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:

> 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.[16]

**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 section 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 section 509(a)(3), if the services are performed by a student who is enrolled and regularly attending classes at the school, college, or university. Remuneration for services that are excluded from the definition of employment under IRC section 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 it can require one to bifurcate the fees paid.

For example, employment that is not incident to, and not 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 under the student FICA exception.

**Making an Argument**

I hope I've demonstrated that there are some gray areas here. Apart from doing everything perfectly (which clients rarely do, particularly in a complex and unforgiving area like employment tax details), sometimes arguments are all that is needed. In our university foundation audit, I do not know if we were really correct or if we merely made sufficient arguments.

After all, there's an adage that it's 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 in any compromise or settlement, neither side knows how a court would have ruled on the issue. At the same time, some settlements are too good to pass up.

As fewer tax controversies reach the courtroom, the taxpayer may not need to have the winning argument. It may suffice to have merely a good argument. If you can settle a $10 million dispute for $500,000, it usually makes sense to do so, especially if defense costs to go to trial will reach $200,000. These victories aren't 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 will arise more frequently. With academic and business people alike, the IRS knows how to play hard ball. 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 that relief usually requires an analysis of 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. Whether or not you are under audit, this is worth considering.

[16]Treas. reg. section 31.3121(b)(7)-2(e)(2)(iii).