

Issues for Government Entities

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O'Connor Davies Munns & Dobbins, llp
ACCOUNTANTS AND CONSULTANTS

BENNETT KIELSON STORCH DESANTIS DIVISION



Top left to right: Susan M. Barossi, John D. Cosgrove, Domenick Consolo, Nicholas DeSantis, Alan Kassay and Nora Galleros. Seated left to right: Scott Oling and Matthew G. McCrosson

The Bennett Kielson Storch DeSantis Division (“BKSD”) of O’Connor Davies Munns & Dobbins, LLP regularly receives inquiries relating to employee compensation, tax forms, pension plans and workman’s compensation. Therefore, we are pleased to provide this guide which addresses issues specifically related to governmental entities such as counties, cities, towns, villages and school districts. This publication is also available at www.odmd.com.

In addition to producing quality audits and tax returns, our goal is to provide resources for clients to keep them current on management and Board issues. We encourage you to contact our experienced Government Services Partners to personally address your questions at a presentation to your Board and management prior to your public meeting.

Subsequent guides will address additional topics that we feel will be of interest to you. We welcome your comments and topic suggestions for future issues.

Very truly yours,

Bennett Kielson Storch DeSantis

The Government Services Division of
O’Connor Davies Munns & Dobbins, LLP



Independent Contractors vs. Employees

Today more and more businesses are making increasing use of outside workers to cut costs, including payroll tax costs. Unfortunately, their trend has caught the attention of the IRS. What the IRS is looking for are workers who are treated as independent contractors but who actually are employees. If the IRS is successful in reclassifying workers, there is the potential of a substantial tax bill, consisting of, just for starters, the employer's back social security taxes and FUTA taxes, plus possible penalties and interest.

The amounts involved are significant. For 2008, apart from income tax withholding, the employer has to withhold 6.2% from taxable wages up to \$102,000 (\$97,500 for 2007) for the employee's share of the Old Age, Survivor and Disability portion of social security and 1.45% of all taxable wages for the Hospital Insurance, or Medicare, portion.

Despite the high stakes, classifying a worker as either an independent contractor or an employee is not straightforward. The determination depends on a number of factors and can be quite complex.

One of the steps we recommend to clients who use independent contractors and who therefore face a heightened risk of a costly IRS payroll tax or benefits audit, is a quick review of some of the key factors the IRS tells its agents to look at in determining whether a worker is really an employee.

The primary inquiries fall into three categories. Who has financial control of the job? Who can exercise control over how the worker performs the specific task? And how do the parties themselves view the relationship? When reviewing the checklist, keep in mind that the IRS will make its decision based on the whole picture, not just a single factor.

Workers are more likely to be classified as independent contractors if they:

- Make a significant investment in business property (a home computer is not significant);
- Pay their own business expenses;
- Receive a flat fee that is not based on an hourly or similar rate;
- Are not prohibited from doing work for other companies;
- Can pay subcontractors to get the job done;
- Are not performing services as an integral part of your regular business;
- Have a contract with an enforceable liquidated damages provision;
- Can make a profit;
- Can suffer a loss;
- Are organized as a corporation receiving income from various sources.



Workers are more likely to be classified as employees if they:

- Are given specific instructions and on-going training in how to get the work done;
- Cannot work for others;
- Have expenses paid by your company;
- Are paid with a salary or hourly wage;
- Do not have a significant investment in their trade or business;
- Are an integral part of your regular business;
- Receive direct reimbursement for all, or almost all, expenses;
- Have no other clients.

Less important is:

- Whether or not the work is performed on the premises of the business;
- Whether the worker has flexibility in setting hours;
- Whether the relationship is temporary or short-term;
- Whether the work is full- or part-time;
- Whether the worker performs services for one or more businesses.

Control of how and when the worker gets the job done may or may not be the most important factor. Some workers are employees no matter how little or how much they are supervised. Others are independent contractors no matter how tightly a business controls them. For some, the IRS uses a 20-factor control test as an analytical tool.

There is some good news in all this intricacy. First, taxes due may be reduced if the misclassification is unintentional. Second, in some cases, if you have always treated workers as independent contractors the IRS may let you continue to do so. You cannot take advantage of this unless there was a reasonable basis for not classifying the individual as an employee in the first place and unless you have filed all returns required for nonemployees, such as **Form 1099** information returns. Third, if you are unable to meet all the safe-haven requirements but have filed returns, the IRS may let you settle for a fraction of the cost.

Please do not hesitate to call us. We can work with you to review existing payment arrangements, help you with future plans and advise you what, if any, action is necessary. We may even find workers are actually independent contractors who have been misclassified as employees.



Retirement Plans

Code Section 403(b)

Retirement plans under Section 403(b) provide tax-favored treatment for public school employees, employees of tax-exempt organizations, and certain ministers. Funding arrangements can include insurance annuity contracts, custodial accounts holding only shares of mutual funds, and church retirement income accounts.

If you **participate in or offer** such a plan, you may be interested to know that the IRS has issued final regulations on Section 403(b) contracts of public schools and tax-exempt organizations. These regulations outdate or supersede decades of rulings, and generally apply for tax years beginning on or after December 31, 2008. The major effect of this legislation has been to diminish the differences between Section 403(b) and 401(k) plans.

Use for Individual Taxpayers

Your employer is required to provide you with the right to make Section 403(b) elective deferrals. However, certain exclusions may continue to apply during the transition period, such as:

- Employees who make a one-time election to participate in a governmental plan;
- Professors who provide services on a temporary basis to another school; and
- Employees who are affiliated with a religious order and have taken a vow of poverty.

If your Section 403(b) plan includes a Roth contribution program, you have the option of making an elective deferral, and/or a designated Roth contribution. This allows for greater flexibility, because it gives you a choice about the timing of your tax benefits. An elective deferral allows a current exclusion of contributions from gross income, while the Roth Section 403(b) option offers a future exclusion of the earnings on contributions.

Some employers provide a matching contribution to the Section 403(b) plan, and if yours does, you should try to take advantage of this free money by making sufficient elective deferrals. However, if you elect to only make designated Roth contributions, you won't be eligible to receive a matching contribution.



Key Rates and Figures:

For 2008 and 2007, the limitation on the exclusion for elective deferral is \$15,500.

You may be able to make catch-up contributions (limited to \$5,000) if you are age 50 or older. Another special Section 403(b) catch-up contribution may be available if you have worked for your employer for at least 15 years. The new regulations also allow you to transfer your plan interest to a current or former employer's Section 403(b) plan.

Use for Employers and Tax-Exempt Organizations

Written Plan Documents. Employers are required to have a written plan for their Section 403(b) contracts, but this plan does not have to be contained in one document. Material provisions may be incorporated by reference to other documents; for example, an annuity contract, which as a result would become part of the plan. In order to reduce costs associated with maintaining a written plan, the IRS intends to publish model plan provisions that may be used by public school employers.

Tax-Exempt Entity Controlled Groups. More permissive aggregation rules for tax-exempt organizations will be allowed under the new regulations, thereby providing economies of scale. Subject to anti-abuse rules, tax-exempt organizations can choose to be aggregated if:

- They maintain a single plan covering one or more employees from each organization, and
- The organizations regularly coordinate their day-to-day exempt activities.

As you can see, these new regulations are quite complex. If you think any of these circumstances apply to you, or if you would like further information, please call our office at your earliest convenience to arrange an appointment.

Section 457 Plans:

Tax code Section 457 provides rules to govern all nonqualified deferred compensation plans of governmental employees and non-church controlled tax-exempt organizations. The pension plan designed to comply with these rules is simply referred to as a Section 457 plan. Employees are allowed to defer compensation on a pre-tax basis through payroll deductions that further allow them to defer Federal and sometimes State taxes until the assets are withdrawn.



Eligible and Ineligible Plans

Eligible Section 457 plans include limits on the amounts deferred and are subject to favorable tax treatment. Plans that provide greater deferral are generally designed for executives and are referred to as *ineligible*. The amount deferred annually by an employee for an eligible plan cannot exceed the lesser of 100% of the employee's compensation or an applicable dollar amount as follows:

2007 and 2008 ----- \$15,500

The limit on catch-up contributions for participants age 50 and over remains at \$5,000 for 2007 and 2008.

Only eligible employers can establish a Section 457 plan.

An eligible employer is defined as states, subdivisions of states, instrumentalities or political subdivisions of states, or any entity that is exempt from Federal income taxes.

Unlike the Section 403(b) plan, there is no universal accessibility under the Section 457(b). This means that employers are not required to make the plan available to all employees. However, any individual who performs services for the employer, including independent contractors, are eligible to participate in the plan. Your employer's plan document should spell out the specific rules for contribution.

Can an Employee Contribute to a Section 457(b) and a Section 403(b)?

Yes. The Section 457(b) plan has traditionally covered State and local government employees, which included some teachers. In the past, teachers who wished to contribute to both plans were limited to the total aggregate amount of the Section 457(b) (only \$8,500).

The Economic Growth and Tax-Relief Reconciliation Act of 2001 (EGTRRA) repealed coordination of contributions between Section 457(b) plans and Section 403(b) plans. This means that employees with enough includable compensation can contribute the maximum elective deferral limit to both a Section 403(b) and a Section 457(b). For 2008, this is \$15,500 for a whopping total of \$31,000. Participants eligible for catch-up provisions can include even more. Check with your employer and your vendor for more details.

Not all employers offer both a Section 457(b) plan and a Section 403(b), nor are they required to do so.



Section 409A – Teachers Salary Over 12 vs. 10 Months:

Section 409A generally establishes deadlines for when employees have to make their elections to defer compensation. The general rule under the law is that an employee who wants to defer payment of compensation to be earned in one year until a later year must make an election to do that no later than the end of the prior year. In other words, if an employee wanted to defer some of his or her salary that would be earned in 2008, the employee would have to make the election no later than December 31, 2007. Congress gave the IRS and Treasury Department authority to provide additional rules for elections, however. Under final Section 409A regulations issued in April, special rules allow teachers (or other taxpayers with similar part-year work periods) to make an election to spread their compensation out for up to 12 months, if their employer is willing to give them that choice. Generally, the regulations require the following:

- The teacher (or other employee) must give a written (or electronic) election to the employer that notifies the employer that the employee wants to spread out the compensation.
- The election must be made before the beginning of the work period (for example, before the first day of the school year for which the teacher is paid, which may be before the first day students arrive for class).
- The election must be irrevocable, so that it can't be changed after the work period begins.
- The election must state how the compensation is going to be paid if the election is made (for example, ratably over the 12 months starting with the beginning of the school year).
- No particular form is necessary for the election and it does not have to be filed with the IRS.

In response to concerns expressed by plan service recipients and providers, the IRS has extended the prior transition relief for compliance with the final regulations under Code Section 409A until January 1, 2009. *However, this relief does not change the underlying compliance requirements.*

A school district may provide that all teachers will have their pay spread over 12 months, without providing any election to the teachers. For the work period or school year 2008-2009, school districts that offer election must set forth in writing how the teachers are to be paid for the compensation.

If your plan does not meet the deferred compensation plan requirements, all compensation deferred under the plan will immediately become includable in gross income. Compensation that fails to meet the requirements is subject to certain additional taxes including 20% additional income taxes. As an employer with a nonqualified deferred compensation plan, any concerns you have about compliance with these rules should be addressed as soon as possible. Please call our office at your earliest convenience to arrange an appointment.



Vehicles Available for Personal Use

Certain fringe benefits may be excluded from an employee's gross income. Benefits such as air flights, cars, computers, educational benefits, entertainment, or travel, may be excludable as working condition fringe benefits. However, these benefits may be includible in income to the extent the employee uses them for personal purposes.

If your employee uses a business vehicle solely for business reasons or if your employee's personal use of a company vehicle is minimal, then the value of the benefit need not be included in your employee's gross income. However, if your employee is required to report the use of a company car as a taxable fringe benefit, then the value of the personal use is taxable to your employee as compensation and is deductible by you as the employer.

There are a number of valuation methods that can be used to determine the value of this fringe benefit. In addition, there are multiple reporting requirements that must be closely followed.

Employer-provided commuting vehicle. If certain requirements are met, the use of an employer-provided commuting vehicle is valued at \$1.50 each way (to and from work) per employee. Even if two or more employees commute in the vehicle (for example, a car pool), each employee includes \$1.50 each way in income. To qualify, personal use of the vehicle must be de minimis and the employer must require the employee or employees to commute to and/or from work in the vehicle for bona-fide noncompensatory business reasons.

Employer-provided vehicle. The value of the personal use of an employer-provided car may be computed under annual lease value tables. The annual lease value of an automobile is computed by first determining the fair market value (FMV) of the automobile on the first date it was made available to any employee for personal use. Under a safe-harbor provision, the employer's cost can be substituted for FMV, provided certain conditions are met. Once the FMV is established, the Annual Lease Value Table, prepared by the IRS, is consulted to determine the annual lease value that corresponds to the FMV. The table is reproduced below. The annual lease values include the FMV of maintenance and insurance for the automobile but do not include the cost of gasoline provided by the employer. The fuel provided can be valued either at its FMV or at 5.5 cents per mile for all miles driven within the United States, Canada, or Mexico by the employee.

Automobile Fair Market Value
(1)

Annual Lease Value
(2)

\$0 to 999	\$600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350



<i>Automobile Fair Market Value</i> (1)	<i>Annual Lease Value</i> (2)
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250

For vehicles having a fair market value in excess of \$59,999, the Annual Lease Value is equal to:
(.25 x the fair market value of the automobile) + \$500.



Cents-per-mile valuation. The value of the personal use of an employer-provided vehicle may be determined by multiplying personal use mileage (if at least 10,000 miles) by the standard mileage rate (48.5 cents per mile for 2007 and 50.5 for 2008) if certain requirements are satisfied. For a passenger automobile first made available to an employee in calendar year 2007, the fair market value of the vehicle cannot exceed \$15,100 and for a truck or van the fair market value cannot exceed \$16,100. Fuel provided by the employer must be valued separately, at either its fair market value or at 5.5 cents per mile for miles driven in North America.

Reimbursement for Use of Employee's Vehicle

- If the employee receives a fixed monthly reimbursement amount (i.e., \$330 per month) the reimbursement is treated as income to the employee.
- If the employee submits a statement detailing the exact vehicle expense incurred per month and the employer reimburses based on this, the reimbursement is not treated as income to the employee.

If you have any questions about the proper reporting of the personal use of business vehicles, please contact our office at your convenience.

Compensation for Injuries and Sickness, Section 207 (Statute in the Nature of a Workman's Compensation Act)

Law provides that any member of a police force or a firefighter of any municipality, who is injured in the performance of their duties, continues to receive their regular salary or wages. Salary or wages shall be paid by the municipality by which he/she is employed until their disability arising therefrom has ceased.

For Employees: Gross income does not include amounts received under a Workman's Compensation Act as compensation for personal injuries where such injury was in the "line of duty."

For Employers: All salary payments made to employees for such injuries are *not* subject to *Income Tax, FICA or Medicare.*

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About the Government Services Division of ODMD

O'Connor Davies Munns & Dobbins, LLP specializes in providing accounting, tax and consulting advice for government managers and executives through our Bennett Kielson Storch DeSantis Division. Within this area of expertise, our clients include governments and agencies at the local, State and National levels. In addition, we serve a number of entities that receive Federal, State and local contracts and grants, or that participate in cooperative agreements. The entities we service include counties, cities, towns, villages, school districts, justice courts, fire districts, hospitals, educational institutions, State agencies and public authorities.

Our Services

The Government Services Division of ODMD offers a wide range of government and agency-specific accounting, tax and consulting services. Our team of specialists is dedicated exclusively to the unique needs of your government or agency. We have significant experience in providing formal reviews, reporting, consulting and advisory services that are tailored to your organization's specific needs in the following key areas:

Audit and Tax

- Audits of governmental entities
- Compliance audits – OMB Circular A-133 and Program Specific Audits
- Internal auditing services
- Advisement on payroll and tax matters
- 403(b) compliance reviews
- Assistance with employee benefit plans
- Deferred compensation plan audits
- Implementation of GASB standards
- Performance auditing

Information Technology Consulting

- Feasibility studies for information technology applications
- Design and implementation of organizational systems and accounting software

Management Advisory Services

- Budget consulting services
- Bookkeeping services
- Grant, contract and cost proposal development – Indirect Cost Rate Calculations
- Fund balance projections

Additional Services

- Preparation and review of Comprehensive Annual Financial Reports (CAFR)
- Review of Official Statements for bond issuances
- Refunding bond verification services
- Assistance in preparation of State reports