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Mandatory SS Recommended by Advisory Council

The Advisory Council on Social Security was established by the Secretary of Health and Human Services, Donna E. Shalala. The council consisted of members representing the general public, business, labor and the self-employed. It was charged with advising the public, the administration and Congress on how best to prepare the long term financing of the social security and Medicare programs for the future.

In the past, efforts to deal with social security's financial difficulties have generally featured cutting benefits and raising tax rates on a pay-as-you-go basis. All Advisory Council members agreed that the pay-as-you-go approach should be changed. Despite its best efforts, the council was not able to agree on one single plan for dealing with social security's financial difficulties. Rather, council members expressed interest in three different approaches to restoring financial solvency and improving money's worth returns.

Maintenance of Benefits Plan

One group of members favors an approach, labeled as the Maintenance of Benefits (MB) plan, that involves an increase in income taxes on social security benefits, a redirection to the OASDI funds beginning in 2010 of the part of the revenue from taxes on OASDI benefits now going to the Hospital Insurance (HI) Trust Fund, **coverage of newly hired state and local governments workers not currently covered by social security**, a payroll tax increase in 2045, and serious consideration of a plan allowing the governments to begin investing a portion of trust fund assets directly in common stocks indexed to the broad market.

Individual Accounts Plan

Another group supports an approach, labeled the Individual Accounts (IA) plan, that creates individual accounts alongside the social security system. This plan involves an increase in the income taxation of benefits (though not the redirection of HI funds), **mandatory state and local coverage**, an acceleration of the already-scheduled increase in the age of eligibility for full benefits up

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Details for Excluding Educational Assistance

The employer-paid educational assistance exclusion (Section 127 of the Internal Revenue Code) was reinstated with the passage of the Small Business Job Protection Act last year and allows employers to provide up to \$5,250 annually in educational assistance tax-free to individual employees. Graduate level courses were covered by this provision only for courses beginning prior to June 30, 1996. Employer paid assistance for undergraduate courses can be excluded for courses beginning through June 30, 1997, for tax years beginning in 1997.

According to the IRS in Revenue Notice 96-68, a "graduate level course," for purposes of the Section 127 exclusion, is a course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by an individual in a program that leads to a law, business, medical or other advanced academic and professional degree.

Revenue Ruling 96-68 states that the first day on which regular classes begin during a term at an education institution is considered the day a course begins for purposes of qualifying for the educational assistance exclusion. The registration and enrollment dates do not determine when the course begins. Assistance is excludable for an employee who registers in an undergraduate class in January 1997 for a summer term, if the first day in which courses are held that summer term is Monday, June 3, 1997, and classes continue until August. Even if the employee meets with a professor the first time in July, the educational assistance would be excluded under Section 127.

Job-Related Educational Assistance

If employer-provided educational assistance is not covered under Section 127, either because the amount exceeds \$5,250, or because of the graduate level exclusion, Section 132(j)(8) of the IRC specifically states that such amounts may be excludable as a working condition fringe benefit. This is of particular importance as a backstop during the periods when Section 127 may not be effective.

The criteria for excluding job-related educational

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Mandatory Social Security

to year 2011 and then an automatic increase in that age tied to longevity, a reduction in the growth of future social security benefits is structured to affect middle- and high-wage workers the most, and an increase in employees' mandatory contribution to social security of 1.6 percent of covered payroll, which would be allocated to individual defined contribution accounts. These individual accounts would be held by the federal government but with constrained investment choices available to individuals.

Personal Security Account

A third group of members favors an approach, labeled the Personal Security Accounts (PSA) plan, that creates even larger, fully-funded individual accounts which would replace a portion of social security. Under this plan, workers would direct five percentage points of the current payroll tax into a PSA, which would be managed privately and could be invested in a range of financial instruments. The balance of the payroll tax would go to fund a modified retirement program and modified disability and survivor benefits.

When fully phased in, the modified retirement program would offer all full-career workers a flat dollar benefit (the equivalent of \$410 monthly in 1996, the amount being automatically increased to reflect increases in national average wages prior to retirement) plus the proceeds of their PSAs. This plan also would involve a change in benefit taxation, **mandatory state and local coverage**, an acceleration of the already-scheduled increase from 65 to 67 in the age of eligibility for full retirement benefits, with the age increased in future years to reflect increases in longevity, a gradual increase from 62 to 65 in the age of eligibility for early retirement benefits (although workers could begin withdrawing the proceeds of their PSAs at 62), a reduction in future benefits for disabled workers, a reduction in benefits for women who never worked outside the home and an increase in benefits for many elderly widows.

The cost to Kentucky is in millions

Mandatory social security coverage, included in all three revenue plans, is proposed to be phased in through the new-hire concept, similar to that of Medicare coverage. An example of a "new hire" would be an employee hired into a KTRS position in the Department of Education or Workforce Development Cabinet.

Mandatory social security would place a financial burden on all Kentucky governmental employers and employees of about \$8.2 million during its first year of implementation based on a 7.5 percent new hire rate in the Commonwealth. The burden will increase annually at about \$8.2 million a year, plus increases in salaries and the cost of living. Full implementation of mandatory social security coverage will ultimately cost Kentucky governmental employers and their employees about \$230 million annually.

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Education Assistance

expense does not hinge on the type of class or course per se, but rather, focuses on the purpose for taking the course. Treasury regulations beginning at 1.162-5(a) break it down into two general categories. The education must either:

- Maintain or improve the skills required by the individual in his/her employment, or
- Meet the express requirement of the employer, or the requirements of applicable laws or regulations, imposed as a condition to the retention of the person's employment, status or rate of compensation.

No deduction of assistance is allowed if the education is required to meet minimal qualifications for the job. "The fact that an individual is already performing service in an employment status does not establish that he/she has met the minimum education requirements for qualification of that employment," the regulations state. The regulations use the example of a law-school student, hired by a firm to do legal research full-time, who is required to obtain a law degree and pass the state bar examination to keep the job. Law courses and a bar review course related to meeting that requirement are not deductible because they are intended to meet the minimum education requirements.

The exclusion is allowed, however, in a situation where a bachelor's degree is required for a position. It also applies in cases where the completion of a fifth college year within ten years is required in order to retain the position. The employee's fifth college year courses taken to earn a standard certificate "is not education required to meet the minimum educational requirements" in this example, the regulations state. The bachelor's degree had been determined to be the minimum educational requirement for hire in that position.

Not excludible is assistance for courses that would qualify a person for a new trade or business. A simple change of duties does not constitute a new trade or business if the new duties involve the same general type of work. Using the education field as an example, courses that would help a classroom teacher move into the principal position involve the same general type of work and would qualify for tax exclusion. Assistance for a computer programmer who attends law school at night and receives a law degree is not excludible since it qualifies the programmer for a new trade or business.

Assistance is allowed for cases where a person takes a two-week course to review several new developments in the field he/she is already working.



The Commonwealth of Kentucky does not discriminate on the basis of race, color, national origin, sex religion, age or disability in employment or the providing of services and will provide, upon request, reasonable accommodation including auxiliary aids and services necessary to afford individuals with disabilities an equal opportunity to participate in all programs and activities.

1997 Payroll Rates

The taxability of several major items have been adjusted for 1997 by some automatic inflationary mechanisms and by the Internal Revenue Service.

- The 1997 optional standard mileage allowance increases to 31.5 cents per mile and applies to the business use of an automobile.
- The new mileage allowance for moving purposes is 10 cents per mile.
- The tax-free limit on employer-provided parking increases to \$170 for 1997. The "vehicle/transit" reimbursement tax-free limit remains at \$65.
- The Executive Level V salary amount used for determining a governmental "control employee" is \$108,200, unchanged from 1996. This definition is applicable when choosing the valuation method for employer provided vehicles.

New Features for Division of Social Security Web Site

A number of new features have also been added to the Division of Social Security internet web page including a list of Kentucky political subdivisions that have entered into Section 218 Agreements with the Commonwealth and statutes dealing specifically with Section 218 coverage. Also, the section on the taxing of employer-provided vehicles has been updated and this newsletter (Spring 1997) is available on-line.

The DOSS internet web site address is:

<http://www.state.ky.us/agencies/finance/divss.htm>

Any suggestions for additions to the DOSS web site and comments on its current contents are certainly welcome. You may contact Daryl Dunagan at:

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PLEASE NOTE--This publication is for general information only. The material provided within should not be used or cited as authority for employment tax obligations and requirements. The Social Security Act, Kentucky Revised Statutes and the Internal Revenue Code, along with regulations and revenue rulings and case law, are the only valid citations of authority.

IRS to Examine Forms 1099-MISC During Compliance Effort

The Internal Revenue Service's education and compliance effort was previously covered in the Winter 1996 issue of this newsletter. The IRS has since indicated that it will concentrate a portion of its compliance resources in checking governmental employers' conformance with the Form 1099 requirements.

The Form 1099-MISC is an IRS information return used by payors to report such diverse items non-employee compensation, rents, services, prizes and awards, etc. State agencies should ensure that all payments through STARS (state government's accounting system) are properly coded for Forms 1099 processing. Also, state agencies should ensure that the proper employee/contractor status is accorded to individuals with personal service contracts.

The IRS lets the issue of whether an employment relationship exists with an contractor turn on the question of whether the state agency for which services are performed has the right to control the contract holder performing the services as to the manner and means by which the services are performed to a degree sufficient to establish the relationship of employer and employee under common law rules. State agencies should review each contract and apply the IRS common-law control test (available from the DOSS) to determine whether an individual holding a personal service contract in an employee or an independent contractor.

State agencies should also take care in their manner of reporting appointed officials, such as board or commission members, who are considered employees.

The definition of employee under the Social Security Act includes "an individual who, under the usual common-law rules applicable in determining an employer-employee relationship, has the status of an employee." The act also defines an officer of a state as an employee.

The Internal Revenue Code defines employee as "an officer, employee or elected official of the United States, a state or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing."

The Kentucky Revised Statutes state that an employee is "any person in the service of the Commonwealth, a political subdivision or an interstate instrumentality of which the Commonwealth is a principal and shall include all persons designated officers, including those which are elected and those which are appointed."

The DOSS has prepared an fact sheet on determining employment status titled "Who is a Governmental Employee". A copy of the fact sheet can be obtained by calling the DOSS at 502/564-3952 or by downloading from our web site at <http://www.state.ky.us/agencies/finance/divss.htm>.

Revenue Ruling 96-65

Addresses Personal Injury, Sickness and Discrimination Settlements

Back pay and damages received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964 must be included as gross income, unless as otherwise provided by law, according to Internal Revenue Ruling 96-65.

Section 104(a)(2), as amended by the Small Business Job Protection Act of 1996, provides generally that gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal physical injuries or physical sickness. Section 104(a) further provides that, for purposes of paragraph (2), emotional distress is not treated as a physical injury or physical sickness except to the extent of damages paid for medical care or attributable to emotional distress. The new amendments apply to amounts received after August 20, 1996, but not to amounts received under a written binding agreement, court decree or mediation award in effect or issued on or before September 13, 1995.

According to the revenue ruling, back pay received under Title VII is not excludable because it is completely independent of, and thus is not damages received on account of, personal physical injuries or physical sickness under Section 104(a)(2). Similarly, amounts received for emotional distress in satisfaction of such a claim are not excludable from gross income under Section 104, except to the extent they are damages paid for medical care or attributable to emotional distress. Copies of Rev. Ruling 96-65 can be obtained from the DOSS.

Back Pay Review

Back pay is pay received in one period for actual or deemed employment in an earlier period. For social security purposes, all back pay, whether or not under a statute, is wages if it constitutes remuneration paid for covered employment. Any other amounts determined to be damages received on account of personal physical injuries or physical sickness, interest, or legal fees in conjunction with back pay awards are not considered wages. The employee need not have worked during the period in question for a back pay award to be considered wages. If a back pay wage award is not under a statute, SSA credits back pay as wages when paid. Back pay not under a statute cannot be allocated to prior periods. If the back pay was awarded under a statute, however, SSA credits the back pay award to the year(s) it should have been paid.

Back pay under a statute

Back pay awarded under a statute is a payment by an employer pursuant to an award, determination or agreement

approved or sanctioned by a court or government agency responsible for enforcing a federal or state statute that protects an employee's right to employment or wages. Examples of pertinent statutes include:

- Age Discrimination in Employment Act
- Americans with Disabilities Act
- Equal Pay Act
- National Labor Relations Act
- State minimum wage laws
- State statutes that protect rights to employment and wages

Payments based on laws that have a similar effect as those listed above also may qualify as payments made under a statute. Some awards may be considered damages received on account of personal physical injury or physical sickness and not remuneration for employment. Such awards would not be considered wages for social security purposes.

If a court-approved or sanctioned settle agreement includes a clause that states the agreement is not an admission of liability, discrimination or acts of wrongdoing, the clause does not change the nature of the back pay award. The payments made pursuant to such a settlement may still constitute back pay and be considered wages.

Reporting back pay awards

Back pay awards which constitute wages are treated differently by the IRS and by SSA. The IRS treats all back pay as wages in the year the award is paid for taxation purposes. SSA also treats back pay as wages in the period(s) paid, **except for back pay under a statute.**

Pursuant to U.S. Supreme Court decision, *Social Security Board v. Joseph Nierotko*, 66 U.S. 637 (1946), SSA credits back payments awarded under a statute to an employee's earnings record in the period(s) wages should or would have been paid. This is important because wages credited to more than one year result in higher social security benefits or enable the individual to meet the earnings requirement for benefits.

In order for SSA to properly credit back pay under a statute to the proper period(s), state agencies must prepare a special report and send it to DOSS. Form SS-9, available in paper format or on an Excel spreadsheet from DOSS, is used to report back pay under a statute to the DOSS.

FICA tax treatment

Kentucky state agencies should consider back pay as "wages" for social security and Medicare (full FICA) withholding if the services are performed:

- in a non-KTRS position, or
- by an individual in a KTRS position and who is not a participant in a state retirement system.

The back pay is "wages" for Medicare-only withholding if the individual:

- is performing services in a KTRS position,
- is a participant in a state retirement system, and
- was hired by the state after March 31, 1986.

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