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State Government Edition

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State Agencies Asked to Review Use of Personal Service Contracts and 1099s

The Internal Revenue Service has instituted a nationwide employment tax compliance program targeting state and local governments. The IRS is sending audit teams to state government agencies to ensure the state is properly withholding and reporting federal employment taxes. The IRS teams, in performing their audits, look in particular areas where it is believed significant noncompliance may be found.

One of these areas is the way holders of personal service contracts are treated for withholding and reporting such items as FICA by the employer. IRS regulations require federal employment tax withholding and reporting on any worker considered an "employee", no matter if remuneration is provided via a contract, petty cash or a standard payroll system. Whether an individual is an "employee" can be determined by applying the IRS common law test. The Division of Social Security has available an information sheet—*Who is an Employee*—concerning the classification of a worker as either a contractor or an employee. The proper withholding of FICA taxes is determined by applying the common law factors discussed in the publication.

This is not an optional program. Individuals performing service in an employment relationship with an agency do not have a choice of paying FICA and other employment taxes. Each agency is responsible for reviewing each and every personal service contract with an individual to determine if that person is an "employee" according to IRS considerations. Agencies are also responsible for ensuring that any payment issued via petty cash or on Form DOA-19 and made to an individual for services performed in an employment relationship have the appropriate payroll taxes withheld and reported on Form W-2. If such an individual is indeed considered an "employee", then all applicable federal employment taxes must be withheld and reported.

Another "red flag" used by IRS auditors is the issuance of both a Form W-2 and a Form 1099 to the same individual in a single tax year. A check of state records revealed that a number of agencies issued a Form 1099 to several state employees in 1997.

Again, individuals performing service in an employment relationship with an agency do not have a choice of paying FICA and other employment taxes. An employee should be issued a Form W-2—not a Form 1099.

If the services are performed in an employment relationship, the employee must either be paid on the UPPS or, if paid outside UPPS, on a Form DOA-27. Wages and taxes withheld from an employee paid from a petty cash fund are reported to the DOSS on Form SS-21. In either situation, the appropriate employment taxes must be withheld and reported on a Form W-2, not a Form 1099.

Agencies should review this material and apply it to all personal service contracts with individuals for the coming fiscal year and also any other payments made to individuals for services. Any questions concerning these requirements or requests for a copy of *Who is an Employee* should be directed to:

The Division of Social Security
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Frankfort, KY 40601
Telephone 502/564-3952
FAX 502/564-2124

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.

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, the KRS and the IRC, along with regulations and revenue rulings and case law, are the only valid citations of authority.

GOVERNMENT OWNED CARS.....

When a state agency provides a car for an employee's personal use, the value of that use is generally treated as a taxable fringe benefit. That means the value of the employee's personal use of the car must be reported as wages on a Form W-2 and all appropriate taxes (income and FICA) must be reported on the value of the use of the car as a fringe benefit.

If the car is used 100 percent for business reasons (which must be substantiated) then the use of the car is considered a "working-condition fringe benefit," not a taxable fringe benefit, and as such, the value of the use of the car is not included in the wages of the employee. If the car is used for both business and personal purposes, an allocation between the types of use is required which is based on the number of miles driven. The portion allocated to the employee's personal use is generally taxable to the employee as a fringe benefit. The remaining business usage is generally considered a working-condition fringe benefit and excluded from the employee's income.

If the employee's personal use of the car is so small as to make accounting for it unreasonable or impracticable, a "de minimus" exception can be applied. In making the determination of a "de minimus" exception, the frequency with which the benefit is provided to the employee must be taken into account. A "de minimus" exception would apply in situations where the personal use of a car would be limited to an occasional lunch trip or an occasional detour to go shopping. Care must be exercised to ensure that such personal use does not become so frequent or significant that it is removed from the "de minimus" exception.

Determining the Value of Personal Use

The amount included in an employee's wages for employment tax purposes due to personal use is determined by the fair market value of its availability. This is generally the cost of leasing the same car (or a comparable model) from a third party on terms comparable to those found in the geographic area in which the car is used.

Use the following formula to calculate the value of personal use under the fair market value (FMV) rule:
$$\text{FMV} \times \text{Personal Use Miles} / \text{Total Use Miles} = \text{Personal Use Value}$$

Alternative rules of valuation which may be used include:

The Annual Lease Valuation Rule

This rule is based on the fair market value of the car and is determined under the annual lease value table provided by the Internal Revenue Service. This rule may be used only if it was adopted at the time a vehicle was first made available to an employee.

Maintenance and insurance are included in the annual lease value table because it is assumed that these services are provided by the employer. The annual lease value table does not include the value of employer provided fuel which is valued at fair market value or 5.5 cents per mile driven. This must be included in the employee's taxable wages.

The Cent-per-mile Valuation Rule

The value of the fringe benefit may be calculated by multiplying the standard mileage rate by the number of miles the vehicle is driven for personal use. The cents-per-mile rule may be used only for a car that has a fair market value less than an IRS established amount on the day it was first made available to the employee (\$15,600 for 1998). Once this rule has been adopted for a particular vehicle, no other use valuation rule can be attributed to this vehicle while in use.

Commuting Valuation Rule

The value of the commuting use of an employer-provided car is \$1.50 per one-way commute, if the following requirements are met:

- 1) The vehicle is owned or leased by the employer and is provided for use in the employer's trade or business.
- 2) The employer requires the employee to commute in the vehicle for bona fide noncompensatory business reasons.

.....AND FRINGE BENEFITS

3) The employer has established a written policy forbidding the use of the vehicle for personal purposes other than commuting and “de minimus” personal use.

4) The employee does not use the vehicle for any personal purpose except for “de minimus” personal use.

5) The employee required to use the vehicle for commuting is not a “control employee” of the employer. A control employee of a state government agency is defined as an elected official or an employee whose annual compensation exceeds \$110,700 for 1998.

Excluded Vehicles

Some vehicles, by nature, are not likely to be used more than a minimum amount for personal purposes and are excluded from wage considerations as working condition fringe benefits. Those vehicles are:

1) clearly marked police and fire vehicles defined as “a vehicle owned or leased by a governmental unit, or any agency or instrumentality thereof, that is required to be used for commuting by a police officer or firefighter who, when not on a regular shift, is on call at all time, provided that any personal use (other than commuting outside the limit of the police officer’s arrest powers or the firefighter’s obligation to respond to an emergency) is prohibited by such governmental unit. A police or fire vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police or fire vehicle. A marking on a license plate is NOT a clear marking for this purpose;

2) ambulances and hearses;

3) any vehicle designed to carry cargo with a loaded gross weight of more than 14,000 pounds;

4) bucket trucks (cherry pickers);

5) cement mixers;

6) combines;

7) cranes and derricks;

8) delivery trucks with seating for the driver only or for the driver plus a folding jump seat;

9) dump and garbage trucks;

10) flatbed trucks;

11) forklifts;

12) passenger buses with a capacity for at least 20 passenger;

13) qualified moving vans;

14) qualified special utility repair trucks defined as “any truck (not including a van or pickup truck) specifically designed and used to carry heavy tools, testing equipment or parts if— a) the shelves, racks or other permanent interior construction has been installed to carry and store such heavy items is such that it is unlikely that the truck will be used more than a “de minimus” amount for personal purposes and, b) the employer requires the employee to drive the truck home in order to be able to respond in emergency situations for purposes of restoring or maintaining electricity, gas, telephone, water, sewer or steam utility services;

15) refrigerated trucks;

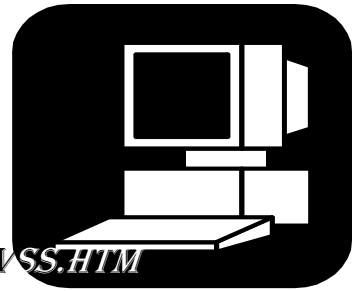
16) school buses;

17) tractors and other special purpose farm vehicles;

18) unmarked vehicles used by law enforcement officers and are incident to law enforcement functions. Substantiation requirements do not apply to officials’ authorized uses of an unmarked vehicle by a law enforcement officer as long as any county or local government agency or department that owns or leases the vehicle and employs the officer, and any personal use is incident to law enforcement functions, such as being able to report directly from home to a stakeout or surveillance site or to the scene of an emergency. (A “law enforcement officer” means an individual employed on a full time basis by a governmental unit that is responsible for the prevention or investigation of crime involving injury to persons or property, who is authorized to carry firearms, execute search warrants and to make arrests and who regularly carries firearms.)

CHECK US OUT!

[HTTP://WWW.STATE.KY.US/AGENCIES/FINANCE/DEPTS/SS/DIVSS.HTM](http://www.state.ky.us/agencies/finance/depts/ss/divss.htm)



Now Available on the DOSS Web Site

- Assistance in accurately completing a 1998 Form W-4 can be found in [IRS Publication 919](#) "Is My Withholding Correct for 1998?" The publication covers the new provisions of the Tax Relief Act of 1997--including higher education tax credits and child tax credits.
- The [1998 Form W-4](#), [Form W-2](#) and [Form W-2 Instructions](#) have been installed.
- [IRS Publication 963](#) "Fed/State Reference Guide" is available. Pub. 963 is a great help to all state and local payroll officials, fiscal officers and personnel administrators who are responsible for accurately withholding from and reporting the wages of public employees. This should be used in conjunction with DOSS' own ["Governmental Employer Manual"](#) which offers a more Kentucky specific outlook. The manual is also available on this site.
- The 1998 income tax withholding and advanced earned income credit tables are now available, as is the [1998 Form W-5](#).
- We have also added IRS Publication 957 which covers reporting back pay under a statute and special wage payments

The [DOSS web site](#) is an excellent conduit to other FICA-related sites covering such topics as state and federal legislation, IRS forms, EFTPS and Social Security Administration district offices. The web site address is: <http://www.state.ky.us/agencies/finance/depts/ss/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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FICA Tax Rates and Wage Bases

The 1998 wage base for social security withholding is \$68,400. The full wage amount is taxable for Medicare purposes. The social security tax rate is 6.2 percent on the employee's taxable wages up to \$68,400 in 1998. The medicare tax rate is 1.45 percent on the employee's taxable wages. Because the maximums for social security and medicare are different, Forms W-2, W-3 and 941 require employers to report social security wages and taxes separately from medicare taxes and wages. Refer to the [DOSS chart](#) at <http://www.state.ky.us/agencies/finance/depts/ss/dosstabl.htm> for projected and historical wage amounts.