

# Government Finance Review

GOVERNMENT FINANCE OFFICERS ASSOCIATION

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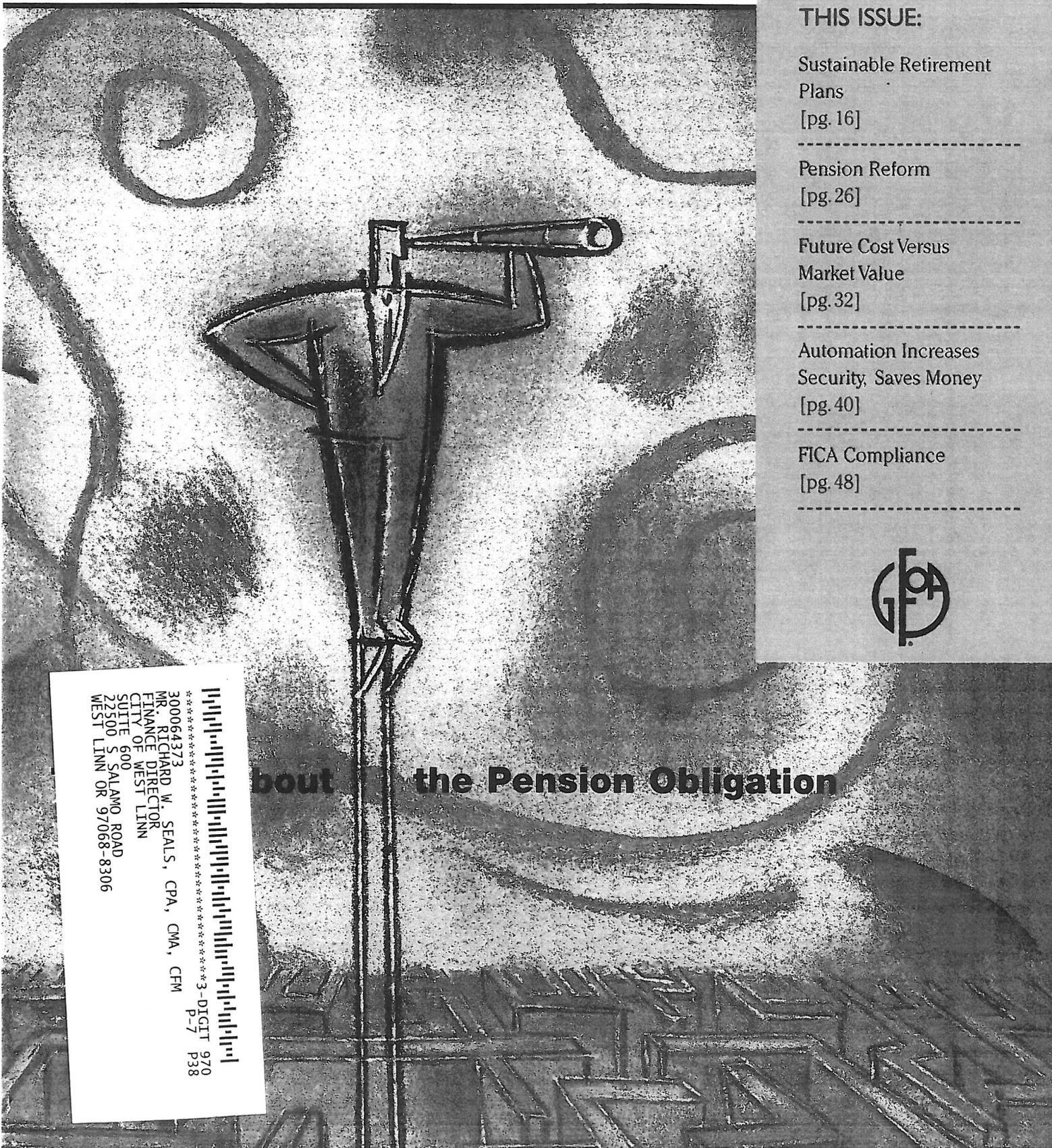
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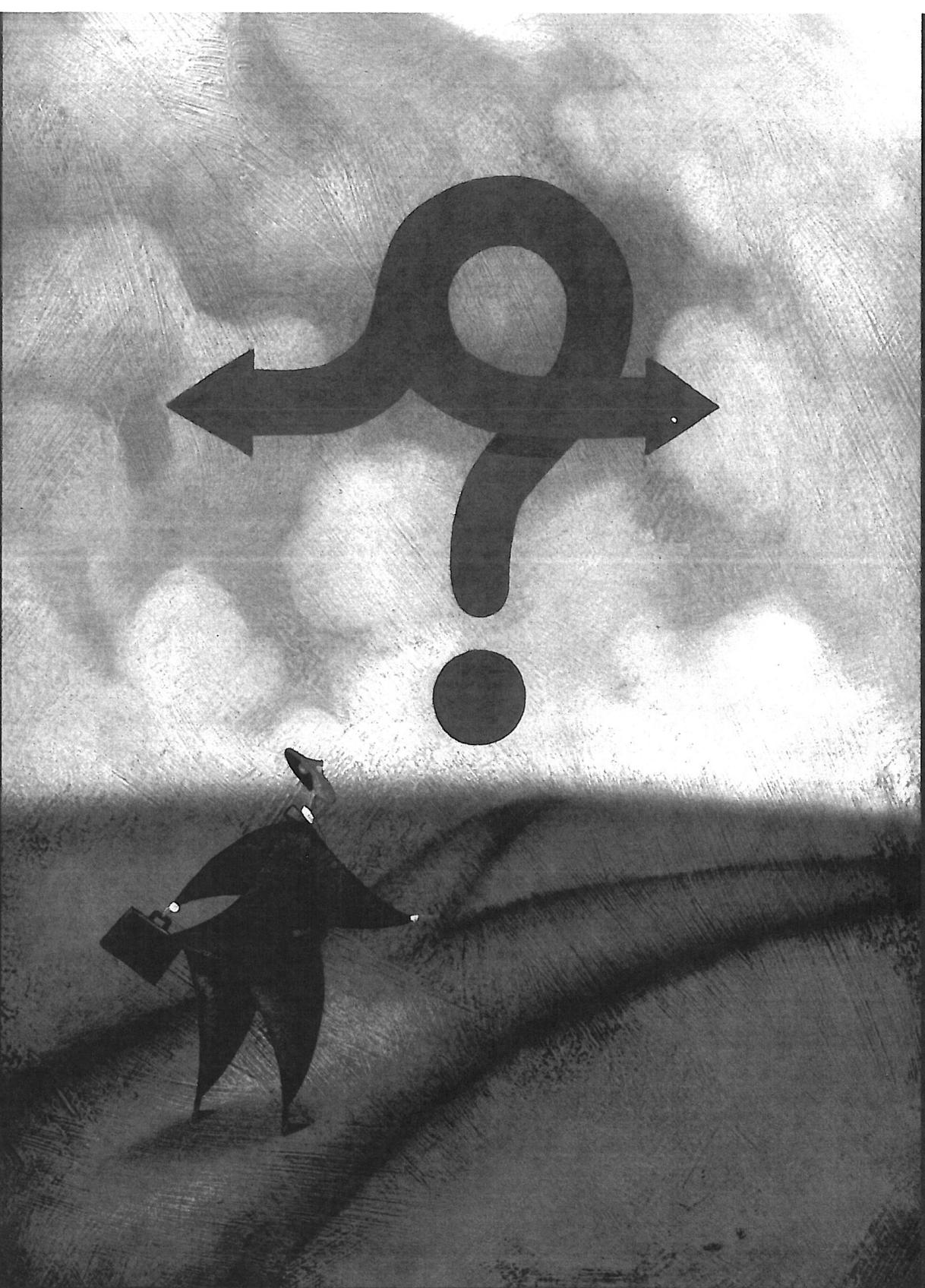
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COMMON ERRORS in State and Local Government  
FICA and Public RETIREMENT System Compliance

BY MARYANN MOTZA AND DEAN J. CONDER

**M**any state and local government employers and employees are confused by the Federal Insurance Contribution Act (FICA) tax and public retirement system obligations. This employment tax, which is the basis for Social Security and Medicare, is straightforward in the private sector. Applying FICA to state and local government employment, however, can be exceedingly difficult. In addition, the Governmental Accounting Standards Board (GASB) does not test for FICA compliance, which can lead to a false sense of security when a state or local government receives an audit compliance certificate based on GASB audit standards.

The laws and rules that affect public employers' federal FICA tax obligations regarding Social Security and Medicare coverage provisions include numerous exemptions and exceptions to the laws that apply to the private sector. Further exacerbating the situation are the semantics associated with the laws, which can create confusion that results in inadvertent noncompliance:

- “Voluntary” Social Security coverage through a Section 218 agreement was once the only way state and local governments could elect Social Security coverage for their employees. Since April 20, 1983, coverage under a Section 218 agreement cannot be terminated unless the governmental entity is legally dissolved.
- “Mandatory” Social Security coverage is not really mandatory for all state and local government employees. If a public employer has a qualifying FICA replacement retirement system for its employees, it is not required to pay the Old-Age, Survivor, Disability portion of Social Security.
- “Mandatory” Medicare coverage is also not really mandatory for all state and local government employees. It is actually illegal to pay Medicare tax for Medicare-exempt employees. The Medicare-only portion, however, is required for anyone hired by a public employer after March 31, 1986.

If you are not confused yet, you soon will be.

## HOW WE GOT HERE

Congress enacted the Social Security Act in 1935 to establish an insurance program for “persons working in industry

and commerce as a long-run safeguard against the occurrence of old-age dependency.” Congress, however, faced constitutional questions as to whether it could force state and local governments to include their employees in the Social Security system, so state and local government entities were not compelled to take part. In fact, at that time, public employers were actually forbidden to do so.

Beginning in 1951, states were allowed to enter into voluntary agreements (authorized by Section 218 of the Social Security Act and thus called Section 218 agreements) with the federal government to provide Social Security coverage to their public employees. Each state enacted its own legislation to provide the authorization for the state and its political subdivisions to voluntarily enter into individual Section 218 agreements with the federal government that provided coverage to different classes and positions of employees. These

original Section 218 agreements have a provision that allows an entity to withdraw from the agreement, but since 1983, that provision has been overridden by federal law.

With the enactment of the Medicare portion of FICA in 1965, all Section 218 agreements were automatically covered with Medicare. In 1985, Congress enacted what is popularly termed mandatory Medicare. Under this law, anyone hired on or after April 1, 1986, is subject to the Medicare portion of the FICA tax, regardless of whether or not the entity covers its

employees by a public retirement system. Those employees covered only by Medicare (and not Social Security) are said to be Medicare Qualified Government Employment (MQGE). The employer is required to file W-2 and 941 forms for each MQGE employee.

In 1990, Congress amended the Internal Revenue Code (IRC) and the Social Security Act, making Social Security and Medicare coverage mandatory for most state and local government employees who were not covered by a qualifying FICA replacement public retirement system or a Section 218 agreement. This law became known as mandatory Social Security, which is different from mandatory Medicare. Medicare is mandatory regardless of the existence of a retirement system, but Social Security is mandatory *only in the absence* of a retirement system or Section 218 agreement.

## STATE SOCIAL SECURITY ADMINISTRATOR

States are required by federal regulation to appoint an official as the state Social Security administrator. The state administrator is the person responsible for administering the Section 218 agreements for each state. Until 1987, the state administrator was also responsible for collecting the Social Security and Medicare contributions (now referred to as the FICA taxes) from state and local government employers and to deposit the funds with the United States Treasury. When the Internal Revenue Service (IRS) assumed this function in 1987, many states interpreted this change as eliminating any further responsibilities, but that is incorrect; the majority of functions and responsibilities of the state administrator remain.<sup>1</sup> In fact, the responsibilities have become even more complicated since 1987, with the advent of the mandatory Social Security and Medicare provisions.

The state administrator is often thought of as a bridge between the federal agencies and local entities. Many small local entities do not have the expertise to effectively communicate and respond to the relevant issues, as this area of taxation is extremely complex and changing a single fact can alter a particular outcome. See Exhibit 1 for examples of typical fact patterns that result in vastly different conclusions about an entity's probable tax compliance when seemingly minor additional factors are added to the scenario.



## DETERMINING COMPLIANCE

**Employee or Contractor?** In determining FICA compliance, the first question to ask is if the worker is an employee or an independent contractor. No FICA taxes are withheld for independent contractors; instead, the payment is recorded and filed on IRS Form 1099-MISC.

**Is There a Section 218 Agreement In Place?** This question can most readily be answered by the state Social Security administrator, whose office is responsible for administering the particular state's master agreement and each individual entity's agreement. Each entity's Section 218 agreement can differ, even within the same jurisdiction.

Coverage under Section 218 agreements can be extended only to groups of employees known as coverage groups. Once a position is covered under a Section 218 agreement, any employee filling that position is permanently covered for Social Security and Medicare. Each entity decides, within federal and state laws, which groups to include under its Section 218 agreement. Federal law excludes certain services or positions from coverage and requires coverage of others. For example, individuals whose compensation is solely fee based are excluded from mandatory coverage under federal law but can be included as optional coverage under an entity's Section 218 agreement.

**Does the Entity Have a Qualifying Public Retirement System?** State and local government employees must be covered by either a qualifying public retirement system or Social Security, by either a Section 218 agreement or the mandatory provisions of the federal law. (There is, however, new legislation regarding contracts involving goods and services.) Regardless of whether or not employees are covered by a retirement system, the employer is subject to the Medicare portion of the FICA tax for employees hired on or after April 1, 1986. Similarly, it is equally improper to withhold and pay Medicare on an employee who is covered by a retirement system and was hired before April 1, 1986, if that employee is not covered under a Section 218 agreement — unless the referendum<sup>2</sup> procedures are followed.

Finally, not all retirement systems qualify under the Omnibus Budget Reconciliation Act (OBRA) of 1990. If the position is not covered under a Section 218 agreement, an employer can provide an alternative retirement system, so long as it meets IRC requirements. According to Treasury Regulation 26 C.F.R. 31.3121(b)(7)-2, a pension, annuity, retire-

**Exhibit I: Complexity Chart — Representative Examples of State and Local Government FICA Issues\***

<b>Primary Fact Situation</b>	<b>Additional Relevant Facts (Nuance/Possible Issue)</b>	<b>Probably Non-Compliant</b>	<b>Probably Compliant</b>
Employer is not withholding Medicare on all employees.	If all employees are covered under a Section 218 agreement.	■	
	If all employees are covered under a public retirement system and Medicare is being withheld only from employees hired on or after April 1, 1986.		■
Political entity has stopped paying Social Security and is paying into a qualifying public retirement plan.	If political entity is covered for Social Security under a Section 218 agreement.	■	
	If political entity is covered for Social Security by mandatory Social Security provisions.		■
Political entity has a Section 218 agreement and is not paying FICA.	If entity did not opt out of the agreement before April 20, 1983, it is permanently locked into the agreement and must pay FICA on all covered employees.	■	
	If entity opted out of its Section 218 agreement before April 20, 1983, and its employees are covered by a public retirement system and are paying Medicare, as applicable.		■
Political entity has continuously been paying Social Security and also into a public retirement system for all employees.	Officials erroneously think the entity must pay into a public pension system and into Social Security, believing the requirement is "mandatory" for all public employers since July 1991. No Section 218 agreement exists.	■	
	Public entity voluntarily elected to be double covered by entering into a Section 218 agreement while continuing to pay into a public pension plan.		■

\*At least 500 compliance scenarios exist related to state and local government FICA, Social Security and Medicare coverage, and public pension system issues.

ment, or similar fund or system "is not a retirement system with respect to an employee unless it provides a retirement benefit to the employee that is comparable to the benefit provided under the Old-Age portion of the Old-Age, Survivor, and Disability Insurance (OASDI) program of Social Security." A defined contribution retirement system meets the test provided by this regulation if allocations to the employee's account

are 7.5 percent of compensation and do not include any credited interest in the calculation. Matching contributions by the employer may be taken into account for this purpose. Thus, a defined contribution plan that has a contribution rate from the employer, employee, or both that is 7.5 percent of compensation can take the place of the OASDI portion of Social Security under OBRA 1990 (unless of course, the position is

covered under a Section 218 agreement). Mandatory Medicare still must be paid.

**What About Rehired Annuitants?** State and local employees who are part of a retirement system, were hired before April 1, 1986, and have been continuously employed are exempt from mandatory Medicare. In fact, it is equally incorrect to pay and cover those employees with Medicare. However, in the public sector, many employees who have retired and who receive a pension from their retirement systems are rehired under the retirement system (e.g., retired teachers are rehired as substitute teachers). These employees are called rehired annuitants; they are receiving their annuity, or pension, but they have been rehired — even if only part-time.

This is a common area of confusion within the public sector. One of the requirements for the exemption is continuous employment, and the act of retiring and receiving a pension breaks the continuity of employment. Therefore, any further employment after retirement is subject to the Medicare portion of the FICA tax. Further, if the retirement system does not cover these annuitants, they are subject to full FICA.

## **OBTAINING SOCIAL SECURITY COVERAGE**

Although initially the only way for a state or local government employer to have Social Security coverage for its employees was to enter into a Section 218 agreement, this is inadvisable today because of the permanence of the agreement. Instead, current law allows for Social Security coverage of state and local employees under the mandatory provisions discussed above. An entity without a Section 218 agreement is free to choose between pension coverage and Social Security coverage and can move from one to the other, without penalty, by merely withholding (or stopping its withholding) and matching the FICA tax — and, of course, filing appropriate W-2 and 941 forms. Remember, however, that *all* employees, regardless of the type of coverage, hired after March 31, 1986, are required to pay the Medicare portion of FICA.

The state administrator is often thought of as a bridge between the federal agencies and local entities. Many small local entities do not have the expertise to effectively communicate and respond to the relevant issues, as this area of taxation is extremely complex and changing a single fact can alter a particular outcome.

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For employees hired before April 1, 1986, a Section 218 agreement can be executed to provide Medicare-only coverage for employees who are members of a qualifying retirement system and who are not already covered under a Section 218 agreement. Under the majority vote referendum procedures, if a majority of employees vote for Medicare coverage and the entity agrees to match and withhold the Medicare portion of FICA, it is lawful to extend Medicare-only coverage to these otherwise excluded employees.

The referendum process is also available to those employees who want Social Security coverage in addition to their public retirement system. The majority vote referendum process requires a majority of employees eligible to vote in the referendum, rather than those actually voting, to approve the referendum. If the referendum passes, then all pension eligible employees within that entity would have FICA coverage. All states are authorized by federal law to use this referendum process, and 21 states can use another process called the divided retirement system referendum, which in essence allows each employee to elect Social Security and/or Medicare coverage in addition to the retirement system. The procedures are the same except that there are no secret ballots, as the individual choosing coverage must be identified. The election by the individual to be covered by FICA covers the position, not the individual, so all future holders of that position will be covered by FICA.

All referenda are conducted under the direction of the State Social Security administrator under the provisions of federal and state law. Because each state's enabling legislation is unique and provides for difference procedures, the state statutes and the federal law regarding the procedural process must be consulted.

## **OTHER PROVISIONS: WEP AND GPO**

The windfall elimination provision (WEP) affects an employee's Social Security benefit when a person works for an employer that has a public retirement system rather than any form of Social Security coverage. For example, Employee A works in the private sector for at least ten years and is then

employed by a local government that provides a retirement system rather than FICA coverage. In considering Employee A's entire work record, he would qualify for Social Security benefits because he has at least 40 credits. Employee A's Social Security benefit is offset, however, by the formula known as the windfall elimination provision. The formula is complex, and for this article, the important point is that employees need to be aware that if they work in uncovered employment (i.e., their wages are not subject to the full FICA tax), any Social Security retirement benefit might be reduced under this provision of the law.<sup>3</sup>

The WEP provision does not apply to survivor benefits. Other exceptions to WEP are:

- federal workers first hired after December 31, 1983
- retirees who were 62 years of age or disabled before 1986
- retirees who began receiving a monthly public retirement benefit before 1986, but continued to work beyond 1986
- retirees who have 30 or more years of substantial earnings under Social Security.

The government pension offset (GPO) provision is similar to WEP. This provision offsets a retirement benefit claimed on the work record of a spouse or ex-spouse when the employee is covered by a public retirement system. This offset formula reduces the benefit by two-thirds of the amount of the public retirement benefit. In some cases, the offset will eliminate a Social Security benefit entirely. The GPO provision does not apply to a retiree who receives a public retirement benefit based on work that was also covered by a Section 218 agreement for the preceding five years.

## CONCLUSION

This area of taxation and public retirement system requirements for state and local governments can be complex and confusing. During training sessions, the authors often tell audience members that "if you are not confused by the end of the presentation, you have not been paying attention." Likewise, this article is meant only to broach the subject. Readers are encouraged to use the additional resources provided (see the "Additional Resources" box) to further explore the subject. |

## Notes

1. This fact has recently been documented by an issue that arose in the State of Missouri. See the final Task Force Report for a description of the problem and how it had to be addressed by multiple individuals and agencies: M. Grochowski, et al., *Report: Federal Section 218 Task Force for Missouri School Districts*, March 31, 2009,

## Additional Resources

- IRS Publication 963, *Federal-State Reference Guide*:  
<http://www.ssa.gov/slge/pubs.htm>
- Colorado Public Employees' Social Security:  
<http://pess.cdle.state.co.us/>
- National Conference of State Social Security Administrators:  
<http://www.ncsssa.org/>
- IRS Federal, State, and Local Governments (FSLG) office:  
<http://www.irs.gov/> (click on "Government Entities"). To keep abreast of developments, you can subscribe to the *FSLG Newsletter* by selecting it from the "Topics" section of this Web site.
- IRS Employee Plans (public pension system requirements):  
<http://www.irs.gov/ep>
- Social Security State and Local Government:  
<http://www.ssa.gov/slge/>
- State of Kentucky: <http://sssa.state.ky.us/>

<http://oa.mo.gov/acct/033109FederalTaskForceReport.pdf>.

2. A Section 218 agreement is made between the Social Security Administration and a state's Social Security administrator (acting on behalf of the state) to provide coverage for a group of state or local government employees. A *Section 218 agreement covers positions, not individuals*. Coverage under a Section 218 agreement supersedes all other considerations. If a public employer wants to provide both a qualifying FICA replacement plan and full Social Security coverage for its employees, a referendum election must be conducted by the state Social Security administrator (or by the Social Security Administration, if the entity is an interstate instrumentality). Mandatory Social Security coverage ceases for a state or local government employee when he or she becomes a member of a qualifying public retirement system.
3. For details, see Social Security Administration's Web site at <http://www.ssa.gov/gpo-wep/>.

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