

**WRITTEN TESTIMONY OF  
SUNITA B. LOUGH  
COMMISSIONER  
TAX-EXEMPT/GOVERNMENT ENTITIES DIVISION  
INTERNAL REVENUE SERVICE  
BEFORE THE  
HOUSE WAYS AND MEANS COMMITTEE  
SUBCOMMITTEE ON SOCIAL SECURITY  
AND SUBCOMMITTEE ON OVERSIGHT  
ON COMPLEXITIES AND CHALLENGES OF SOCIAL SECURITY COVERAGE  
AND PAYROLL COMPLIANCE FOR STATE AND LOCAL GOVERNMENTS  
JUNE 29, 2017**

**INTRODUCTION AND BACKGROUND**

Chairman Johnson, Chairman Buchanan, Ranking Member Larson, Ranking Member Lewis and Members of the Subcommittees, thank you for the opportunity to testify on issues surrounding the proper withholding and payment of Social Security and Medicare taxes in regard to state and local government employees.

Mandatory Social Security and Medicare coverage for state and local employees is a relatively recent development. Under the original Social Security Act of 1935, state and local government employees were excluded from Social Security coverage because of unresolved Constitutional questions regarding the federal government's authority to impose taxes on state and local governments and their employees.

Beginning in 1951, states were allowed to enter into voluntary agreements with the federal government to provide Social Security coverage to public employees. These arrangements are called "Section 218 Agreements," because they are authorized by Section 218 of the Social Security Act. All 50 states, along with Puerto Rico, the Virgin Islands, and approximately 60 interstate instrumentalities have Section 218 Agreements with the Social Security Administration (SSA), providing varying degrees of coverage for employees in the state.

In 1986, Social Security and Medicare coverage for state and local government employees became subject to different rules. Prior to 1986, the only way for public employees to be covered for Medicare was under Section 218 Agreements. In 1986, Congress mandated that almost all public employees hired after March 31, 1986, must be covered for Medicare and pay Medicare tax regardless of their membership in a public retirement system. A limited exception is provided to exempt from Medicare certain state and local government employees who have been in continuous employment with the same public employer since 1986 and who are not covered under a Section 218 Agreement.

Originally, the SSA collected Section 218 taxes from governmental employers, but that responsibility was transferred to the IRS in 1987. However, the SSA retains the responsibility for assisting public employers as they follow applicable federal laws regarding Social Security and Medicare coverage, and for helping them ensure earnings records for workers paying into Social Security and Medicare are accurate.

In 1991, Congress made Social Security coverage mandatory for state and local government employees who were not already covered by a Section 218 Agreement. But this mandate does not apply to employees participating in a qualifying public retirement system sponsored by their governmental employer. Approximately one-fourth of the nation's public employees are exempt from Social Security because they are covered by a qualifying public retirement system.

Today, Social Security coverage of government employees varies greatly from state to state. In 26 states, at least 90 percent of state and local government employees work in positions covered by Social Security. By contrast, in California, Colorado, Louisiana, Nevada, and Texas, fewer than half of state and local government employees are covered.

Coverage also varies greatly among the 90,000 local government entities in the U.S. There are an estimated 12 million full-time equivalent employees at the local level with payrolls in excess of \$50 billion. These local entities, which range in size from major cities to tiny villages and school districts, employ approximately 20 percent of the U.S. workforce.

In fact, the largest proportion of government employees not covered by Social Security work at the local level. The majority of uncovered local government public employees are police officers, firefighters and teachers.

Within this context, the interaction of federal tax, Social Security and state statutes and Section 218 Agreements creates complexities for governmental employers trying to determine correct Social Security coverage for their employees. Educating employers and enforcing compliance requires the coordination of the SSA and the IRS, as well as Social Security administrators employed by each state, who act as a bridge between the federal agencies and state and local employers.

## **PUBLIC EMPLOYERS' RESPONSIBILITIES UNDER FICA**

Generally, the funding mechanism for the Social Security and Medicare programs is established under the Internal Revenue Code as the Federal Insurance Contributions Act (FICA). In general, employers are required to

withhold Social Security and Medicare taxes from employees' wages, and also pay the employer share of these taxes.

Employers are responsible for furnishing Form W-2, *Wage and Tax Statement*, annually to each employee from whom income, Social Security and/or Medicare tax was withheld. Employers above a certain size report quarterly to the IRS on total wages, wages subject to Social Security and Medicare tax, and federal income tax, using Form 941, *Employer's Quarterly Federal Tax Return*. Smaller employers file annually using Form 944, *Employer's Annual Federal Tax Return*.

For state and local employers, determining proper withholding of FICA taxes for employees is especially challenging, because employees may or may not be covered by Social Security. As noted above, Social Security coverage does not apply to employees who are members of a qualifying public retirement system – which is also referred to as a “FICA replacement plan” – unless those employees are covered under a Section 218 Agreement. Employers with workers in a qualifying public retirement system and not covered by a 218 Agreement do not withhold Social Security taxes or show any “Social Security wages” on the W-2 form for those employees.

Making this situation still more challenging, variations often exist in Social Security coverage among employees working for the same public employer. For example, a school district may provide a qualifying public retirement system only for a particular group of employees who meet certain criteria, such as teachers, making that group of employees exempt from Social Security coverage. Other workers, such as school bus drivers, who are employed by the same school district but not covered by that retirement system, would be covered by Social Security and thus subject to FICA withholding. Some employees may be covered by both the public retirement system and a Section 218 Agreement.

An additional consideration for local employers involves determining whether their public retirement system does in fact qualify as a FICA replacement plan and thus allows their employees to be exempt from Social Security coverage. Making this determination has become more of a challenge in recent years because of the dramatic changes in retirement-plan design that have occurred since mandatory Social Security coverage was implemented in 1991. Confusion among public employers arises in part because employees must be covered for each payroll period, potentially creating a constant in-and-out-of-coverage situation with each pay period (depending on the plan design), for what the IRS defines as FICA equivalency. This can create situations where entities may have been paying Social Security in error, or not paying Social Security when they should have been.

## **IRS COMPLIANCE EFFORTS IN THE STATE AND LOCAL AREA**

### *Ensuring Employment Tax Compliance among Public Employers*

The IRS has the responsibility for ensuring that all employers, both public and private, properly withhold and pay Social Security and Medicare taxes for their employees.

In attempting to determine proper withholding and payment of employment taxes, the IRS and the SSA routinely match Social Security and Medicare wages on Form 941 with amounts reported on Form W-3, *Transmittal of Wage and Tax Statements*.

When more wages are reported on Form 941 than on W-3, the SSA investigates, and the employer ultimately may be subject to penalties for inaccuracies under the tax law. When more wages are reported on Form W-3 than Form 941, the IRS will investigate whether the employer underpaid employment tax, and can assess any additional tax that may be due. Typically, the first action the IRS will take when a discrepancy is found is to send the employer a reconciliation notice, giving them a chance to explain or correct the discrepancy.

After compiling all the information from submitted employment tax returns, the IRS gathers employment tax data on government entities through its Return Information and Classification System (RICS) to classify returns for further attention. If the IRS determines that a potential discrepancy exists, it may take compliance action. This may involve an audit.

Looking at the overall picture of a public employer's reported withholding and payment amounts does not always allow the IRS to uncover errors, because applicable exceptions apply at the employee level, not at the entity level. Coverage exceptions are based on the circumstances of each employee, such as job position and date of hiring.

The IRS can glean some information from the W-2, because employers must report on line 13 if the employee is an active participant in a plan for federal, state or local employees. However, employees participating in such a plan may still be covered under a Section 218 Agreement. Generally, these line items indicate valid reasons why FICA may not apply, but not the precise amount of any exception, which may vary employee by employee. Moreover, a state or local employer – like all employers, public or private – may take a filing position under the tax law that certain payments to employees are excludable from wages, and thus not subject to FICA or reported to the IRS.

#### *The IRS's Federal, State and Local Function*

The IRS created the Federal, State and Local (FSL) function within the Tax Exempt/Government Entities (TE/GE) division in 2000 to serve as the focal point within the IRS for meeting its compliance responsibilities in the state and local

government area. Since then, FSL has provided extensive outreach services and training to units of state and local governments.

For example, the FSL section on IRS.gov provides a wealth of information to state and local employers, including the Public Employers Toolkit. The Toolkit includes links to various employment tax forms, along with IRS publications available to public employers to help them understand and comply with employment tax requirements.

FSL has also focused on conducting audits to evaluate employment tax and information reporting compliance at the state and local levels. However, the number of these audits is relatively small. FSL completed 372 audits of public employers in Fiscal Year (FY) 2015 and 362 audits in FY 2016.

As part of its efforts, FSL several years ago conducted reviews of state-level Section 218 Agreements in order to develop a more complete picture of these agreements and structures that define Social Security coverage of public employees in each state. The information gained from this assessment is helping improve FSL's overall service and compliance efforts at the state and local levels.

FSL also works with the SSA and state-employed Social Security administrators on an ongoing basis on significant issues related to Social Security and Medicare coverage of public employees. This includes coordinating, when necessary, with the SSA or state administrators when there is an audit of a public employer. For example, during an audit of a local government, the IRS may contact the Social Security administrator for that locality's state to clarify the employer's status. This includes determining whether the entity's employees are covered under a Section 218 Agreement and, if so, what specific exclusions apply to that entity that must be taken into account during the audit, including exceptions that are unique to certain employees.

The IRS also regularly receives helpful guidance and support from its Advisory Committee on Tax-Exempt/ Government Entities (ACT) on employment tax issues related to state and local governments. For example, in its 2017 annual report, the ACT noted the confusion that exists among various local governments, especially smaller entities, regarding whether their retirement systems can be considered FICA replacement plans. The ACT recommended that the IRS provide additional training and support, both to FSL examiners and local governments, on the complexities of retirement plan design. Additionally, the ACT recommended that auditors of state and local entities include Section 218 coverage and FICA replacement plan requirements within the auditing scope for their financial statements.

FSL will continue working to improve outreach, education and compliance activities related to state and local government employers. FSL also looks

forward to continuing collaboration with the SSA and state Social Security administrators, to ensure that Social Security earnings are accurately reported for public employees.

Chairman Johnson, Chairman Buchanan, Ranking Member Larson, Ranking Member Lewis and Members of the Subcommittees, this concludes my statement. I would be happy to answer your questions.