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Social Security Trustees Issue Annual Report With Projected Wage Bases

The Board of Trustees of the Social Security Trust Fund reports each year on the financial condition of the social security program. The *2007 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, issued on April 23, includes both short- and long-term projections about the social security system. The projections, which are only an indication of the expected trend, are based on social security program provisions in current law and do not take into account any changes in these provisions that might be made in the future. The report is available on the SSA's Web site at www.socialsecurity.gov.

Short-term projections: wage base

Using "intermediate" forecasting assumptions (described as "best estimates") and projecting out 10 years, the report estimates that the social security wage base will increase to

Calendar Year	Estimated Wage Base (Intermediate Estimate)
2008	\$102,300
2009	\$106,800
2010	\$111,600
2011	\$116,400
2012	\$121,500
2013	\$126,300
2014	\$131,700
2015	\$136,800
2016	\$141,900

\$102,300 in 2008 and to \$141,900 by 2016. Note that these numbers are only estimates. The formal announcement of the 2008 wage base will not come until mid-October.

Long-term projections: trust fund solvency

Again using "intermediate" forecasting assumptions, the report projects that the social security trust funds (the Old-Age and Survivors Insurance trust

fund and the Disability Insurance trust fund) will be adequately financed over the next 9 years. The projected point at which tax revenues will fall below program costs comes in 2017, the same as the estimate in last year's report. Trust fund interest earnings and asset redemptions will enable full benefits to be paid until the trust funds become exhausted in 2041, which is one year later than the projection in last year's report. Once the trust funds are exhausted, tax revenue at present rates will be sufficient to pay only 75% of scheduled benefits, declining to 70% of scheduled benefits by 2081.

"The Trustees Report is an important tool for those in the legislative and executive branches who will have to make the very difficult decisions about how best to ensure Social Security remains viable for the long term," said Michael J. Astrue, Commissioner of Social Security, as the *2007 Report* was released. **PC**

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IRS Issues Final Regulations on §409A Nonqualified Deferred Compensation Restrictions

The American Jobs Creation Act of 2004 (Pub. L. No. 108-357; see *PAYROLL CURRENTLY*, Issue No. 22, Vol. 12) added §409A to the Internal Revenue Code. Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met.

The IRS has issued final regulations identifying which plans and arrangements are covered under §409A and describing operational requirements and permissible timing for deferred compensation payments made under

the rules [72 F.R. 19234, 4-17-07; go to <http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-1820.pdf> for the complete text].

Written plan

The final regulations provide that a plan or arrangement must be in writing to comply with §409A (the statute does not explicitly state this). The final regulations provide that in order to satisfy this requirement, the document or documents constituting the plan must specify, at the time an amount is deferred, the amount that the employee has a right to be paid (or, in the case of an amount determinable under an objective, nondiscretionary formula, the terms of

such formula), the payment schedule or payment triggering events, and the conditions under which deferral elections may be made.

General definition

Under the final regulations, a plan provides for the deferral of compensation only if, under the terms of the plan and the facts and circumstances, the employee has a legally binding right during a taxable year to compensation that is or may be payable to (or on behalf of) him or her in a later year. The legally binding right may exist even though the right is subject to future conditions that constitute a substantial risk of forfeiture (e.g., a minimum period of service for the employer), so long as the compensation cannot be unilaterally reduced or eliminated. A legally binding right includes a contractual right as well as a right created under other applicable law.

Safe harbor for independent contractors

The final regulations provide that §409A generally does not apply to a deferral under an arrangement between a "service provider" (i.e., an independent contractor) and an unrelated employer if during the contractor's taxable year that he/she obtains a legally binding right to the deferred amount, the contractor is actively engaged in the trade or business of providing services (other than as an employee or corporate director), and provides significant services to two or more employers to which he/she is not related and that are not related to one another.

The final regulations contain a safe harbor under which an independent contractor is deemed to be providing significant services to two or more employers if the revenues generated from the services provided to any employer or

group of related employers during the contractor's taxable year do not exceed 70% of the total revenues from the contractor's business.

If an independent contractor qualifies for this safe harbor, an arrangement between the contractor and an employer will not be subject to §409A if the arrangement and related practices are bona fide, arise in the ordinary course of business, and are substantially the same as the arrangements and practices (e.g., billing and collection practices) applicable to one or more unrelated employers for whom the contractor provides substantial services and that produce a majority of the contractor's business revenue during the year.

The final regulations clarify that if an independent contractor is eligible for this exclusion from §409A coverage, then the amount deferred under the qualifying arrangement (and earnings on the deferred amount) will not become subject to §409A in a later year if the contractor becomes an employee or otherwise subject to §409A.

The final regulations also adopt an additional safe harbor under which an independent contractor who has actually met the 70% threshold in the three immediately preceding years is deemed to meet the threshold for the current year, but only if at the time of the deferral the contractor does not know or have reason to anticipate that he/she will fail to meet the current-year threshold.

Short-term deferral exception

The final regulations include an exception from coverage under §409A for short-term deferrals. Under this exception, a deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later

period, at all times the terms of the plan require payment by, and an amount is actually or constructively received by the employee by, the later of (1) the date that is 2½ months from the end of his/her first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or (2) the date that is 2½ months from the end of the employer's year in which the amount is no longer subject to a substantial risk of forfeiture (subject to certain extensions for unforeseeable events). Note that under this rule, many multi-year bonus arrangements that require payments promptly after the amount vests would not be subject to §409A.

The final regulations liberalize the standard under which a payment can be a short-term deferral even if it is delayed due to unforeseen events to include the situation where making the payment would jeopardize the employer's ability to stay in business. And they clarify that where a series of payments is scheduled to commence following the lapse of a substantial risk of forfeiture, the short-term deferral rule applies to each payment, provided that the entire series of payments is made during the short-term deferral period.

Separation (severance) pay arrangements

Under the final regulations, separation pay arrangements upon an involuntary separation from service are exempt from coverage under §409A where:

- the entire amount of the payments does not exceed two times the lesser of the employee's annual compensation for the calendar year before the year in which the employee separates from service, or two times the limit on annual compensation that may be taken into

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Payroll Solutions

Q. Our restaurant's bookkeeper needs extra help, so management has decided to ask one of the servers to work part-time as the bookkeeper's assistant. This work would only be a few hours per week and would be in addition to the server's full-time serving duties. The server earns substantial tips each month and management believes that it can apply the tip credit to her bookkeeping work because it is not her primary duty. Is this correct?

A. No. Your restaurant cannot apply the tip credit to the server performing bookkeeping duties, even if she is well compensated with tips and serving is her primary duty. Under the FLSA, "tipped employees" for whom the employer may take a "tip credit" of up to \$3.02 per hour are employees who work in an occupation in which they regularly receive more than \$30 a month in tips (see *The Payroll Source*[®], p. 2-35). FLSA regulations (29 C.F.R. §531.56(e)) clarify that when an employee has two jobs – one tipped occupation and one non-tipped occupation – then the tip credit is available only for the hours spent in the tipped occupation. For example, an employee who qualifies as a tipped employee working as a server, but who also has a job as a maintenance worker, is only considered a tipped employee with respect to the work as a server – such an employee is working in two occupations and no tip credit can be taken for the maintenance work.

The Department of Labor's *Field Operations Handbook* (§30d00) permits employers to take the tip credit for activities of tipped employees that are not, in and of themselves, directed toward producing tips, if the duties are incidental to the regular duties of those employees. For example, a restaurant server who spends some time cleaning and setting tables, making coffee, and occasionally washing dishes continues to be engaged in a tipped occupation even though these duties are not tip-producing, so long as the duties are incidental to the server's regular duties and are generally assigned to servers. However, where specific employees are routinely assigned to maintenance duties or tipped employees spend a substantial amount of time (more than 20%) performing general preparation work or maintenance, then no tip credit may be taken for the time spent performing such duties.

account for qualified plan purposes under §401(a)(17) (i.e., \$225,000 for calendar year 2007) for the year of the separation from service, and

- the arrangement requires that all payments be made by no later than the end of the second calendar year following the year in which the employee terminates service.

The final regulations clarify that where an employee is entitled to a payment that qualifies for the exception but for the fact that it exceeds the applicable limit, only the excess over the limit will be subject to §409A.

The final regulations also clarify that separation pay refers only to compensation to which the employee is entitled upon a separation from service. It does not refer to compensation the employee could receive without separating from service (i.e., an amount payable on a change of control, as a result of an unforeseen emergency, or on a date certain).

Separations due to participation in a "window program" are treated the same as arrangements with respect to involuntary separations from service. Under a window program, certain groups of employees are identified as being subject to a separation from service, and the employer provides an incentive to

voluntarily separate from service and obtain a benefit.

Separation from service

Under the final regulations, an employee will be treated as separating from service for purposes of §409A if the employee dies, retires, or otherwise terminates his/her employment with the employer. Whether the employee has experienced a termination of employment is determined based on the facts and circumstances.

The employment relationship will be treated as continuing intact while the individual is on military leave, sick leave, or other bona fide leave of absence if:

- the period of such leave does not exceed six months, or

- if longer, so long as the individual's right to reemployment with the employer is provided either by statute or contract. *Note:* If the individual's right to reemployment is not provided by either statute or contract, then the employment relationship is deemed to terminate on the first day following the six-month period. With respect to disability leave, the employment relationship will be treated as continuing for a period of up to 29 months, unless otherwise terminated by the employer or employee, regardless of whether the employee has a contractual right to reemployment.

20% rule. Where an employee continues to perform some services as an employee or an independent contractor, under the final regulations the general standard for determining that the individual has terminated employment is based on whether the facts and circumstances indicate that the employer reasonably anticipated either:

- that no further services would be performed after a certain date, or

- that the level of bona fide services the employee would perform after such date would permanently decrease to no more than 20% of the average level of bona fide services performed over the immediately preceding 36-month period (or, if the employee has been providing services for less than 36 months, the full period in which the employee provided services to the employer), whether as an employee or independent contractor.

Facts and circumstances to be considered include (but are not limited to) the following:

- whether the employee continues to be treated as an employee for other purposes (e.g., continuation of salary and participation in employee benefit programs),

- whether similarly situated "service providers" have been treated consistently, and

- whether the employee is eligible and realistically available to perform services for other employers in the same line of business.

An employee generally will be presumed to have separated from employment where the level of bona fide service performed (as an employee or an independent contractor) changes to a level equal to 20% or less of the average level of services provided during the previous 36 months.

No presumption applies to a change to a level of services between 20% and

50% of the average level of services provided during the previous 36 months.

Phased retirement. The final regulations permit certain flexibility for a plan to define a separation from service as including a change to a reduced level of bona fide services, often referred to as a phased retirement.

A plan may treat another level of anticipated permanent reduction in the level of bona fide services as a separation from service, provided that:

- the level of permanent reduction must be set forth in the plan as a specific percentage, and
- the anticipated permanently reduced level of bona fide services must be greater than 20% but less than 50% of the average level of bona fide services provided in the immediately preceding 36 months.

De minimis payments. The final regulations provide a limited payment exception to §409A for incidental benefits often provided on a separation from service, where the parties may not realize that the benefits are nonqualified deferred compensation. Under this exception, a payment or payments of an aggregate amount up to the amount of an elective deferral permitted under IRC §402(g) for the year of the separation of service (e.g., \$15,500 for 2007) may be treated as not providing for a deferral of compensation.

The exclusion may apply only once with respect to amounts paid by an employer to an employee. So, for example, if an employer treats a right to payment of separation pay equal to the applicable limit in the first year following a separation from service as excluded, then the right to the amount is not treated as a deferral of compensation regardless of when the amount is actually paid. On the other hand, the employer may not treat any other right with respect to the same employee in the second year following separation from service as excluded under this exception.

457 plans

Section 409A does not apply to eligible deferred compensation plans under §457(b). However, §409A applies to nonqualified deferred compensation plans to which §457(f) applies, separately and in addition to the requirements

applicable to such plans under §457(f). Section 409A(c) provides that nothing in §409A prevents the inclusion of amounts in gross income under any other provision of the Code.

Stock options

Under the final regulations, a non-discounted stock option that has no other feature for the deferral of compensation generally is not covered by §409A. However, a stock option granted with an exercise price below the fair market value of the underlying shares of stock on the date of grant generally is subject to §409A.

The final regulations clarify that consistency with respect to a valuation method is not required. Accordingly, an employer may use one valuation method to establish an exercise price and another valuation method to establish the payment or buyback amount. However, once an exercise price has been established, it may not be changed through the retroactive use of another method.

Reimbursement arrangements; nontaxable benefits

Under the regulations, a reimbursement arrangement related to a termination of services is not covered by §409A, to the extent that the arrangement covers only expenses incurred and reimbursed before the end of the second calendar year following the calendar year in which the termination occurs.

The final regulations extend – to the end of the third year following the separation from service – the period during which an employee can receive a reimbursement payment. However, the extension applies only to reimbursements of expenses actually incurred by the employee. Where the employer provides in-kind benefits or the employee pays a third party to provide in-kind benefits, then the benefits must be provided by the end of the second year following separation from service.

The types of arrangements excluded include reimbursements for business expenses deductible under IRC §162 or §167, outplacement services, moving expenses, and medical expenses.

The final regulations clarify that for this purpose, reasonable moving

News Notes...

Employer Improperly Substituted Paid Leave for FMLA Leave Where Employee Was Also Receiving Disability Payments

According to the Seventh Circuit Court of Appeals, an employer may not require an employee receiving disability benefits while taking leave under the Family and Medical Leave Act (FMLA) to use accrued paid leave [*Repa v. Roadway Express, Inc.*, 477 F.3d 938 (7th CA, 2-26-07)].

The FMLA allows an employer to require an employee to substitute accrued paid vacation leave, personal leave, or family leave for FMLA leave. However, the substitution is limited by Department of Labor regulations (29 C.F.R. §825.207(d)(1)), which provide that because “leave pursuant to a temporary disability benefit plan is not unpaid, the provision for substitution of paid leave is inapplicable.”

Alice Repa sued her employer, Roadway Express, Inc., for violating her FMLA rights by requiring her to use her accrued paid leave time while on FMLA leave. The company had granted her request for FMLA leave, but said that she would be required to substitute accrued paid leave for unpaid FMLA leave. During the six weeks she was out, Repa was paid for five sick days and two weeks of vacation. She also received \$300 per week in “loss of time” disability benefits under a collective bargaining agreement.

expenses include reimbursement of an amount related to a loss incurred due to the sale of a primary residence, provided that the reimbursement does not exceed the loss actually incurred.

Note also that the final regulations provide that a right to a benefit that is excludable from income (e.g., an arrangement to provide certain health coverage) will not be treated as a deferral of compensation for purposes of §409A.

Educational assistance

The regulations generally provide an exception from coverage under §409A for rights to educational benefits, where the benefits consist solely of educational assistance provided for the employee's benefit.

Split-dollar life insurance arrangements

Under the final regulations, the requirements of §409A may apply to certain types of split-dollar life insurance arrangements. For example, policies structured under the endorsement method, where the employer is the owner of the policy but where the employee has a legally binding right to compensation includible in income in a taxable year after the year in which a substantial risk of forfeiture (if any) lapses, may provide a deferral of compensation.

However, split-dollar life insurance arrangements that provide only death benefits to or for the benefit of the employee may be excluded from coverage under §409A as a death benefit plan. Also, split-dollar life insurance arrangements treated as loan arrangements generally will not give rise to deferrals of compensation under §409A, provided that there is no agreement under which the employer will forgive the related indebtedness and no obligation on the part of the employer to continue to make premium payments without charging the employee a market interest rate on the funds advanced.

For additional guidance on the application of §409A to split-dollar life insurance arrangements, see Notice 2007-34, released 4-10-07, available at www.treas.gov/press/releases/reports/notice200734.pdf.

Bonuses

Generally, deferral elections must be made before the year during which services are performed to satisfy §409A.

A deferral election with respect to bonus compensation based on services performed over a period of at least 12 months will be treated as meeting the requirements of §409A if the election is made at least six months before the end of the service period.

Bonus (i.e., performance-based) compensation is defined as compensation where the payment or amount of the compensation is contingent on satisfying organizational or individual performance criteria that are not substantially certain to be met at the time the criteria are established. Under the final regulations, the criteria may be established up to 90 days after the beginning of the period of service to which the criteria relate.

The regulations provide that at the time of the deferral election, either the amount of the bonus must not be readily ascertainable, or the right to the bonus must not be substantially certain.

Where a portion of a bonus would qualify as performance-based compensation if it were the sole amount available under the plan but another portion of the bonus does not qualify, the final regulations provide that the qualifying portion of the award will qualify if it is separately identifiable under the terms of the plan and each portion is determined independently of the other.

Commissions

The final regulations adopt a deferral election rule that permits an employee to make a deferral election with respect to compensation in the form of sales commissions through December 31 of the calendar year preceding the year in which the customer makes the payment from which the commission is derived. This rule treats the services related to a commission payment as performed in the year in which the customer remits payment. Note, however, that the final regulations permit the taxable year in which the sale occurs to be substituted for the year the customer remits payment (if the choice of year is applied consistently to all similarly situated employees).

Under the final regulations, for purposes of the initial deferral election rules, an employee's services with respect to investment commissions (earned due to the increase in value, or maintenance

in overall value, of assets or accounts) are deemed to be performed over the 12 months immediately preceding the date when the overall value of the assets or accounts is determined for purposes of calculating the investment commission compensation.

Annualizing recurring part-year compensation

The final regulations provide that with respect to recurring part-year compensation, an election to defer all or part of the compensation to be earned during a particular period of service may be made at any time before the period of service begins, provided that no amounts are deferred under the election to a date after the last day of the 13th month following the first day of the performance period.

Recurring part-year compensation is defined as compensation paid for an employee's services that the employer reasonably anticipates will continue in subsequent years on similar terms and conditions, and will require services to be provided over successive service periods of less than 12 months, each of which begins in one taxable year and ends in the following taxable year.

For example, a teacher earning compensation from September 15 of one year through June 30 of the following year could elect to defer compensation earned during this period on any date on or before September 15 of the first year, provided that no amount is deferred beyond October 31 of the following year.

Anti-acceleration provision

The regulations provide that a plan may permit the acceleration of the time or schedule of a payment to a service provider (i.e., employee) to pay the amount he/she includes in income as a result of the plan failing to meet the requirements of §409A. For this purpose, a service provider will be deemed to have included the amount in income if it is timely reported on a Form W-2, *Wage and Tax Statement*, or Form 1099-MISC, *Miscellaneous Income*, as appropriate.

Effective date

The final regulations are generally effective January 1, 2008. For periods before January 1, 2008, the standards and transition rules set forth in Notice 2006-79 continue to

apply. For further information on transition relief for periods before the effective date of the final regulations,

see Notice 2006-79 (2006-43 IRB 763; see **PAYROLL CURRENTLY, Issue No. 21, Vol. 14**) and Section XI of the

preamble to the proposed regulations (see **PAYROLL CURRENTLY, Issue No. 21, Vol. 13**). **PC**

Employer That Contracted With Agent to Pay Employment Taxes Was Liable for Penalties

The Third Circuit Court of Appeals has affirmed that an employer that relied on a service provider to handle its taxpaying obligations was liable for past due taxes, plus penalties and interest, when the service provider embezzled the employer's funds [*Pediatric Affiliates v. U.S.*, No. 06-1979 (3rd CA, 4-16-07)].

Pediatric Affiliates, P.A., a New Jersey medical professional corporation, retained PAL Data to perform its payroll accounting. During 1999 and 2000, Menachem Hirsch, PAL's founder, embezzled employment tax payments from various clients, including Pediatric. Hirsch would send an actual statement of employment tax liability to Pediatric, which would remit the amount shown on the statement to Hirsch. Instead of depositing those funds, however, Hirsch prepared tax forms for the IRS that understated Pediatric's tax liability, sent the lesser amount as a tax deposit, and kept the difference.

When the IRS sent a deficiency

notice to Pediatric in 2002, the company checked its records (which showed withdrawals equal to its tax liability as stated by Hirsch) and did nothing because it thought the IRS had made a mistake. After two more deficiency notices, the IRS sent documents showing the underpayment, and Pediatric finally learned of the embezzlements.

The IRS sought to recover Pediatric's past due taxes, interest, and penalties for 1999 and 2000. The Service said that Hirsch's embezzlement did not constitute reasonable cause for Pediatric's failure to pay employment taxes in a timely manner, and the court agreed with the IRS.

To be excused for failure to timely pay taxes owed, a taxpayer must show that the failure (1) did not result from willful neglect, and (2) was due to reasonable cause. To demonstrate reasonable cause, a taxpayer must show that it exercised "ordinary business care and prudence" but was nonetheless

unable to file the return or pay the taxes within the prescribed time.

Reliance on an agent is not reasonable cause and does not excuse a taxpayer's failure to deposit withheld taxes or to file a tax return. This is so even when the agent embezzles a company's tax payments. The company still bears the ultimate control and responsibility for overseeing its agents and for its tax obligations. An agent's failure to pay taxes does not render the company unable to meet its tax obligations.

The court refused to order an abatement of the penalties and interest that accrued on Pediatric's unpaid tax liability while the criminal prosecution of PAL and Hirsch was ongoing and the IRS was holding Pediatric's case in abeyance, saying the IRS's action was not unreasonable. Moreover, nothing prevented Pediatric from paying the delinquency in the interim, thereby mitigating the penalties that continued to accrue. **PC**

IRS Lists Countries for Which Foreign Earned Income Exclusion Requirements Are Waived for 2006

In Rev. Proc. 2007-28 [2007-16 IRB 974], the IRS has announced the list of countries for which the foreign earned income exclusion requirements of IRC §911 are waived for 2006 (with departure dates). The list includes East Timor (5-23-06), Lebanon (7-27-06), and Nepal (4-26-06).

IRC §911 allows a "qualified individual" to exclude foreign earned income from gross income up to a certain amount (\$82,400 in 2006). An employer need not withhold federal income tax from any wages paid to

a qualifying employee it reasonably believes will be excluded under §911. A qualifying individual is an individual who is a U.S. citizen and a bona fide resident of or present in a foreign country for a specified portion of the taxable year (see *The Payroll Source*®, beginning at p. 14-6 for a detailed discussion).

IRC §911(d)(4) provides an exception to these eligibility requirements if an otherwise qualified individual:

- leaves a listed foreign country because of war, civil unrest, or similar adverse conditions that preclude the

normal conduct of business,

- on or after a certain date,
- pursuant to a determination by the Secretary of the Treasury (in consultation with the Secretary of State).

In such a case, the income exclusion will apply even though the individual was not in the foreign country for the statutorily prescribed period, if the individual can show that *but for* the adverse conditions he or she had a reasonable expectation of meeting the requirements of §911. **PC**

No §530 Relief for Trucking Company That Improperly Treated Drivers as Independent Contractors

A U.S. Tax Court has ruled that a trucking company's drivers were employees, not independent contractors. Additionally, the company

had no reasonable basis for treating the drivers as independent contractors and was therefore not entitled to relief from employment taxes under

§530 of the Revenue Act of 1978 [*Peno Trucking, Inc. v. Commissioner*, T.C. Memo 2007-66, No. 21070-03 (3-21-07)].

Background

Peno Trucking Inc. leased tractor-trailer trucks to Ohio Transport Corp. Under the lease agreements, Peno was required to provide drivers to operate the trucks and confirm that their work was performed according to the leases. As a result, Peno was responsible for directing, supervising, paying, disciplining, and discharging its drivers. In addition, Peno was obligated to determine the days and hours worked by the drivers, the routes they traveled, the order in which shipments would be picked up and delivered, and that drivers had the appropriate commercial licenses.

Peno entered into written agreements with each of its drivers. The agreements specified that the drivers were independent contractors and that they were solely responsible for the payment of employment taxes. Peno did not require the drivers to accept requests to transport a shipment, work on any specific day, or even work on a particular schedule. The company provided the trucks and other necessary equipment for the drivers, although drivers were free to supply additional equipment at their own expense. Peno paid for all fuel, oil, highway use taxes, and repairs on the trucks, and determined when maintenance and repairs would be performed. Throughout the employment period in question, Peno filed Forms 1099-MISC for each of its drivers.

Drivers were employees

The court applied the common law test and determined that the drivers were employees rather than independent contractors. The factors the court considered included the following: (1) the degree of control exercised by Peno over the details of the drivers' work; (2) which party invested in the work facilities used by the drivers; (3) the drivers' opportunity for profit or loss; (4) whether Peno could discharge the drivers; (5) whether the work performed by the drivers was an integral part of Peno's business; (6) the permanency of the relationship between the parties; and (7) the relationship the parties believed they were creating.

Peno determined the days the

drivers could work and the loads they would haul. The company required drivers to have appropriate commercial licenses, deliver freight to certain places at certain times, maintain driving logs, and carry beepers. Peno determined when and whether to make truck repairs. It did not matter that Peno allowed drivers to choose their own routes, made drivers liable for paying tolls, or allowed drivers to stop and rest when desired – an employer “is not required to direct or control the manner in which services are performed, so long as it has the right to do so if necessary.”

Peno, not the drivers, had a substantial investment in the company, with its acquisition and maintenance of a fleet of trucks – the drivers' investment in some of their own tools was minor. Drivers were paid a percentage of what Peno received from Ohio Transport for hauling a load, so they had no risk of loss and under their agreement could not incur indebtedness on behalf of Peno. Peno retained the right to discharge drivers, who were likewise free to terminate their relationship with the company. The success of Peno's operations depended on the services of the drivers, which made the drivers' services integral to Peno's operations.

The fact that the written agreements supported independent contractor status was outweighed by the evidence supporting employee status.

Section 530 relief

Section 530 of the Revenue Act of 1978 provides relief from employment tax liability in employee classification cases where, among other things, the employer had a reasonable basis for not treating the individual as an employee. Reliance on judicial precedent, a previous employment tax audit, or longstanding industry practice may be used to establish a “reasonable basis” (§530(a)(2)(A)-(C)).

Peno sought §530 relief on the basis of judicial precedent and cited rulings by the Ohio Court of Common Pleas and workers' compensation administrative proceedings finding that two of the drivers were independent contractors.

The court explained that judicial precedent qualifying for §530 relief must evaluate the employment relationship using the common law test. The Ohio court rulings did not use this test. And only one of the administrative workers' compensation decisions indicated the basis for its decision – the signed agreement. Moreover, there was no indication that Peno had actually relied on these rulings in making its employment decisions. **PC**

News Notes...

Medical Savings Account Pilot Project Continues

Medical Savings Accounts (now known as Archer MSAs) were first authorized as a pilot project by the Health Insurance Portability and Accountability Act of 1996. The pilot has been extended several times, most recently by the Tax Relief and Health Care Act of 2006 (Pub. L. No. 109-432; see **PAYROLL CURRENTLY, Issue No. 26, Vol. 14**), which extended it until December 31, 2007. However, the ability to establish Archer MSAs will end sooner if the number of individuals contributing to an MSA exceeds certain limits.

IRC §220 provides that if the number of MSA returns filed for either 2005 or 2006 exceeds 750,000, then that year is a cut-off year for the pilot project. However, the IRS has determined that the number of Archer MSA returns projected to be filed for 2005 is 35,246, and the number of Archer MSA returns projected to be filed for 2006 is 15,192. Consequently, neither 2005 nor 2006 is a cut-off year for the Archer MSA pilot project [Ann. 2007-44, released 4-17-07]. (See *The Payroll Source*®, pp. 4-8 to 4-11 for a detailed discussion of Archer MSAs.)

Note: MSA trustees and custodians must report by August 1 of each year the number of MSAs established by July 1 of that year. The number of MSAs established must be reported on Form 8851, *Summary of Medical Savings Accounts*. On April 23, 2007, the IRS issued guidance revising the procedure for electronic filing of Form 8851 [Rev. Proc. 2007-29, 2007-17 IRB 1004; www.irs.gov/irb/2007-17_IRB/ar14.html]. The procedure was last updated in 2001.

Athletic Trainers Were Exempt Professional Employees

Athletic trainers employed by the El Paso Independent School District complained that the school district required them to work in excess of the 207 days noted on their salary cards without additional compensation. They said that the unpaid hours amounted to 30 extra days and sued, claiming violations of the Fair Labor Standards Act (FLSA). The district said that the athletic trainers were exempt “learned professional” employees under the FLSA and the court agreed [*Villegas v. El Paso Independent School Dist.*, No. EP-06-CA-00172-KC, 2006 U.S. Dist. LEXIS 95893 (WD Tex., 12-6-06)].

In order for an employee to qualify for the FLSA learned professional exemption: (1) the employee must be compensated with a minimum salary of \$455 per week; and (2) the employee must

perform work requiring advanced knowledge in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction. Work requiring advanced knowledge is work that is predominantly intellectual and includes work requiring the consistent exercise of discretion and independent judgment. (See *The Payroll Source*®, p. 2-15.)

The court pointed out that the FLSA “white collar” regulations that became effective on August 23, 2004, specifically include athletic trainers among employees who generally satisfy the duties requirements for the learned professional exemption. The court also cited a case decided under the prior regulations that said that athletic trainers were exempt learned professionals based on Texas state licensing requirements and

occupational responsibilities, and noted that educational requirements for athletic trainers are even more stringent today.

It did not matter that the athletic trainers did not work under the supervision of a physician at practices and other events as required by Texas law. Such supervision was irrelevant to the employees’ exempt status. Moreover, said the court, the absence of such supervision supported the argument that the athletic trainers exercised the discretion required for the learned professional exemption.

Finally, the trainers met the salary requirement for exemption despite the fact that they were not paid for working Saturdays and holidays. The trainers earned between \$212 and \$290 per day for their work, generating weekly salaries ranging from \$1,060 to \$1,450. **PC**



STATE AND LOCAL NEWS

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California The California Supreme Court has ruled that a payment made to an employee for failure to provide meal periods (one additional hour of pay), as required by state law, is a wage earned by the employee and not a penalty against the employer. This means that employees have a longer period for which they can recover payments – three years, rather than one year. The state appeals courts had issued conflicting rulings on how to classify such payments. The Division of Labor Standards Enforcement had issued proposed regulations classifying such payments as a penalty, but withdrew them after it became clear that the California Supreme Court would be deciding the issue [*Murphy v. Kenneth Cole Productions, Inc.*, No. S140308 (Cal. Sup. Ct., 4-16-07); Department of Industrial Relations News Release, IR#07-14, 4-16-07].

Idaho Effective 4-11-07, the state minimum wage will conform with and track the federal minimum wage. Currently, the state minimum wage is \$5.15 an hour (see *The Payroll Source*®, p. 2-65), which is the same as the federal minimum wage [H.B. 184, L. 2007].

Also effective 4-11-07, the tip credit is no longer expressed as 35% of the state minimum wage (\$1.80). Instead, a tipped employee must receive a minimum cash wage of \$3.35 an hour (this updates *The Payroll Source*®, p. 2-66). Since the current state minimum wage is \$5.15 an hour, this does not change the tip credit amount ($\$5.15 - \$3.35 = \$1.80$) [H.B. 184, L. 2007].

North Dakota If the federal minimum wage is increased, the state minimum wage will increase to \$5.85 an hour from \$5.15 an hour, effective on the same effective date as the federal increase. The state minimum wage would increase again to \$6.55 an hour, effective a year later, and then to \$7.25 an hour, effective two years later [H.B. 1454, L. 2007].

South Dakota If the federal minimum wage is increased, the state minimum wage will increase to \$5.85 an hour from \$5.15 an hour, effective on the same effective date as the federal increase or 7-1-07, whichever is later. The state minimum wage would increase again to \$6.55 an hour, effective a year later, and then to \$7.25 an hour, effective two years later [S.B. 207, L. 2007].