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## All Employer Payments Under Reduction-in-Force Program Were FICA Wages

The Federal Circuit Court of Appeals, in a long-awaited decision, has ruled that all of the payments made by CSX Corporation to employees under a series of workforce reduction programs in the 1980s were wages for FICA tax purposes. Accordingly, the company was not entitled to a refund [*CSX Corp., Inc. v. U.S.*, Nos. 2007-5003, -5007, 2008 U.S. App. LEXIS 4849 (Fed. Cir. CA, 3-6-08)].

### Background

CSX Corporation, the parent company of a group of railroads, implemented a major reduction in its workforce between 1984 and 1990. This workforce reduction was accomplished by (1) layoffs (amount of benefits determined as a percentage of the employee's average monthly compensation/duration of benefits determined by length of service), (2) reductions in hours of work and rates of pay (minimum guaranteed, adjusted by amounts paid for work actually performed), and (3) termination of employment (separation payments in exchange for agreement).

This decision affirms in part and reverses in part a controversial 2002 ruling by the Court of Federal Claims that some of the payments (where the separation was voluntary) were FICA wages, but others – which qualified as supplemental unemployment benefits (where the separation was involuntary)

– were not. Note that a final judgment in the original case was not filed until August 8, 2006 (see [PAYROLL CURRENTLY, Issue No. 7, Vol. 15](#)).

This decision also puts an end to employer uncertainty. For the past six years, as the litigation has dragged on, many employers that experienced layoffs protected themselves by withholding and/or paying social security, Medicare (FICA), and FUTA taxes on severance payments to laid-off employees and then filing refund claims “just in case.”

### Section 3402(o) and the SUB rule

Supplemental unemployment compensation benefit (SUB) payments are considered to be “payments other than wages,” although a SUB payment must be “treated as if it were a payment of wages” for federal income tax withholding purposes under IRC §3402(o)(2)(A).

CSX argued that the payments here were SUB payments, and that because such benefits are not subject to income tax withholding they are not subject to FICA tax either. The court disagreed, noting that the income tax withholding system and the FICA tax withholding system serve different interests. The statute itself (§3402(o)(1)) limits its application to IRC Chapter 24 (income tax withholding), and the court refused to extend application of the SUB rule to Chapter 21 (FICA) or Chapter 23

## Payroll Solutions

**Q.** My company is considering setting up a §401(k) plan that would include both employee contributions (withheld from participating employees' pay) and matching employer contributions up to 3% of wages. Are there rules governing when these amounts must be paid into the plan?

**A.** Yes. Department of Labor regulations provide that employees' elective deferrals must be paid over by "the earliest date on which [they] can reasonably be segregated from the employer's general assets" (29 C.F.R. §2510.3-102), but in no event later than "the 15th business day of the month following the month during which the amount deferred would have been paid to the employee" (see *The Payroll Source*®, p. 4-74).

A Field Assistance Bulletin from the Employee Benefits Security Administration clarifies that employer contributions are delinquent when they are due and owing according to the documents governing the plan, but have not been remitted to the plan in a timely manner. If the plan documents are ambiguous, promised employer contributions are delinquent if they are not transmitted to the plan "within a reasonable time after the legally enforceable obligation of the employer to make the contribution arises" (see FAB No. 2008-01, 2-1-08).

(FUTA).

CSX also argued that when the statute says that all SUB payments must be "treated as if" they were payments of wages it implies that they are not wages. Again, the court disagreed, saying the inference was "too strained." While some SUB payments do not constitute "wages," it does not follow that all SUB payments are non-wages.

### Other arguments also rejected

CSX tried to limit the rule that "dismissal" payments constitute wages to involuntary dismissals only, but the court rejected this limitation as being against "both precedent and policy." IRS precedent and practice treat dismissal or severance payments as wages regardless of whether the employee's separation is voluntary or involuntary. And "it also makes good sense as a policy matter," because whether a particular payment constitutes "wages" depends on the reason for the

payment, and "the reason the payment is made does not depend on whether the options before the employee are such that he feels free to accept or decline the payment, feels that he has little choice but to accept it, or feels that his situation is somewhere in between those extremes." A separation payment may be designed to induce an employee to leave or to cushion the effect of a separation, but it is still wages for FICA-tax purposes, concluded the court.

Finally, CSX argued that unionized employees gave up certain employment rights under their collective bargaining agreement when they accepted the buyout. In other words, payments to those employees were not wages but contractual exchanges of property. The court rejected this argument, too, saying it applied only to university tenured faculty members surrendering their tenure rights and only in certain jurisdictions. ■

## IRS Reissues 2008 Forms W-2 and W-3 Due to Errors in Employer Instructions

The IRS has reissued the 2008 Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statements*, as well as the *2008 Instructions for Forms W-2 and W-3*. If you downloaded any of these items before March 11, 2008, please note the following corrections to the due dates:

- **Form W-2.** On page 10, under *Due dates*, the first two sentences should read, "Furnish Copies B, C, and 2 to the employee generally by February 2, 2009. File Copy A with the SSA by March 2, 2009."

- **Form W-3.** Under *When To File*, the first sentence should read, "Mail any paper Forms W-2 under cover of this Form W-3 Transmittal by March 2, 2009."

- **Instructions.**

- On page 3, under *Furnishing Copies B, C, and 2 to employees*, the first sentence should read, "Furnish Copies B, C, and 2 of Form W-2 to your employees, generally, by February 2, 2009."

- On page 8, under *Failure to file correct information returns by the due date*, the third, fourth, and fifth sentences should read,

- "\$15 per Form W-2 if you correctly file within 30 days (by March 31 if the due date is March 2); maximum

penalty \$75,000 per year (\$25,000 for small businesses, defined later)."

- "\$30 per Form W-2 if you correctly file more than 30 days after the due date but by August 3; maximum penalty \$150,000 per year (\$50,000 for small businesses)."

- "\$50 per Form W-2 if you file after August 3 or you do not file required Forms W-2; maximum penalty \$250,000 per year (\$100,000 for small businesses)."

- On page 8, under *Exceptions to the penalty*, the last bullet should read, "Filed corrections of these forms by August 3."

- On page 8, under *Failure to furnish correct payee statements*, the second sentence should read, "The penalty applies if you fail to provide the statement by February 2, if you fail to include all information required to be shown on the statement, or if you include incorrect information on the statement." The last sentence of the second paragraph should read, "The penalty is not reduced for furnishing a correct statement by August 3."

*Note:* You can obtain the corrected version of the forms and instructions from the APA website at [www.payroll.org/i4a/pages/index.cfm?pageid=139](http://www.payroll.org/i4a/pages/index.cfm?pageid=139). ■

## Changes Made to Federal Per Diem Rates

Several changes have been made to the list of federal per diem rates for travel to locations within the continental U.S. (CONUS). FTR Per Diem Bulletin 08-3 is effective for

travel undertaken on or after March 17, 2008 [73 F.R. 12448, 3-7-08]. The Bulletin is available on the APA website at [www.payroll.org/i4a/pages/index.cfm?pageid=139](http://www.payroll.org/i4a/pages/index.cfm?pageid=139). The changes are

as follows:

#### Alabama

- An entry for *Mobile* is added and seasonal rates are created. From March 17 – September 30, the lodging rate is set at \$94 (was \$70) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$143 (was \$109).

#### California

- An entry for *Eureka/Arcata/McKinleyville* is added and seasonal rates are created. From March 17 – September 30, the lodging rate is set at \$87 (was \$70) and the M&IE rate is set at \$54 (was \$39), so that the maximum per diem rate is \$141 (was \$109).

- The entry for *Monterey* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$133 (was \$125) from March 17 – September 30.

#### Illinois

- An entry for *O'Fallon/Fairview Heights/Collinsville* is added and seasonal rates are created. From March 17 – September 30, the lodging rate is set at \$111 (was \$70) and the M&IE rate is set at \$59 (was \$39), so that the maximum per diem rate is \$170 (was \$109).

#### Missouri

- The entry for *St. Louis* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$111 (was \$106) from March 17 – September 30.

#### New York

- The entry for *Queens* is modified to add new seasonal lodging and M&IE rates. The lodging rate is increased to \$244 (was \$135) and the M&IE rate is increased to \$64 (was \$59) from March 17 – June 30. The lodging rate is increased to \$220 (was \$135) and the M&IE rate is increased to \$64 (was \$59) from July 1 – August 31. And the lodging rate is increased to \$311 (was \$135) and the M&IE rate is increased to \$64 (was \$59) from September 1 – 30.

#### Texas

- An entry for *Beaumont* is added and seasonal rates are created. From March 17 – September 30, the lodging rate is set at \$81 (was \$70) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$130 (was \$109).

#### Note: California wildfires

FTR Per Diem Bulletin 08-2 – effective for travel undertaken from October 27, 2007, through January 24, 2008 – was issued in response to wildfires in parts of California (72 F.R. 61652, 10-31-07). It said that federal agencies could approve actual subsistence expense reimbursement, not to exceed 300% of the applicable per diem rate, without further justification, for employees performing official travel in affected areas. This bulletin is also available on the APA website at the location given above. ■

## Employer Was Not Liable for Complying With IRS Lock-in Letter

In April 2004, Charles Giles submitted a Form W-4 (*Employee's Withholding Allowance Certificate*) to his employer, Volvo Trucks North America, claiming that he was exempt from federal income tax withholding. Volvo implemented Giles' request by noting on the form and entering into its payroll system that Giles was claiming 99 allowances, effectively preventing any withholding from his pay. Giles' exempt W-4 remained in effect until May 2006, when Volvo changed his withholding status to single with no allowances in response to a "lock-in" letter from the IRS.

Giles sued Volvo and the IRS agent who issued the lock-in letter for: (1) unlawfully adjusting his withholding status; (2) depriving him of property without due process of law by adjusting his withholding status without adequate notice and a hearing; and (3) violating the Racketeer Influenced and Corrupt Organizations (RICO) Act.

#### Unlawful adjustment of withholding status

Giles argued that under IRC §3402(n), Volvo could not adjust his withholding status without a court order. The court explained that although §3402(n) says that an employer "shall not be required" to withhold "any tax" when a Form W-4 is in effect claiming that an employee is exempt from withholding, it also requires the IRS to issue regulations providing for "coordination" of this subsection with other provisions regarding withholding.

IRS regulations issued under §3402 authorize the Service to notify an employer when an employee is not entitled to exemption from withholding and to order withholding based on a specified number of exemptions (a lock-in letter). And because IRC §3403 shields an employer from liability to an employee for withholding that employee's taxes, Volvo was not liable to Giles for disregarding his Form W-4 and withholding in accordance with the IRS lock-in letter.

#### Fifth Amendment

Volvo did not violate Giles' Fifth Amendment rights

because Volvo was a private entity and the Fifth Amendment only protects individuals against abuses by the federal government and the states. And IRS agents are shielded from liability as federal officials because "Congress has created an extensive scheme" providing remedies "in connection with tax assessments and collections," explained the court.

#### RICO

RICO was enacted to combat organized crime in the U.S. The Act makes it unlawful for anyone employed by, or associated with, any enterprise engaged in (or the activities of which affect) interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of that enterprise's affairs through the collection of an unlawful debt or a pattern of racketeering activity.

A RICO violation requires the existence of an "enterprise." To be found guilty of a RICO violation, a person must be aware of the existence of that enterprise. Giles offered no proof that Volvo's employees, Volvo, or the IRS agent were aware that they were part of an enterprise together.

Neither Volvo nor the IRS were collecting an unlawful debt because RICO (18 USC §1961(6)) specifies that such a debt must be connected to illegal gambling or usurious lending. The fact that Giles thought withholding on his wages was wrong did not make it a RICO violation.

Racketeering requires an underlying "predicate act." The IRS lock-in letter and Volvo's response were not predicate acts constituting mail fraud, as alleged by Giles. Nor was it fraud for Volvo to add 99 withholding allowances to Giles' W-4; Volvo did not misrepresent Giles' desire to be exempt from all federal withholding [*Giles v. Volvo Trucks North America*, No. 1:07-CV-00336, 2008 U.S. Dist. LEXIS 12991 (MD Pa., 2-20-08)].

✉ **APA COMMENT** – Jim Medlock, CPP, APA Director of Education and Training, comments that an employee claiming exempt status must complete a new Form W-4 each year

by February 15 or the employer is required to withhold at single and zero. Here, Volvo apparently did not review Forms W-4 as part of its year-end process in 2004 or 2005 and request a new W-4 from employees claiming exempt – as APA

recommends in our *Preparing for Year-End* course. Accordingly, Giles' withholding was not changed to single and zero until the IRS intervened. ■

## Court Affirms Validity of FMLA Notice Regulation

Susan Downey was an employee in the crime lab of the St. Tammany Parish (Louisiana) Sheriff's Office. From November 7, 2002, until March 16, 2003, she was on paid leave for surgery on her neck and shoulder. On December 29, 2002, Sheriff Rodney Strain informed her that the leave would be designated Family and Medical Leave Act (FMLA) leave, effective that day. Downey's leave from December 29, 2002, until March 17, 2003, left her with 52 hours of FMLA leave available through December 28, 2003. She used another eight hours of FMLA leave after she suffered a knee injury on June 18, 2003.

Downey went out on leave from July 30, 2003, until October 3, 2003, for knee surgery related to the June 18 injury and Strain charged her with FMLA leave but did not tell her. Downey exhausted her FMLA leave for 2003 on August 7, 2003. After she returned to work following the July 30 leave, she was reassigned from the crime lab to the corrections division and lost fringe benefits she previously enjoyed, such as overtime pay and the use of a car. She sued Strain for interfering with her rights under the FMLA because of his failure to provide her with individualized notice that her July 30 leave would be designated as FMLA leave

### Individualized notice requirement

Under FMLA regulations (29 C.F.R. §825.208), an employer must designate leave, paid or unpaid, as FMLA-qualifying, and must give notice of the designation to the employee. Once an employer knows that leave is being taken for an FMLA-required reason, the employer must "promptly" (within two business days, absent extenuating circumstances)

notify the employee that paid leave is designated and will be counted as FMLA leave.

### Ruling

The Fifth Circuit said the regulation at issue here was valid, unlike the regulation at issue in the *Ragsdale* case. There the U.S. Supreme Court invalidated a notice regulation (29 C.F.R. §825.700(a)) that specified a remedy without requiring the employer to show harm.

The regulation at issue here does not specify a remedy regardless of whether the employer's noncompliance has harmed the employee. Even though Strain's noncompliance was undisputed, Downey was required to prove that she was harmed by it. This she did: If she had received the required individualized notice, she would have been able to postpone her surgery to another FMLA period, she would have been able to take 12 weeks of FMLA leave, and her position in the crime lab would not have been jeopardized. She was awarded back pay (\$16,400) and front pay (\$13,128).

### Front pay

The FMLA authorizes a court to award "front pay" (what an employee would have earned had there not been an FMLA violation). Here, Downey was awarded two years of front pay rather than the five years she originally sought because: (1) Sheriff Strain was an elected official and there is uncertainty of employment in a political office; (2) Downey had twice previously requested a transfer out of the crime lab; and (3) front pay becomes more speculative the longer the period of time it covers [*Downey v. Strain*, No. 06-30613, 2007 U.S. App. LEXIS 28796 (5th CA, 12-12-07)]. ■

## Different Rates of Pay for Different Shift Schedules Did Not Violate FLSA

In 1990 Pomona Valley Hospital Medical Center (PVHMC) implemented a pay plan giving its nurses the option of working either six 12-hour shifts (12-hour schedule) or 10 eight-hour shifts (eight-hour schedule) during a 14-day work period. The base hourly rate for the 12-hour schedule was lower than the rate for the eight-hour schedule. Most nurses worked the 12-hour schedule, including Louise Parth, a clinical nurse who signed an agreement that included a reduction in the hourly wage she had been receiving under her previous eight-hour schedule.

During 2002-2003, the nurses at PVHMC unionized and adopted a collective bargaining agreement (CBA) that retained the 12-hour pay plan. Pursuant to the CBA, PVHMC computed Parth's overtime pay for weekday overtime hours and weekend overtime hours by using a "blended" regular rate of pay that was determined by multiplying the total number of hours worked by the base rates (for weekday and weekend shifts, respectively), and dividing the total amount of pay by the total number of hours worked.

Parth sued – arguing that PVHMC's pay scheme violated the overtime provisions of the Fair Labor Standards Act (FLSA) – and lost. The court ruled that the pay plan did not violate the FLSA.

### Analysis

PVHMC could set a lower base rate for its 12-hour schedule nurses and a higher one for its eight-hour schedule nurses in order to keep its wage costs even. The 12-hour pay plan satisfied the minimum wage requirements of the FLSA, and as long as those requirements are satisfied, there is nothing inherently improper about an employer and employee agreeing to an hourly rate lower than was previously paid.

There was also nothing improper about paying nurses different rates for identical work depending on whether the work was done pursuant to a 12-hour schedule or an eight-hour schedule. Courts have routinely approved the payment of different base rates for identical work that is performed during shifts of different lengths. And the 12-hour pay plan did not impermissibly pay a lower rate for work done during overtime because it applied a lower rate to *all* hours of work in a 12-hour shift.

Employers and employees are free to establish a regular rate of pay in any manner they choose so long as the rate complies with the minimum wage requirements and is not a sham, said the court. Here, the CBA satisfied the requirements of the FLSA exception for hospitals and nursing homes (see *The Payroll Source*®, p. 2-39) that permits a 14-day work period; it paid overtime for hours worked in excess of eight

in a day or 80 in a work period. The use of a blended regular rate of pay was not a scheme to avoid the FLSA's overtime requirements because it was explicitly set out in the CBA, and job applicants were given fact sheets disclosing and explaining

the computation of the blended rate [*Parth v. Pomona Valley Hospital Medical Center*, No. CV 06-04703 MMM (FFMx), 2007 U.S. Dist. LEXIS 96146 (CD Cal., 12-5-07)]. ■

## DOL Wins Over \$4 Million for Maid Service Workers

The U.S. Department of Labor (DOL) has won a judgment of over \$4 million against a company providing maid and carpet cleaning services for violations of the minimum wage, overtime, and recordkeeping requirements of the Fair Labor Standards Act (FLSA) [*Chao v. Southern California Maid Service and Carpet Cleaning, Inc.*, No. CV 06-3903 AG MANx, 2007 U.S. Dist. LEXIS 96143 (CD Cal., 8-20-07)].

### Calculating back wages owed

SCMS required its cleaners to work in teams of at least two, designating one worker as team leader and the other(s) as helper(s). SCMS issued Forms 1099 to the team leaders, but did not pay or maintain any records for the helpers. The court affirmed that the DOL's estimate of \$3,467,789.44 for back wages owed these employees was reasonable (rejecting the argument that they were independent contractors), based on statements by the cleaners and the DOL investigator's findings.

The cleaners said they worked 10.5 hours a day six days a

week. The DOL investigator determined the regular rate of pay during the investigation period by dividing the amount listed on the Form 1099 for each lead worker by two to estimate the lead worker's and helper's earnings. This information was then used to calculate minimum wage underpayments and unpaid overtime for part of the period at issue in the lawsuit. A proportional calculation was used to determine back wages owed for the part of the period at issue that was not fully investigated.

### Liquidated damages

An employer violating the FLSA (i.e., required to pay back minimum wages and overtime) must pay an additional equal amount in liquidated damages unless it can show good faith and a reasonable basis for believing that it was not in violation of the FLSA. Here, the court awarded \$1,058,972.81 in liquidated damages because the company knew the requirements of the FLSA and was aware that its actions violated the statute. ■

## IRS Announces Quarterly Interest Rates

The IRS has announced that the interest rates for the second quarter of 2008 (i.e., the calendar quarter beginning April 1, 2008) will decrease. The rates will drop to:

- 6% (5% in the case of a corporation) for tax overpayments;

- 6% for tax underpayments;
- 8% for large corporate underpayments; and
- 3.5% for the portion of a corporate overpayment exceeding \$10,000 [Rev. Rul. 2008-10, released 3-3-08]. ■

## IRS Issues Final Regulations on Determining W-2 Wages for §199 Domestic Production Deduction

The IRS has issued final regulations on "income attributable to domestic production activities" for purposes of IRC §199 [73 F.R. 8798, 2-15-08; <http://a257.g.akamaitech.net/7/257/2422/01jan20081800/edocket.access.gpo.gov/2008/pdf/E8-2761.pdf>].

### Background

Section 199 was added to the IRC by the American Jobs Creation Act of 2004 (AJCA; Pub. L. No. 108-357). Effective for taxable years beginning after December 31, 2004, §199(b)(1) provides a business tax deduction for "income attributable to domestic production activities" of 50% of the W-2 wages of production employees. AJCA has been amended three times, most notably by The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; Pub. L. No. 109-222). Before the enactment of TIPRA, there was no requirement that W-2 wages be allocated to domestic production gross receipts (DPGR) to qualify for the §199(b)(1) deduction. TIPRA provides that wages must be properly allocable to DPGR to qualify for this deduction.

### Regulations: effective date

The IRS published temporary regulations on the TIPRA amendments (see *PAYROLL CURRENTLY*, Issue No. 23, Vol. 14), effective October 19, 2006. The temporary regulations were also published in "proposed" form in order to invite comments. They are now adopted as final and the temporary

regulations are removed.

The provisions discussed here, unchanged from identical provisions published as temporary, are effective for taxable years beginning on or after October 19, 2006. Other provisions are applicable for taxable years beginning on or after February 15, 2008.

### Regulations: safe harbors

The new final regulations offer two safe harbor methods for determining the amount of wages allocable to DPGR:

- Under the wage expense safe harbor (for employers using either the §861 method of cost allocation under 26 C.F.R. §1-199-4(d) or the simplified deduction method under §1-199-4(e)), an employer may determine the amount of wages properly allocable to DPGR by multiplying the amount of wages by the ratio of its wage expense included in calculating qualified production activity income to its total wage expense used in calculating its taxable income for the taxable year.

- Under the small business simplified overall method safe harbor (for employers that use the small business simplified overall method of cost allocation under 26 C.F.R. §1-199-4(f)), the amount of wages properly allocable to DPGR is equal to the same proportion of wages that the amount of DPGR bears to the employer's total gross receipts. ■

## Horse Race Officials Were Exempt Administrative Employees

PNGI Charles Town Gaming, LLC, operates thoroughbred horse racing and video slot machines. Racing Officials employed by PNGI perform various roles during a typical racing day.

As Entry Clerks at the beginning of the day, they produce the next day's racing program, file entries on the racing card, make rider changes, compile information for the racing program, and can make determinations about a horse's ability to race.

During live races, a Racing Official may serve as Horse Identifier, Paddock Judge, Clerk of Scales, or Placing Judge. A Horse Identifier confirms the identity of each horse scheduled to race and can recommend that a horse be disqualified if fraud is suspected. A Paddock Judge observes horses in the paddock and while traveling to the starting gate and can recommend that a horse be disqualified if it is likely to be a health or safety risk to itself, the jockey, or other people and horses. The Clerk of Scales works in the jockeys' room to verify the jockeys' presence and licensure and monitor their weight and can recommend that a jockey see a nurse or be disqualified if substance abuse is suspected. Placing Judges sit in the judges' stand, observe the horse race, and determine the order in which the horses finish.

When three Racing Officials sued to recover overtime for hours worked over 40 in a week under the Fair Labor Standards Act (FLSA), the court agreed with PNGI that they were exempt administrative employees and dismissed the case [*Desmond v. PNGI Charles Town Gaming, LLC*, Nos. 3:06-CV-128, 3:06-CV-129, 3:06-CV-135, 2008 U.S. Dist. LEXIS 2824 (D W.Va., 1-14-08)].

☞ **WHAT THE LAW SAYS** – To qualify as an exempt administrative employee: (1) the employee must be paid at least \$455 a week on a salary or fee basis, not including board, lodging, or other facilities; (2) the employee's primary duty must be the performance of office or nonmanual work directly related to the management or general business operations of the employer or the employer's customers; and (3) the employee's primary duty must include the exercise of discretion and independent judgment regarding matters of significance (see *The Payroll Source*®, p. 2-9).

### Primary duty

It is the employee's actual duties that are important in determining whether an employee's primary duty involves the performance of exempt work, the court said, so it did not matter that PNGI had initially classified the Racing Officials as

nonexempt.

The Racing Officials spent roughly the same amount of time performing clerical duties in the morning and nonclerical duties in the evening. The court explained that time is only one factor in determining an employee's primary duty, and there is no requirement that an employee spend more than 50% of his or her time performing exempt work. The relative importance of the exempt duties compared with the employees' other duties, as well as the employees' relative freedom from direct supervision should be considered, and these factors indicated that the Racing Officials' primary duties involved the performance of exempt work.

State regulations required that "racing official" duties (e.g., Horse Identifier, Paddock Judge, Placing Judge) be performed at all thoroughbred race tracks, and these duties were much more important than the clerical morning duties. The PNGI Racing Officials were subject only to general supervision by the Board of Stewards and the Racing Secretary, so they performed their duties independently and free from direct supervision.

### Nonmanual work directly related to management or business operations

The duties performed by the Racing Officials were nonmanual and were directly related to PNGI's general business operations because the company "could not conduct its business legally without them." Moreover, the FLSA was not intended to exclude duties related only to a particular segment of a business, so it did not matter that only a small portion of PNGI's income came from live horse races.

Work directly related to management or business operations also includes work in functional areas such as quality control, safety and health, public relations, and government relations, explained the court. Here, the Racing Officials were involved with quality control and public relations because they acted as judges to preserve the integrity and fairness of races. There was a safety and health component because they were responsible for identifying jockeys or horses that might create a safety or health risk. And their presence was required by state law.

### Discretion and independent judgment

The Racing Officials exercised significant discretion and judgment. For example, as Placing Judges, they determined the order in which horses finished a race, a decision that often affected large sums of money. And as Paddock Judges, they determined whether a horse was fit to participate in a race. ■

## Drivers Were Employees, Not Independent Contractors

A U.S. District Court has ruled that drivers for a courier company were employees entitled to overtime under the Fair Labor Standards Act (FLSA) because they were employees, not independent contractors [*Sakacs v. Quicksilver Delivery Systems, Inc.*, No. 8:06-cv-1297-T-24-MAP, 2007 U.S. Dist. LEXIS 88747 (MD Fla., 11-28-07)].

### Background

Quicksilver Delivery Systems, Inc. (QDS) delivered prescription drugs from institutional pharmacies to nursing homes, assisted living facilities, and skilled nursing facilities. QDS operated its business using the services of account managers and a group of drivers.

When they were hired, drivers were required to sign an

agreement that they were independent contractors. Under the agreement, drivers were required to provide their own vehicles and were paid on a per-job basis. They were permitted to seek delivery work for other businesses. And they agreed not to compete with QDS for two years after the agreement terminated.

### Analysis

Factors considered by the court in determining that the "economic reality" of the relationship between the drivers and QDS indicated that the drivers were employees rather than independent contractors included: (1) the degree of control QDS had over the manner in which the drivers' work was performed; (2) the relative investments of QDS and the drivers

in equipment or material; (3) whether the drivers had an opportunity for profit or loss based on their own managerial skill; (4) the degree of skill required for the work; and (5) the degree to which the services rendered were an integral part of QDS' business.

**Degree of control.** Although drivers could reject work at any time and could exchange routes with each other, this was insignificant when compared to the extensive control exercised by QDS. The company placed drivers in specific routes as they became available, gave new drivers a training manual, controlled the order in which deliveries would be completed, required drivers to contact account managers when varying a delivery route, and subjected drivers to disciplinary action. In addition, drivers were required to wear a uniform with the QDS logo and badges identifying themselves as QDS drivers.

The court rejected the company's argument that many of its controls, such as prohibiting drivers from carrying passengers or helpers, were dictated by the requirements of the pharmacies it served and should therefore not be attributed to it. "The key inquiry, rather, is how QDS goes about meeting the pharmacies' needs, and to what extent the chosen methods operate to control the activities of QDS drivers and in turn restrict their autonomy."

**Relative investments.** The fact that drivers provided their own cars and paid for fuel, maintenance, and automobile insurance was not that important because most drivers used

their personal vehicles to make deliveries – they did not purchase vehicles exclusively for making deliveries.

On the other hand, QDS invested more than \$900,000 in computer hardware, software, and handheld devices to allow drivers to scan deliveries into the QDS computer system. The court rejected the company's argument that its technology outlay should be disregarded because its business was the delivery of pharmaceuticals and because businesses must invest in technology in order to stay competitive.

**Opportunity for profit or loss.** QDS determined the drivers' opportunities for profit or loss because it set the pay rates for all route deliveries, set the hourly rate for drivers required to wait at a delivery stop for more than 15 minutes, and controlled the assignment of routes (each of which carried a different pay rate).

**Skill and initiative.** A lack of specialization indicates that a worker is an employee, said the court. Here, the job of a driver was simple, straight-forward, and required little ability beyond being able to drive a car from one destination to another. QDS provided the drivers with training and gave them daily routes that could not be varied without prior company approval.

**Integral nature of the work.** The drivers were integral to QDS' business because without them the company could not function. ■

## Payment to Settle Emotional Distress Claim Was Excluded From Income

Charles Wright was a co-founder of Marvin Engineering Co., Inc., a California corporation in the business of manufacturing parts for the defense and aerospace industries. When Wright decided to leave in 1988, a dispute arose because he contended that he owned 40% of the company's shares, not the 10% shown on the company's record books. The dispute was settled by several written agreements in 1992. The IRS assessed a deficiency arising from the settlement payment. Wright sued, arguing that \$1,257,500 of the settlement was excludable from his gross income under IRC §104(a)(2) as payment for personal injuries, and won.

*Note:* An award of damages is excludable from gross income under IRC §104(a) if it is based on tort or tort-like rights and is received on account of personal physical injuries or physical sickness. (The settlement in this case, which was paid in 1992, was not subject to the "physical" injuries test; the word "physical" was added to §104(a)(2) effective for amounts received after August 20, 1996.)

The court explained that where amounts are received pursuant to a settlement agreement, the nature of the

claim underlying the damage award determines whether damages are excludable under §104(a)(2). The nature of the claim is generally determined by considering the facts and circumstances surrounding the settlement agreement.

Here, Wright asserted three causes of action against Marvin Engineering, each of which was separately negotiated. A large portion of the settlement was paid to Wright as compensation and for the option to purchase Wright's stock. Wright asserted a tort/tort-like claim for the intentional infliction of emotional distress that was part of the settlement negotiations throughout and he did, in fact, suffer from emotional distress as a result of his dispute with fellow shareholders. This was not an attempt to recast the entire settlement late in the negotiations to provide a favorable tax result for the payee. Under these circumstances, said the court, the terms of the settlement agreement would not be disregarded, and the payment of \$1,257,500 was excludable under §104(a)(2) as it existed in 1992 [*Wright v. Commissioner*, T.C. Memo. 2007-278, No. 173-97 (9-13-07)]. ■

## Supreme Court Denies Review of Case Involving Compensability of Government Employees' Commuting Time in Official Vehicles

The U.S. Supreme Court has refused to hear the appeal of a case involving the compensability of commuting time for employees of the U.S. Secret Service, U.S. Customs Service, and other federal law enforcement agencies who are required to drive government vehicles home at night in order to be able to use them to respond to emergencies from their homes [*Adams v. U.S.*, No. 07-116 (U.S. Sup. Ct., 1-7-08)].

The officers are not allowed to run any personal errands in their government vehicles or to make any unauthorized

detours or stops, they are required to have their weapons and other law enforcement-related equipment with them, and they must have on and monitor their vehicles' communication equipment.

The U.S. Court of Appeals for the Federal Circuit (see *PAYROLL CURRENTLY*, Issue No. 1, Vol. 15) said that the requirement does not make that driving time compensable under the Fair Labor Standards Act. Merely commuting in government-owned vehicles is insufficient. At the same time,

commuting done for the employer's benefit and under the employer's rules is not compensable "if the labor beyond the mere act of driving is de minimis." Here, the requirements and

restrictions placed on the officers' commutes do not rise to the level of compensable work. ■



## STATE AND LOCAL NEWS

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### Arizona

**Withholding tax holiday in December 2008.** Employers that want to elect not to withhold Arizona income tax from compensation paid to employees during December 2008 must complete Form A1-E, *Employer's Election to Not Withhold Arizona Taxes in December* (download at [www.azdor.gov/Forms/2007/A1-E\\_2008\\_f.pdf](http://www.azdor.gov/Forms/2007/A1-E_2008_f.pdf)). The election applies to all employees. By 7-1-08, Form A1-E must be filed with the Department of Revenue and employees must be notified of the election.

### Illinois

**Garnishments: administrative fee amount adjusted.** Effective 1-1-08, the administrative fee that an employer may charge for a garnishment order is 2% of the amount required to be deducted by the order. This fee is charged to the employee. Previously, the administrative fee was the greater of \$12 or 2% of the amount required to be deducted by the garnishment order.

**Garnishments: consequences for stopping deductions unlawfully.** Also effective 1-1-08, an employer that stops remitting payments pursuant to a garnishment order without a lawful reason (e.g., employee left employment) may have a conditional judgment entered against it by a court for the balance due on the judgment. The employer will have the chance to show why the conditional judgment should not be made a final judgment. If the employer fails to respond, the court will finalize the judgment and add court costs [S.B. 229, L. 2007].

### New York

**New York City and Yonkers online address locator available.** The Withholding Tax Jurisdiction Lookup is a new online service available from the Department of Taxation and Finance (DTF) at [www8.nystax.gov/WTLR/wtlrHome](http://www8.nystax.gov/WTLR/wtlrHome). Employers can enter a street address and zip code to determine whether an address is located in New York City or the city of Yonkers for purposes of withholding the New York City resident earnings tax or the Yonkers resident surcharge and nonresident earnings tax [DTF Notice, 3-7-08].

### Texas

**UI Replenishment Tax suspended for 2008.** Due to the strength of the unemployment insurance (UI) trust fund in 2007, the Texas Workforce Commission (TWC) is suspending the 0.12% Replenishment Tax (RT) for 2008. The RT rate is one component of an employer's overall UI tax rate. The TWC is sending employers revised tax rate notices for 2008. Employers should use this rate for their 2008 Employer's Quarterly Tax Report calculations, rather than the rate in the notices they received during December 2007 [Office of the Governor, News Release, 3-10-08; TWC Tax Department Tip of the Month, 3-08].

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