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The Honorable Christopher Dodd
United States Senate
Washington, DC 20510

Dear Senator Dodd:

Because a question involving technical aspects of the Tax Code is involved, I have been asked by Commissioner Shulman to respond to the letter dated January 14, 2008, signed by you and your colleagues, regarding recently enacted section 139B of the Internal Revenue Code (the Code) (enacted under Public Law 110-142). Section 139B provides an income tax exclusion for certain fringe benefits provided to volunteer firefighters and other emergency workers. Specifically, you requested that the Internal Revenue Service provide guidance on this provision as soon as possible in order to ease the administrative burden on local governments and municipalities that comes with the requirement to report certain payments.

We appreciate your concerns and will be able to confirm through guidance that benefits excluded from income under section 139B that are paid to volunteer firefighters and other emergency workers who are not employees of the localities providing the benefits do not need to be reported on Form 1099-MISC. However, we believe a legislative change is necessary to eliminate requirements for information reporting and employment taxes associated with these payments where the volunteer firefighters or emergency workers qualify as employees of the localities providing the benefits. Also, while the tax relief provided by state and local governments will be excludible from gross income under section 139B, states and localities may be required to report refund or rebate payments on Form 1099-G. As background, we provide a description of the requirements under current law.

Exclusion from Gross Income Under Section 139B

Section 139B provides that for any member of a qualified volunteer emergency response organization, gross income shall not include any qualified state or local tax benefit, and any qualified payment. A qualified state or local tax benefit is defined as

any reduction or rebate of a tax described in section 164(a)(1), (2) or (3) of the Code, including state and local real property, personal property, and income taxes. The term qualified payment means any payment (limited to \$30 per month) provided by the State or political division thereof for the performance of services as a member of a qualified volunteer emergency response organization.

Employment Tax and Reporting Treatment of Section 139B Benefits

The employment tax and information reporting requirements for section 139B benefits depend on whether a volunteer firefighter or emergency worker is a common law employee or an independent contractor (non-employee). Guides for determining a worker's status for purposes of the Federal Insurance Contributions Act (FICA) are found in section 31.3121(d)-1 of the Employment Tax Regulations. In general, if the worker provides services under the direction and control of the service recipient, the worker is considered an employee for employment tax and related reporting purposes. A volunteer who is not paid for his services can still qualify as an employee for purposes of determining the employment taxes and information reporting applicable to any benefits the volunteer may receive.

Employment means any service performed by an employee for the person employing him, with certain exceptions. If it is determined that a volunteer is an employee under the common law test described above, then liability for FICA on section 139B benefits and reporting of the benefits on Form W-2 must be considered.

The law imposes FICA taxes on the "wages" paid by employers to employees for "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the law specifically excludes the payments from the term wages or the services are specifically excepted from the term employment. See sections 3101 and 3111 of the Code.

Wages include the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions. No exception in the Code currently would ensure that all benefits excluded from income under section 139B would also be excluded from wages for FICA purposes. Under section 6051 and Treas. Reg. 31.6051-1(b), employers must report all payments of wages to employees on Form W-2. Thus, if the benefits provided under section 139B are wages for purposes of FICA, a reporting requirement will occur under section 6051.

Self-Employment Tax and Information Reporting Requirements for Non-employees

Section 1401 imposes self-employment tax on the self-employment income of independent contractors. Section 1402(a)(1) defines net earnings from self-employment, in general, as the gross income derived by such individual. Because the qualified benefits under section 139B do not constitute gross income, these amounts would not be subject to self-employment tax.

When a payor makes payments for services to a worker who is an independent contractor and not an employee, the payor is not required under section 6041 of the Code to file and furnish a Form 1099-MISC return for the payments if they are not

includible in the recipient's gross income. Therefore, the state or local government has no information reporting obligation under section 6041 for benefits that are excluded from gross income under section 139B if they are paid to volunteer firefighters or other emergency workers who do not qualify as employees. However, if payments exceed the maximum amount of qualified payments, and therefore constitute income, section 6041 reporting would be required. Further, as discussed below, a reporting requirement may exist for qualified tax benefits under section 6050E, if such benefits result in a state or local income tax refund to a volunteer firefighter or emergency worker.

Reporting Requirements for Reductions or Rebates of State or Local Income Taxes

For reductions or rebates of state or local income taxes, section 6050E of the Code may apply to require reporting of any resulting state or local income tax refunds. Section 6050E provides that every person who during any calendar year makes payments of refunds of state or local income taxes to an individual (or allows credit or offsets for such taxes) totaling \$10 or more must file a return according to forms or regulations. The form prescribed is Form 1099-G. This section applies only to income tax refunds; as discussed above, refunds of personal property or real property taxes excludable under section 139B are not reportable on Form 1099-MISC.

Under section 6050E, the amount of the state or local income tax refund is reportable regardless of whether it constitutes income to the recipient. Generally, such an income tax refund is income to a recipient who itemized deductions on his federal tax return for the year to which the refund relates. It is not income to a recipient who did not claim itemized deductions on his federal tax return. The section 6050E regulations provide that even if the state refund officer can verify that the recipient did not itemize deductions, a Form 1099-G must be filed; however, it need not be furnished to the recipient. See sections 1.6050E-1(c) and (k)(2) of the Income Tax Regulations. Therefore, no reporting exception exists for a state or local income tax refund that is non-taxable, and only a limited exception exists to the requirement to furnish a payee statement to the recipient for such a non-taxable refund.

The qualified tax benefits under section 139B are in the form of a reduction or rebate of tax. We do not know how a particular state or locality will set up its program to offer such reductions or rebates, and therefore we cannot determine whether a state or local income tax refund (or credit or offset) would be reported under section 6050E. For example, a state or locality might generate a rebate check to each emergency worker or reduce his tax liability by allowing a tax deduction or tax credit on his income tax return. Some programs may instead offer credits against property taxes or other taxes that are not income taxes. Without specific information about a particular state or locality's income tax reduction or rebate program, we can only advise generally that if, in the case of a specific volunteer, such tax benefit results in a state or local income tax refund (or credit or offset), the amount would be reportable on Form 1099-G, under section 6050E. Whether a volunteer receives an income tax refund depends on his total tax liability and computation of balance due or overpayment. Therefore, in each individual case, the qualified tax benefit may comprise the entire refund, be a component of the refund, or result in a smaller balance due than the firefighter would otherwise owe.

States and localities have been following the reporting requirements found in section

6050E for income tax refunds. They may report the section 139B benefits under that section, but only to the extent they result in an income tax refund. The reporting of refunds comprised of section 139B benefits could be exempted by statute, but the states and local governments would then have the additional burden of calculating how much of the refund is the result of the qualified benefits.

Summary

Whether or not volunteer firefighters or emergency workers are independent contractors or employees depends on the facts and circumstances of each locality. I understand that in at least one prior case where the facts and circumstances were considered in detail, it appeared that volunteer firefighters for one locality were employees. The IRS and the Treasury Department's Office of Tax Policy believe a legislative change is required if the intent of the legislation is to eliminate Form W-2 information reporting requirements or potential FICA liabilities associated with benefits described in section 139B.

A model for a statutory change that would eliminate all FICA and Form W-2 reporting appears in section 139, which provides an exclusion from income for qualified disaster relief payments. Section 139(d) provides for coordination between the reporting and employment tax requirements of chapter 2 and subtitle C and the exclusion under section 139, such that qualified disaster relief payments are not treated as wages for employment taxation or information reporting.

Another option is to amend section 3121(a), to remove section 139B payments from the definition of wages, making the payments no longer subject to FICA or section 6051 reporting. See for example section 3121(a)(20), providing a FICA exception for certain non-taxable fringe benefits. In addition, even when a fringe benefit is excluded from gross income, the Code generally includes a specific exception from federal income tax withholding for the benefit. See section 3401(a)(19).

Finally, state and local income tax refunds must be reported on Form 1099-G, under section 6050E, and depending on how a particular benefits program is structured, qualified tax benefits under section 139B may result in reportable refunds.

I am sending a similar letter to your colleagues. I hope this information is helpful. Please contact me or call _____, Director, Office of Legislative Affairs, at _____ if you need further assistance.

Sincerely,

Donald L. Korb