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MEMORANDUM FOR GARY PETERSEN  
REVENUE AGENT  
TEGE/FSLG

FROM: Jerry E. Holmes  
Branch Chief  
TEGE:EOEG:ET2

SUBJECT: School Superintendents

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Key:

State =

Mr. A =

School District A =

Mr. B =

School District B =

This is in response to the questions you raised in your memorandum of January 3, 2001. We agree with all your conclusions and have decided not to discuss section 530 in this memorandum. We agree that, since the individuals in question were formerly treated as employees, section 530 treatment is not appropriate.

QUESTIONS

1. Are former school superintendents who provide administrative services to school districts under contract with a corporation properly classified as employees for purposes of taxes under the Federal Insurance Contributions Act (FICA)?

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2. Do Old-Age, Survivors and Disability Insurance (OASDI) tax and Medicare tax apply to former school superintendents under these facts?

#### BRIEF ANSWERS

1. State statutes provide that school superintendents are employees of their school districts.

2. If the independent contractor arrangements are disregarded, the former superintendents should be treated as rehired annuitants. Under Internal Revenue Code (Code) section 3121(b)(7)(F), no OASDI taxes need be paid with respect to them. Medicare tax would be payable, even if the superintendents previously qualified for the continuing employment exception, because they terminated their employment.

#### FACTS

State has a teachers' retirement system which is assumed to qualify as a retirement system within the meaning of Code section 3121(b)(7) and regulations. Teachers and superintendents are not covered by an agreement under section 218 of the Social Security Act (section 218 agreement).

State statute provides that a school board may select and employ a qualified person as chief school administrator for a school district, i.e. school superintendent.

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This provision has been interpreted to mean that a chief school administrator may be treated as an independent contractor. School districts are obtaining the services of school superintendents through either an incorporated or an unincorporated entity established by the superintendent. We understand that the superintendents whose services are retained in this way are retired and receiving pensions from the State teachers' retirement system. Under State law, a rehired annuitant may not receive retirement benefits. Instead, additional contributions to the retirement system are required to be made on the individual's behalf, and upon subsequent retirement the individual receives a recalculated benefit based on the additional contributions.<sup>2</sup>

The file contains several of these contracts. We will focus upon two examples in which an individual at one point entered into an employment contract as a superintendent, then formed a corporation which entered into an Agreement to Provide School District Administrative Services. In both cases, the contracts state that the corporation is an independent contractor. Other available contracts are similar in material respects.

Mr. A, former superintendent of School District A, formed a limited liability company (ALLC), which now makes his services available to School District A through a contractual relationship. The contract states that ALLC will provide administrative services as described in

The contract states that "ALLC is an independent contractor and is not an employee" of School District A. Though ALLC is given sole authority to hire and supervise its employees, ALLC is required to employ Mr. A. Failure to do so is a breach of contract. An 2½ page attachment to the contract outlines the Superintendent's Goals, listing what appear to be new projects the superintendent is required to undertake.

ALLC is required to pay all costs and expenses connected with its provision of services pursuant to the agreement. These costs include the payment of FICA and income tax withholding. Nevertheless, School District A is required to provide a fully equipped office in its administrative building for Mr. A, as well as a secretary and clerical staff. The contract specifies the equipment and services to be provided, including computer, phone and fax and all materials and supplies. ALLC is required to supply all vehicles and cell phones and supplies for its separate office off school premises. Both ALLC and School District A are required to maintain insurance, each listing the other as an additional insured.

The contract contains a provision stating: "If a court or administrative agency finds that ALLC is an employee of School District A, ALLC shall indemnify and hold School District A harmless and shall pay all of School District A's related fines,

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damages, assessments, benefits and attorney's fees, and the employee's share of any taxes paid by School District A."

The contract provides for termination at any time by mutual agreement or with 30 days' notice following material breach.

A memorandum dated August 28, 2000, from the Office of the Superintendent to the School Board states that by entering into the agreement with ALLC, School District A will save \$23,739, or 13 percent, for the first year of the contract and \$19,350 for the second. This exceeds the initial target of 10 percent budget reductions for the school year.

Another former superintendent, Mr. B, formed B Corp, which entered into a Contract for Administrative Services with School District B. The contract does not mention any individual by name, but states that B Corp shall employ and designate one individual, termed the Designee, who shall have primary responsibility for directing B Corp's activities. The Designee is to be chosen from a list of names attached to the contract. The attachment contains only one name, that of Mr. B. The Designee is required to devote his/her best efforts to providing services under the contract, and, should the Designee become unavailable due to death, disability, etc., School District B has a right of refusal concerning any new Designee. The contract is terminable by School District B with or without cause with 60 days' written notice; B Corp can terminate only with cause, upon 30 days' notice.

B Corp's contract provides for payment of a fixed amount per year, to be prorated in case of early termination. It also provides for payment of a bonus, one-half of the cost saving realized by School District B during the first year of the agreement.

The contract enumerates eight categories of duties, including directing and supervising School district B's activities to ensure that they comply with all applicable state and federal laws and regulations; directing and supervising recruiting, screening, employment and supervision of School District B personnel, and administering and complying with collective bargaining agreements. In most respects the contract is similar to ALLC's contract with School District A. It requires B Corp to pay all expenses, except that School District B will provide a fully equipped and staffed office, pay business expenses and provide insurance.

## LAW AND ANALYSIS

### A. Worker Classification

1. Are former school superintendents who provide administrative services to school districts under contract with a corporation properly classified as employees for purposes of taxes under the Federal Insurance Contributions Act (FICA)?

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For purposes of FICA taxes, employee status is determined under the common law. Code section 3121(d)(2). An individual is an employee if, under the common law rules, the relationship between the individual and the person for whom he or she performs services is the legal relationship of employer and employee. Generally this relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished but also as to the details and means by which the result is accomplished. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. Section 31.3121(d)-1(c), Employment Tax Regulations.

In applying the common-law rules, the IRS considers three types of evidence, the service recipient's degree of behavioral and financial control over the worker and the relationship of the parties, including evidence of how they view their relationship.

The fact that an individual is employed part-time, or works for more than one employer, is not evidence of independent contractor status. A part-time worker may be an employee under the common-law rules.

#### I. Behavioral Control

Behavioral control is evidenced by facts which indicate whether the service recipient has a right to direct and control how the worker performs the tasks for which he or she is hired. Facts which illustrate the right to control how a worker performs a task include the provision of training and evaluation and the existence of employee manuals or policies indicating intent to control the performance of the employee. The presence of a chain of command is indicative of a right to control, as is the requirement of an oath of office.

When the service recipient is a government entity and the position is created by a constitution or statute, we look at the law establishing the position and its duties to determine whether the statute creating the position creates a right to control the worker typical of the employer-employee relationship.

The position of school superintendent and its duties are established by statute. A school superintendent is required to administer a district in accordance with policies the school board prescribes by bylaw. The school superintendent is required to select, appoint and control all school district employees, subject to the approval of the school board. These facts show that a school superintendent is an employee under the control of a school board with supervisory control over teachers.

State statutes bear out this conclusion, as the term "teacher" is defined as a person serving in a teaching, counseling, or administrative capacity and required to be

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certificated.<sup>3</sup> In another provision, the term “employer” is defined to include a superintendent who appoints a teacher.<sup>4</sup>

State has an educational system under which there is a State Department of Education (Department) and a State Board of Education (Board), which supervise the local boards. The Department prescribes by regulation a minimum course of study, develops performance standards to be met by students at designated age levels, and by regulation establishes safety standards for schools, among many other areas of responsibility.<sup>5</sup> The duties of school superintendents are prescribed by regulation

Local school boards are composed of elected officials whose duty it is to establish school policies and supervise their implementation. They are required to express their policies for management and control of their districts in written bylaws formally adopted.<sup>6</sup>

School districts are required to adopt educational goals and policies and are evaluated as to their success or failure in achieving the goals. School boards control budgets, determine compensation of all school employees and administrative officers, hold meetings, keep records, etc.<sup>7</sup> School boards are required to adopt written bylaws expressing policies relating to management and control of the school district.<sup>8</sup> The State Supreme Court has affirmed that a school board has a duty to control the administrative practices of its school superintendent.<sup>9</sup>

As an illustration of facts typical of right to control, State has adopted a statute concerning school accountability. If a school is rated deficient, it must prepare an improvement plan with participation of parents, teachers and community groups. The

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Department monitors progress, and, if a school continues to be deficient for two years, the chief school administrator, the president of the governing body and the principal must present a written report on the performance of the school. The Board is required to promulgate regulations to assist public schools in the improvement of performance.<sup>10</sup>

State statutes governing employment and tenure provide for the issuance of contracts to employees regularly qualified under the regulations of the department. These employees include the school superintendent.<sup>11</sup>

Our conclusion is that State statutes provide school districts a right to behavioral control over superintendents sufficient for superintendents to be classified as employees. School districts “employ” a chief school administrator, and the administrator is required to administer the district in accordance with the policies that the school board prescribes by bylaw. School superintendents select, appoint, and otherwise control all subordinate school district employees subject to the approval of the school board. State statutes specifically define school superintendents are both “teachers” and “employers.” They provide for a right on the part of school boards to control and direct superintendents. The performance of superintendents is evaluated by school boards, and this is another means of control. Finally, we see no inconsistency with employee status when a State statute defines “employment” to include “employment by contract.”

## II. Financial Control

Financial control is evidenced by facts which indicate that the service recipient has a right to direct or control the financial aspects of the worker's activities. Control is obviously a matter of degree: a service recipient has more economic control over an employee than over an independent contractor. Moreover, an independent contractor has a genuine possibility of profit or loss beyond that of an employee, who receives a salary as long as he works.

Facts indicative of a genuine possibility of profit or loss are expenditures for equipment and facilities and fixed costs incurred regardless of whether the individual works. Other potential factors are offering one's services to the public, maintaining an office, and hiring staff and employees. Typical of an independent contractor relationship are working by the day or by the job and incurring substantial unreimbursed business expenses.

Under both contracts in this case, there is little economic risk. ALLC and B Corp are required to pay their own expenses and pay their employees, but School Districts A

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and B provide office space, equipment, supplies and staff. They reimburse most business expenses, with the exception of professional dues, insurance, employment taxes, home office, if any, and staff. We conclude, in the absence of evidence to the contrary, that the administrator or Designee is generally the only staff member. In some cases, we know, corporations are also supplying the services of retired teachers, but in such cases there would be additional payments from the school districts to the corporations to pay the teachers' salaries.

The contracts are of two years' duration, renewable, and can be terminated upon 30 to 60 days' notice, in this respect resembling employment contracts. The contracts allow the entities to offer their services to the public. The B Corp contract provides, however, that the Designee shall be directed to devote his/her best efforts to performance of services under the agreement, thereby implying that an employment-like arrangement is contemplated with one individual. We note also that State statute provides for the option of a part-time school superintendent, so the fact that superintendent works for more than one school district does not necessarily indicate independent contractor status.

In conclusion, both contracts resemble contracts for employment. Neither involves any real possibility of loss or economic risk. School District B's contract provides for a bonus in the amount of one-half of the cost savings from contracting out the superintendent's duties, but there is no possibility of loss. This arrangement is more consistent with an employer-employee relationship than with an independent contractor relationship..

### III. Relationship of the Parties

The relationship of the parties is generally determined by examining the parties' agreements and actions with respect to each other, paying close attention to those facts which show not only how they perceive their relationship but also how they represent their relationship to others. Facts which illustrate how the parties perceive their relationship include the intent of the parties as expressed in written contracts; the provision of, or lack of, employee benefits; the permanency of the relationship, and whether the services performed are part of the service recipient's regular business activities. The right of the parties to terminate the relationship without penalty to either is typical of an employer-employee relationship.

It is important to consider any written contract in which the parties state the type of relationship they intended to create. If the relationship of employer and employee exists, however, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if an employer-employee relationship exists, it is of no consequence that the employee is designated as a partner, co-adventurer, agent, independent contractor or the like. Section 31.3121(d)-1(a)(3), Employment Tax Regulations.



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In this case, there is a written contract stating that the parties envisioned an independent contractor relationship. A and B have also formed limited liability company and a regular corporation, for which no information reporting is required.

The realities of the situation suggest otherwise, however. The School Districts have sufficient behavioral control over the two school superintendents under State statute to create an employer-employee relationship. This statutory right to control cannot be waived by private contract. The contracts recognize this risk by incorporating a clause which shifts to the superintendents the anticipated risk of the contract's being set aside.

It is clear from the contract and the August 28, 2000, memorandum that School District A intended to retain the services of Mr. A. Failure of ALLC to employ Mr. A, except by reason of his death or disability, constitutes a breach of the contract. The choice of the Designee in School District B's contract also indicates the desire to retain the services of a specific individual, though suggesting a stratagem intended to avoid giving that impression. The contracts make it clear that both individuals will continue to work in their offices on school district property, with very little change in their working conditions.

It also appears likely that the circumstances of employment of A and B require them to hold themselves out to others as employees and agents of their school districts. They hire, evaluate, and fire teachers. They represent the school districts in negotiations with teachers' unions. Documents and letters prepared on school district stationery also give an administrator apparent authority as an agent of a school system.

Under these facts, we conclude that the attempt to create an independent contractor relationship by contract is unsuccessful and that the school superintendents are employees of the school districts.

#### B. Application of FICA tax.

##### A. OASDI Tax

A state or local government employee who is not covered under a section 218 agreement is subject to the OASDI portion of FICA tax under the provisions of Code section 3121(b)(7)(F) unless he is a "qualified participant" in a "retirement system" within the meaning of the regulations. Section 31.3121(b)(7)-2, Employment Tax Regulations. We assume that the individuals in question were qualified participants in a retirement system.

According to the regulations, a previously retired participant in a state teachers' retirement system who is either "in pay status," i.e., currently receiving retirement benefits, or who has reached normal retirement age is deemed to be a qualified participant in the retirement system without regard to whether he or she continues to

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accrue a benefit or whether the distribution of benefits under the retirement system has been suspended pending cessation of services. Section 31.3121.(b)(7)-2(d)(4)(ii), Employment Tax Regulations.

Since an annuitant rehired by the school district from which he is retired is deemed to be a qualified participant in a retirement system, an employing school district is not required to withhold and pay OASDI tax for this individual. In this case State law requires that the individual cease receiving pension payments and begin paying into the teachers' retirement system when rehired.

OASDI tax would have to be withheld and paid as long as the superintendents were employed by their own corporations. If the relationship is recharacterized and the superintendents are treated as employed by the school districts, then their payment of OASDI tax will be erroneous, and they will be entitled to a refund for open years.

#### B. Medicare Tax

The Medicare tax for a state and local government employee who is not covered under a section 218 agreement is applied separately from the OASDI portion under the terms of Code section 3121(u)(2).

In general, Medicare taxes apply to state and local government employees. Code section 3121(u)(2)(A). Under section 3121(u)(2)(C), services performed by state or local government employees hired on or before March 31, 1986, are exempt from Medicare taxes (if section 3121(b)(7) otherwise applies), provided that the employees (1) were performing regular and substantial services for pay on or before that date, (2) were employed in good faith on that date, (3) were not hired for purposes of avoiding the Medicare taxes, and (4) have not at any time since that date experienced a termination of the employment relationship with the employer. This is referred to as the "continuing employment exception."

If the form of this transaction is recognized, the individuals in question would be subject to the Medicare tax because they terminated their employment relationship with the school districts and were employed by their own corporations. If the relationship is recharacterized and the superintendents are treated as employed by the school districts, we think the best answer is that the outcome would be the same. The individuals actually retired and began to receive pensions. Consequently, if the continuing employment exception ever applied to them, they would no longer be eligible for it because their employment relationship with the school districts was terminated.<sup>12</sup>

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<sup>12</sup>It is also possible to see the situation in another way: if the independent contractor relationship was actually a sham, the retirements were also a sham and, if the teachers' retirement system allows this, the individuals might be treated as never having terminated their employment relationship.

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If you have any questions, please contact Elizabeth Edwards of this office at (202) 622-6040.